asset management group

November 7, 2016

Via Email

Office of the Comptroller of the Currency

Board of Governors of the Federal Reserve System

Federal Deposit Insurance Corporation

Farm Credit Administration

Federal Housing Finance Agency

Commodity Futures Trading Commission

Re: Uncleared Swap Margin Requirements – Minimum Transfer Amount for Separately Managed Accounts

Dear Sirs and Madams:

The Securities Industry and Financial Markets Association's Asset Management Group ("SIFMA AMG" or "AMG") writes to request relief relating to the minimum transfer amount ("MTA") set by the uncleared swap margin rules promulgated by the Department of the Treasury's Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Farm Credit Administration, Federal Housing Finance Agency and Commodity Futures Trading Commission (collectively, the "Prudential Regulators and CFTC").[1]

SIFMA AMG's members represent U.S. and multinational 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.

For the reasons explained below, AMG believes that separately managed accounts (as defined below) should be provided an account-level MTA of $100,000 or $50,000 to reduce de

[1] 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).

minimis transfers of collateral that will burden the financial system, clients, dealers and custodians without any corresponding furtherance of the goals intended by the uncleared swap margin rules. The absence of relief will mean that pension plans, endowments and other institutional clients and the financial institutions that face them will incur higher costs to use uncleared derivatives than was intended under the rules and without any added benefit to the rules' regulatory aims.

"Separately Managed Accounts"

Large institutional clients, like pension plans and endowments, often hire multiple asset managers in addition to managing funds internally. This approach achieves diversity of investment perspectives and asset allocations for the invested assets, gaining expert investment advice with a goal of maximizing returns while minimizing the risk that any one strategy causes a major loss. The institutional clients will typically hire the asset manager to exercise investment discretion over a portion of the client's assets referred to as assets under management ("AUM") for management in accounts referred to as "separately managed accounts."

The separately managed account relationship between the client and each asset manager is established by an investment management agreement ("IMA"). The IMA, among other things, sets forth the account parameters and the scope of the asset manager's authority, which will be limited to the specified AUM. Through the IMA, the asset manager is given authority to open accounts at financial institutions and establish trading relationships for derivatives, if derivatives are utilized as part of the overall investment strategy.

A dealer counterparty will likely face the same separately managed account client through multiple separately managed accounts of multiple asset managers. For uncleared derivatives trades executed by asset managers for separately managed accounts, the asset manager will typically execute derivatives transactions as an agent for the separately managed account on behalf of the client and often will limit any liability under the documentation to that account's AUM. While it is difficult to generalize about the average number of separately managed accounts established by each client or client type that trades uncleared derivatives, we estimate that large pension funds, endowments or other institutional investors may have dozens of asset managers with these accounts.

Each separately managed account that trades uncleared derivatives will typically have its own payment netting set corresponding to each ISDA master agreement and credit support annex ("CSA") used by the relevant asset manager.[2] As a result, collateral movements for initial or variation margin are not netted across the client's separately managed accounts, including separately

[2] For example, JPMorgan Chase Bank, N.A. may face a separately managed account of XYZ pension fund as principal on an ISDA negotiated and signed on behalf of the pension fund by Asset Manager 1 (managing 1% of the assets of the pension), while facing multiple other separately managed accounts of XYZ pension fund on numerous other ISDAs that were negotiated and signed by the pension fund's other asset managers. Alternatively, XYZ pension fund may negotiate its own ISDA with JPMorgan. Each asset manager will establish a CSA to manage each payment netting set separately. As such, each ISDA or CSA will have its own payment netting set, with eligible collateral, collateral haircuts and other features negotiated by the relevant asset manager, with such asset manager responsible for collateral movements.

managed accounts with different investment strategies handled by the same asset manager. Although the client could post less collateral by netting across all accounts, separation is needed to allow asset managers to execute effectively on the investment strategy and to track the profits and losses for each strategy (in turn allowing the institutional client the ability to measure the effectiveness of each strategy and asset manager).

Problems with separately managed accounts utilizing client-level MTA

MTA calculated at the client level defeats the purpose of MTA in the case of separately managed accounts. The purpose of MTA under an eligible master netting agreement was and is to allow parties to reduce the operational burden of exchanging sums of collateral when exposures move only slightly or are of a de minimis amount.[3] MTA temporarily excludes from the uncleared swap margin requirements insignificant interim exposures that do not justify the burden of mandating collateral transfers between counterparties until the exposure exceeds $500,000, after which the full amount must be exchanged. In this way, MTA operates as a buffer to avoid unnecessary costs for de minimis transfers below $500,000 (*i.e.*, the $35 charge per wire transfer or the costs of hiring staff to handle significant increases in collateral transfer volumes). MTA also reduces disputes over immaterial valuation differences between parties by not requiring transfers below the MTA. Variation margin, which will be of greatest relevance to separately managed account clients,[4] will have valuations that vary due to the absence of a standard, shared model. As a result, counterparties will each utilize their own valuation assumptions that invariably will not result in identical results.

