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February 1, 2011

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington D.C. 20581

Re: Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy (RIN 3038-AD28)

Dear Mr. Stawick:

The Asset Management Group (the "**AMG**") of the Securities Industry and Financial Markets Association ("**SIFMA**") is writing in response to the Notice of Proposed Rulemaking (the "**Release**"), issued on December 3, 2010 by the Commodity Futures Trading Commission (the "**CFTC**"), regarding the CFTC's proposed rules regarding protection of collateral posted by counterparties to swap dealers and major swap participants ("**SD/MSPs**") with respect to uncleared swaps. 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, state and local government pension funds, universities, ERISA funds, 401(k) and similar types of retirement 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, including transactions for hedging and risk management purposes, that are classified as "swaps" under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**"). A significant part of our clients' swap transactions are bilateral over-the counter ("**OTC**") swaps, and some of these may continue to be uncleared after mandatory clearing under the Commodity Exchange Act ("**CEA**") goes into effect. We appreciate the opportunity to provide the CFTC with our comments and concerns regarding the proposed rule.

Summary

New CEA Section 4s(l), added by Dodd-Frank Section 724(c), guarantees to any counterparty of an SD/MSP (a "**Customer Counterparty**") the right to require that any initial margin it posts in respect of an uncleared swap be held in a segregated account, maintained with an independent third-party custodian for the Customer Counterparty's benefit and invested only in such investments as the CFTC may by rule permit. The AMG believes the right of Customer Counterparties to request segregation is an

important protection under Dodd-Frank and supports the steps that the CFTC is taking to clarify and implement the Dodd-Frank requirements. The availability of segregation will reduce uncertainty surrounding customer collateral in the event of an SD/MSP bankruptcy, reduce exposure to SD/MSP counterparties, prevent the misuse of customer assets and generally serve to mitigate systemic risk. In addition, the proposed segregation rules are largely in line with the existing ability of certain customers to uncleared swaps, such as mutual funds and certain other managed accounts, to enter into tri-party custody arrangements with third-party custodians.

The AMG is concerned, however, that the proposed rules in their current form may be interpreted as a prohibition on alternative segregation arrangements – for example, with a custodian that is not independent of the SD/MSP, or with different instructions regarding the investment of collateral – even if alternative arrangements are preferable and more beneficial to the Customer Counterparty. The AMG does not believe that this interpretation reflects the intent of Dodd-Frank Section 724 or serves the best interests of participants or the system as a whole, as discussed further below. Accordingly, the AMG would recommend that the CFTC clarify that, where a Customer Counterparty exercises its right to segregation, it also has the right to elect the corollary requirements of the proposed rules – such as the unaffiliated custodian requirement and the requirements regarding notice procedures and investment of collateral – but it is not obligated to do so, and may instead elect alternative arrangements that better suit its operational and regulatory needs.

I. SD/MSP counterparties should be permitted the flexibility to elect to have segregated collateral held with any custodian including those that may or may not be affiliated with any SD/MSP.

The CFTC's proposed Regulation 23.602(a) would require that, where a counterparty to an SD/MSP elects segregation of its initial margin, the parties must use a custodian that is independent of both the SD/MSP and the Customer Counterparty. The AMG believes that the CFTC should not limit the choice of custodian solely to those unaffiliated with the relevant SD/MSPs and Customer Counterparties but should provide the flexibility to use a custodian who may also be affiliated with any SD/MSP or Customer Counterparty. Any regulatory prohibitions on the use of a custodian could interfere with custodial relationships that may have already been established by Customer Counterparties.

In many cases, a Customer Counterparty will have well established custodial relationships under which one custodian or a selected few custodians hold all or substantially all of its assets. Regulated investment companies' custody arrangements, in particular, are strictly regulated under Section 17(f) of the Investment Company Act of 1940 ("**40 Act**") and must meet the requirements of the Securities and Exchange Commission's ("**SEC's**") rules and interpretations thereunder. Since a fund's custodian has access to the fund's assets in the custody account, it is generally a seamless process for it to segregate the collateral in its books and records. Given regulatory requirements and the procedural difficulty of moving assets outside of their approved designated custodian, most funds arrange for swap margin to be held through separate sub-accounts within their main account with their primary custodian. This type of arrangement is also most efficient in many cases for Customer Counterparties that are not registered investment companies.

Since there are a limited number of custodians that offer services acceptable to pension plans, mutual funds and similar investors, and these custodians are sometimes part of a large financial institution's business, a Customer Counterparty's custodian may sometimes be an affiliate of the SD/MSP that offers the best terms on a particular swap transaction. If investors were not permitted the flexibility to use the custodian of their choice when entering into a tri-party agreement with a custodian and an SD/MSP, many regulated investors would have to obtain board approval and set up a new custody arrangement just for these uncleared swap transactions with the affiliated SD/MSP. In these situations, there is no apparent justification to restrict the parties' choice of a custodian even if such custodian is an affiliate of the SD/MSP. The AMG believes that, since Customer Counterparties have the right to choose not to segregate, they should also be permitted to agree to enter into swap transactions with affiliates of their custodians if so desired. As OTC participants that will necessarily be "eligible contract participants" under new CEA Section 2(e), Customer Counterparties will, the AMG believes, have the requisite size and sophistication to make their own determinations as to whether use of a particular custodian, affiliated or non-affiliated, best serves their interests.

The Release also asks for comment on whether either party should be entitled to choose the custodian, or whether the choice should be left to the agreement of the parties, as currently proposed. The AMG recognizes that both parties have an interest in the safety and creditworthiness of the custodian and recommends that the parties be able to agree to mutually acceptable criteria which any custodian must meet – such as the custodian being a U.S. bank or branch and having a minimum level of assets under custody. Within those criteria, however, the AMG believes that it is appropriate for the Customer Counterparty, as the party most directly affected operationally by the choice of custodian, to have the right to make the selection. This approach would both protect the statutory right of the Customer Counterparty, if it so chooses, to have its initial margin segregated with a custodian that is independent of the SD/MSP, and would preserve the Customer Counterparty's ability to choose segregation with a custodian that is affiliated with the SD/MSP in cases where it determines such an arrangement is in its best interests.

II. The Regulation 1.25 restrictions on the investment of collateral of futures customers are inappropriate as applied to collateral of uncleared swaps customers, particularly if made mandatory for all customers that choose segregation.

Proposed Regulation 22.603(a) would require that any investment of the collateral of a Customer Counterparty that has elected segregation be restricted to the shortened list of permitted noncash investments under the newly amended Regulation 1.25.[1] The AMG recognizes that new CEA Section 4s(l)(2),[2] although somewhat ambiguously worded, implies that margin that is segregated as of right pursuant to

[1] *See generally*, Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions (Proposed Rulemaking), Federal Register 75: 212 (November 3, 2010).

[2] CEA Section 4s(l)(2) reads in relevant part as follows:

> APPLICABILITY.—The requirements described in paragraph (1) shall—
> (ii) not preclude any commercial arrangement regarding—
> (I) the investment of segregated funds or other property that may only be invested in such investments as the Commission may permit by rule or regulation.

Section 4s(l)(1) can be invested only in such investments as the CFTC may by rule permit. The AMG does not object to the adoption by the CFTC of collateral investment standards required to be *offered* by SD/MSPs to Customer Counterparties that exercise their statutory right to segregation. We believe, however, that Customer Counterparties that elect segregation should have the ability to opt out of CFTC-prescribed investment standards in favor of alternative standards that are mutually acceptable to the parties.