We understand that U.S. regulators interpret MTA as applying at the client level (*i.e.*, the legal entity) rather than at the eligible master netting agreement level. However, practical challenges arise with this interpretation. Separately managed accounts are independently managed by the relevant asset managers who do not have knowledge of each other's exposures. Because the assets for each separately managed account managed by a particular asset manager are held, transferred and returned separately at the account level, asset managers cannot collectively calculate MTA across the accounts and cannot move collateral in aggregate across the accounts. Rather, each account must calculate and post or collect collateral separately as per its applicable eligible master agreement.

Potential solutions to this problem—short of setting the MTA for each separately managed account to zero—are not workable. Third party offerings to calculate collateral requirements across

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[3] Specifically, the uncleared swap margin requirements provide an MTA for the collection and posting of margin, such that a counterparty is not required to collect or post margin from or to any individual counterparty unless and until the combined amount of initial and variation margin that must be collected or posted is greater than US$500,000. MTA was described in the Prudential Regulators' rule as having been included to "alleviate the operational burdens associated with making de minimis margin transfers" 80 Fed. Reg. at 74869.

[4] While we expect that many if not most separately managed account clients will be subject to variation margin requirements under the uncleared swap margin requirements, we also expect that few will exceed the aggregate average notional amount thresholds that trigger initial margin requirements.

the separately managed accounts' eligible master netting agreements not only add expense but are extremely hard to manage given the compressed timelines for movement of collateral under the new rules, among other problems. Also, even though *calculations* can be consolidated, collateral *transfers* cannot be similarly consolidated so clients will still end up having to move small amounts of collateral. Likewise, swap dealers cannot dynamically calculate and manage MTA across the client's separate eligible master netting agreements for several reasons, including timing, additional regulatory risk and confidentiality. Even if dealers could take on this responsibly, asset managers would still have to transfer funds due for each account separately. Further, splitting the MTA (*e.g.*, giving $50,000 "shares" of MTA to ten separately managed accounts) creates regulatory risk in ensuring that such a split is not being applied to more accounts than would be permitted by the $500,000 MTA limit. In addition, given that clients may have dozens of relationships, this solution would only meaningfully cover a subset that have a maximum of ten accounts.

If separately managed accounts are left with no choice but to set MTA to zero at the account level, this consequence negatively impacts clients, imposing burdens not necessary to achieve the uncleared swap margin requirements' objectives. Based upon a review of some asset managers' current and anticipated collateral movements, a shift from an MTA of $500,000 to an MTA of zero is estimated to increase daily collateral movements by many multiples, with the need to hire staff and to pay wire transfer costs. While the volume would still increase with an MTA adjustment to $100,000 or $50,000, the increase would be better than having an MTA of zero and would definitionally exclude, for example, $2,000 or $3,000 wire transfers. While we can only estimate the increases in volume through anecdotal information[5] provided by AMG members and some dealers, we believe that the daily collateral movements for separately managed accounts will increase the following:

- <u>MTA of $500,000</u>: daily collateral movement volumes of 100% (baseline)[6]
- <u>MTA of $250,000</u>: daily collateral movement volumes of 150% to 200%;
- <u>MTA of $100,000</u>: daily collateral movement volumes of 200% to 300%;
- <u>MTA of $50,000</u>: daily collateral movement volumes of 200% to 500%;
- <u>MTA of $10,000</u>: daily collateral movement volumes of 300% to 600%;
- <u>MTA of $0</u>, daily collateral movement volumes 350% to 700% (with some expecting even higher percentage increases).

The operational complexities around smaller collateral movements could cause additional problems. Small transfers of non-cash collateral could result in fails (and related charges) in other transactions. Smaller wire transfers receive a lower priority in the queue, and tend to fail more

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[5] Some estimates were based on currently margined swaps and others were based on projections of collateral movements for swaps that will be margined.

[6] We have used $500,000 as the baseline by which to compare other collateral movement levels given that this level has been adopted by the Prudential Regulators and CFTC. Currently, levels of MTA vary and operate with transfer timing that generally is not the T + 1 standard.

frequently, requiring resubmissions. More disputes will arise between counterparties in the absence of a buffer to absorb small differences in valuation calculations, requiring additional resources to address those disputes.