The ability to stipulate specific instructions for collateral investment is an important right to buy-side parties in the current OTC market and should not be relinquished by a Customer Counterparty simply because it elects segregation under the new rules. The mandatory imposition of Regulation 1.25 would prevent certain common collateral practices that OTC swap participants currently depend on as important and expedient means of mitigating risk.[3]

Money market sweeps are an example. In many cases, Customer Counterparties find it most convenient to post their swap collateral in the form of cash; if collateral is maintained in cash form by the custodian, however, it would typically be held as a demand deposit that would be part of the custodian's estate in the event of its insolvency.[4] Accordingly, Customer Counterparties often agree with their SD/MSPs that the custodian will automatically sweep any uninvested funds at the end of each business day into a registered money market mutual fund ("**MMMF**"). MMMFs are well-diversified investment vehicles that can offer higher returns as compared to similar investments and, as securities, are likely to be better protected than cash in the event of a custodian's insolvency. Therefore, in the view of many AMG members, money market sweeps offer a desirable balance of protection, yield and operational convenience. Money market sweep arrangements would generally not be permissible, however, for Customer Counterparties that elect segregation if the requirements of Regulation 1.25 were imposed on a mandatory basis on segregated collateral accounts for uncleared swaps.[5] The AMG believes that this result would be disadvantageous to Customer Counterparties.

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[3] Further, although Regulation 1.25 does not explicitly impose any restrictions on the collateral a customer may post to the custodian, the AMG is concerned that if the Regulation 1.25 investment limitations are applied to uncleared swaps, the types of noncash collateral that SD/MSPs are willing to accept from customers may effectively be limited as certain types of collateral may not be able to be invested in accordance with Regulation 1.25's limitations. The AMG also believes that it is inappropriate for the CFTC, if it should so decide in future rulemaking, to impose any restrictions on the type of collateral that SD/MSPs may accept from uncleared swap customers.

[4] The AMG believes that if cash is held in a deposit account with the custodian, there is a high likelihood that, in a custodian bankruptcy, the Customer Counterparty's claim to the cash investment would be merely that of an unsecured claim against the custodian with priority only over other unsecured creditors and not over other depositor claims.

[5] *See* Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions (Proposed Rulemaking), Federal Register 75: 212, 67648-49 (November 3, 2010) (imposing both a 10% concentration limit on the investment of a customer's collateral in MMMFs and a 2% concentration limit on the investment of a customer's collateral in any single family of MMMFs).

Finally, it is generally inappropriate to apply futures margin limits, designed for an omnibus system where one set of investment standards must be used for all customers, to restrict the types of collateral that parties may agree to use in a bilateral context, where parties have the ability to protect themselves by contract. AMG members are also concerned that, in importing Regulation 1.25 from the futures market, the CFTC would also allow for its corollary practice of rehypothecation. Unlike in the futures market, where futures commission merchants ("**FCMs**") are permitted to rehypothecate customer collateral, in the OTC market rehypothecation is determined by the counterparties and is typically not permitted when collateral is segregated with a third-party custodian. The AMG believes that customers should not lose protection from rehypothecation and that, if Regulation 1.25 is applied on a mandatory basis, the final rules should clarify that rehypothecation of segregated collateral is not permitted without the consent of the Customer Counterparty. The AMG's recommendation, however, is that Regulation 1.25 not be made mandatory for segregated uncleared swap collateral, and that Customer Counterparties have the ability to waive the Regulation 1.25 requirements or agree to other investment parameters, just as they are able to opt out of segregation entirely.

III. The AMG believes that the "temporally-based" CFTC distinction between "initial margin" and "variation margin" should be clarified by using the commonly understood ISDA definitions and that the CFTC should exercise its authority to extend all segregation rights, mandated for initial margin under Dodd-Frank, to variation margin.

The CFTC has never previously defined initial margin (for which Dodd-Frank mandates the right to segregate) or variation margin (for which Dodd Frank neither mandates nor denies such right). Proposed Regulation 23.600 would define initial margin as an amount calculated based on *anticipated exposure to future changes* in the value of a swap, and it would define variation margin as a *payment* made by a party to a swap to cover the current exposure arising from changes in the market value of the position. The Release states that the Commission may consider, in future rulemaking, placing an expanded version of these definitions in Part 1, and incorporating those definitions by reference here.