These consequences will impact clients' ability to use derivatives effectively and will increase client costs. Large pensions, endowments and other institutional investors with multiple managers hired to meet investment policy diversity requirements (and the financial institutions that face them) each are essentially disadvantaged by having to set their account-level MTA to zero compared to other participants in the derivatives market. At the same time, the burdens of a low or zero MTA will hurt separate account clients with smaller derivatives exposures more because smaller exposures logically will be more frequently associated with smaller transfers. Changes in market value, for example, result in a lower dollar value change on a smaller derivatives exposure than a similar calculation performed on a larger position. Further, increases in the costs and complexity may result in the client being paired with a fewer number of dealer counterparties, which will impact credit exposures and best execution for those clients.

These negative consequences also impact the financial system, dealers and custodians, burdening the uncleared swap margin infrastructure across market participants. Dealers, who will have reciprocal MTA requirements under the trading documentation, will also have to manage greater volumes of collateral movements and higher costs for transfers. In addition, custodians will have a significant increase in reconciliation work as they track payments and transfers from the various client accounts and, with smaller transfers of greater volumes, may experience higher rates of errors.

Absence of Evasion Risks

While AMG understands the regulatory concerns regarding evasion, we do not believe evasion risks are present for applying an MTA at the account level, particularly if the account-level relief is at the lower MTA of $100,000 or, alternatively, $50,000. Asset managers do not know the positions of other asset managers trading for the same client and do not act in coordination. In addition, although MTA obviates the need to transfer on a day that the calculation results are below the MTA level, once the calculation exceeds the MTA by even an immaterial amount, the entire amount must be posted.

In order for a market participant to somehow reduce or avoid margin requirements through use of MTA (or, alternatively, to attempt to use the MTA as an uncollateralized "credit line"), the market participant would need to: (a) split netting sets into very small groupings of transactions, at times even having to agree to multiple, smaller transactions to fit below the MTA with sufficient room to be unlikely to cross the MTA, incurring the costs of account set ups and maintenance of those separate payment netting sets; and (b) with the inability to know in advance which positions would be out-of-the-money or in-the-money, accept counterparty risk by having its counterparty not post margin. Further, such activity would require dealers and asset managers to engage in practices that would be unacceptable for registered intermediaries or advisers.

Proposed Relief

AMG proposes that relief is provided for separately managed accounts such that each eligible master netting agreement will be given an independent MTA of $100,000 or, alternatively, $50,000 without an entity-level limit. The client would only be able to use this relief as an alternative to and not in addition to the standard MTA of $500,000.

Specifically, we would propose that the relief would use the term "Separate Account Counterparty," which would be defined to mean:

> "with respect to any non-cleared swap or non-cleared security-based swap to which a person with multiple, independently managed accounts, each subject to a separate eligible master netting agreement, is a party, such person."

We would further propose that the operative section of the relief would include the following:

> Notwithstanding the Minimum Transfer Amount set forth in [section], a covered swap entity is not required to collect or post margin pursuant to this [part] with respect to an eligible master netting agreement of a Separate Account Counterparty unless and until the combined amount of initial margin and variation margin that is required pursuant to this [part] to be collected or posted and that has not been collected or posted with respect to such account under such relevant eligible master netting agreement is greater than $100,000 (the "Separate Account Minimum Transfer Amount").
>
> Separate Account Minimum Transfer Amounts are to be treated separately; the Minimum Transfer Amount for any account of a Separate Account Counterparty under an eligible master netting agreement shall not impact the Minimum Transfer Amount of another account of such Separate Account Counterparty under a separate eligible master netting agreement and exceeding the Minimum Transfer Amount with respect to such eligible master netting agreement shall not cause any party to another eligible master netting agreement involving another account of the same Separate Account Counterparty to be required to collect or post margin thereunder.
>
> Separate Account Minimum Transfer Amounts shall be used in lieu of and not in addition to the Minimum Transfer Amount set forth in [section]. A covered swap entity that uses the Separate Account Minimum Transfer Amount for a Separate Account Counterparty may not use the Minimum Transfer Amount set forth in [section] for any account of the Separate Account Counterparty.

If $100,000 would not be acceptable, AMG would alternatively propose this same relief at a level of $50,000.

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Should you have any questions, please do not hesitate to contact Tim Cameron (+1 202-962-7447 / tcameron@sifma.org) or Laura Martin (+1 212-313-1176 / lmartin@sifma.org).

Respectfully submitted,

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