The AMG believes that the proposed Regulation may create confusion by introducing terms that are similar, but not necessarily identical in meaning, to the terms commonly used in OTC swaps markets.[6] It appears that the CFTC's definition of "initial margin" is intended to correspond to the concept of "independent amount," as defined and specified in the ISDA Credit Support Annex. Because the ISDA term is widely understood in OTC markets, the AMG recommends that "independent amount," defined by reference to the ISDA documentation, be substituted for the "initial margin" definition in proposed Regulation 23.600, or that the "initial margin" definition be revised to track and reference the ISDA Independent Amount definition. We would also recommend that "variation margin" be defined in a manner that corresponds more accurately to the manner in which OTC margin is determined and posted. For example, where market

[6] For example, "initial margin," defined as being based on "anticipated exposure to future changes," could conceivably be interpreted to include what is commonly understood as variation or mark-to-market margin, which is posted to cover fluctuations in the collateral's market value. *See* ISDA Guidelines for Collateral Practitioners, http://www.isda.org/press/pdf/colguide.pdf.

practice and documentation calls for the pledging or posting of variation margin, the proposed Regulation 23.600 definition refers to variation margin as a "payment" made to cover current exposure, suggesting (incorrectly) that title to margin transfers to the counterparty.

In addition, several members of the AMG believe that the Commission should use its ample independent authority to promulgate rules that confirm the right of Customer Counterparties to require segregation of both initial margin and variation margin. The current practice of a number of investors in OTC swap transactions is to require that all of their collateral – both independent and variation margin – be segregated under a tri-party agreement and held by a third-party custodian. The Release discusses the numerous benefits of the proposed segregation rules, including preserving the assets of the Customer Counterparty in the event of an SD/MSP insolvency, reducing the risk of loss in such an insolvency and preventing intentional or inadvertent misuse of Customer Counterparty assets.[7] Several AMG members believe that segregation rights for independent margin alone do not fully advance the goals of the rulemaking since Customer Counterparties would still face significant SD/MSP counterparty exposure through mark-to-market margin not segregated by SD/MSPs. This exposure could be greater than that which Customer Counterparties would have faced for non-segregated independent margin, especially during volatile periods. These members are concerned that the proposed rules could be read to preclude variation margin segregation as a matter of law. Thus, we would request that, in order to further the principles of Dodd-Frank and reduce systemic risk in general, the final rule explicitly grant Customer Counterparties the right to achieve the segregation of both initial and variation margin.

IV. AMG members believe it is inappropriate to require the signature of a party "under penalty of perjury" when the party requests the turnover of control of initial margin pursuant to the agreement between the parties.

The CFTC cites a Committee Interpretation[8] that found that the risk of unwarranted requests for releases of customer funds, without the required knowledge or approval of FCMs, is a real threat. Parties to third-party custody arrangements have not, however, found the need to require statements under penalty of perjury in their agreements with customers. The AMG believes that it has never been market practice to impose personal liability on signatories and that it is not generally appropriate to do so where a signatory's assertion of entitlement to margin may, if later found to be erroneous, be a good faith error of legal or contractual interpretation and not a deliberate misstatement of fact.

V. The AMG has other concerns, including: (i) the burdensome requirement to provide notice of the right to segregate to high-ranking executives; (ii) the inability of counterparties to waive annual notification requirements; (iii) the application of segregation requirements only to swaps entered into after a Customer Counterparty exercises its discretion to change its election to require segregation; (iv) the lack of a requirement for SD/MSPs to justify higher costs if a Customer Counterparty elects

[7] *See* Release at 75437.

[8] *See* Release at 75434 note 13.

segregation; and (v) the lack of a best efforts requirement for parties to effectuate a tri-party arrangement in a timely fashion after the Customer Counterparty elects for segregation.

Under proposed Regulation 23.601, an SD/MSP must notify each uncleared swap counterparty *at the beginning of each swap transaction* of the right to segregate such counterparty's initial margin and, *prior to confirming* the terms of such swap, must obtain from the prescribed representative of the counterparty[9] confirmation of receipt of the notice and notification as to whether the counterparty will elect segregation. The AMG recommends that the rule permit any authorized representative of the Customer Counterparty identified in the ISDA confirmation to provide such election and confirmation of receipt, rather than the CRO, CEO or highest-level decision maker; alternatively, the AMG recommends allowing the CRO, CEO or highest-level decision maker to delegate this responsibility to any other individual representative of the Customer Counterparty.

Proposed Regulation 23.601(e) would require that this notice be given to any individual counterparty of an SD/MSP once a calendar year. The AMG believes that a SD/MSP should only be required to notify a Customer Counterparty once. The AMG is concerned that the proposed obligation to obtain additional confirmations each calendar year thereafter will cause significant operational difficulties and may potentially result in the suspension of trading if the required communications, and corresponding paperwork, are not exchanged between the SD/MSP and counterparties within the prescribed time frames. In addition, under proposed Regulation 23.601(e) customers will be forced to implement and maintain systems to keep track of when each SD/MSP sends its annual notification and ensure that no trades are confirmed with the SD/MSP until the CRO, CEO or highest-level decision maker affirmatively responds. The AMG believes that the regulations should allow the parties to waive this costly and burdensome annual process at the inception of the ISDA relationship. Annual notification is not necessary to protect "periodic reconsideration" of the decision not to elect for segregation since the customer maintains discretion under proposed Regulation 23.601(f) to change its election at any time.

The AMG also would argue that the exercise of Customer Counterparty discretion under proposed Regulation 23.601(f) to require segregation should apply not only *prospectively* to new swap transactions entered into after this decision, but also *to all* existing uncleared swaps between the Customer Counterparty and the SD/MSP if the Customer Counterparty so chooses. This would enable a Customer Counterparty to elect to have *all* of its collateral for a particular SD/MSP segregated in the same manner and with one custodian. Without having the segregation election apply across all transactions, certain Customer Counterparties may face significant operational difficulty, and

[9] Proposed Regulation 23.601(c) would require that notice of the right to segregate be provided to the counterparty's Chief Risk Officer ("**CRO**"), chief executive officer ("**CEO**") (in the absence of a CRO) or highest-level decision maker (in the absence of a CEO and a CRO). Proposed Regulation 23.601(d), by reference to 23.601(c), would also require that the SD/MSP receive confirmation of the receipt of this notice and the decision to elect or decline to elect for segregation from these same representatives.

confusion, in delivering and tracking collateral for swap transactions with a single SD/MSP.

We would also request that proposed CEA Regulation 23.602 be amended to require a good faith standard for parties to exercise their commercially reasonable efforts to execute a tri-party custody agreement as soon as reasonably practicable once a Customer Counterparty has elected to segregate its collateral. This will help ensure that a Customer Counterparty's right to elect segregation is not unduly withheld or delayed.

Finally, the AMG believes that the CFTC should require that, if an SD/MSP imposes higher costs or offers less attractive terms to counterparties electing segregation, the SD/MSP should clearly disclose any additional costs and provide quotes for transactions under each alternative.

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The AMG thanks the CFTC for the opportunity to comment on the proposed rulemaking for the protection of collateral of counterparties to uncleared swaps and treatment of securities in a portfolio margining account in a commodity broker bankruptcy under Title VII. The AMG's members would appreciate the opportunity to further comment on these topics, as well as other rulemakings the CFTC will undertake under Title VII of the Dodd-Frank Act. If you have any questions, please do not hesitate to call the undersigned at 212-313-1389.

Respectfully submitted,

Timothy W. Cameron, Esq.
Managing Director, Asset Management Group
Securities Industry and Financial Markets Association

cc: Chairman Gary Gensler, CFTC
Commissioner Bart Chilton, CFTC
Commissioner Michael Dunn, CFTC
Commissioner Scott D. O'Malia, CFTC
Commissioner Jill E. Sommers, CFTC
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