March 15, 2013

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland
Sent by email to: baselcommittee@bis.org

Secretariat of the International Organization of Securities Commissions
C/ Oquendo 12
28006 Madrid
Spain
Sent by email to: wgmr@iosco.org

Re: Second Consultative Document: Margin Requirements for Non-Centrally-Cleared Derivatives (February 2013)

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association ("**SIFMA**")[1] appreciates the opportunity to comment on the captioned second consultative document (the "**Second Consultation**") issued by the Working Group on Margining Requirements (the "**WGMR**") of the Basel Committee on Banking Supervision ("**BCBS**") and the International Organization of Securities Commissions ("**IOSCO**"). The Second Consultation follows the original consultative document on margin requirements for non-centrally-cleared derivatives released in July 2012 (the "**Original Consultation**" and, together with the Second Consultation, the "**Consultations**"). SIFMA commented on the Original Consultation in a letter dated September 28, 2012 (the "**September Comment Letter**"). SIFMA welcomes the continued attention of the BCBS and IOSCO to international harmonization of margin requirements for non-centrally-cleared derivatives.

---

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

I. GENERAL DISCUSSION

A. Initial Margin

In each of the Consultations, the WGMR has proposed that financial counterparties to non-centrally-cleared derivatives be required to exchange initial and variation margin. In our September Comment Letter, we expressed strong support for the phase-in of robust two-way variation margin requirements, but emphasized our significant concerns regarding the proposed imposition of two-way initial margin requirements for all financial counterparties.

In particular, we explained that the estimated net reduction in liquidity resulting from the proposed mandatory exchange of initial margin, on a gross basis and subject to restrictions on re-hypothecation or re-use, would be very substantial and could lead to a shortage of high-quality collateral. The net reduction in liquidity would be especially severe in the case where substantial numbers of firms were required to rely on standardized schedules to determine their initial margin requirements. Conversely, in cases where firms used risk-sensitive, dynamically adjusted models, initial margin requirements would increase significantly in periods of severe market stress, driving procyclical conduct. Thus, initial margin requirements would result in either a near-term reduction in liquidity that is likely to restrain economic recovery or procyclical and potentially destabilizing effects in future periods of severe market stress.

In our September Comment Letter, we also respectfully disagreed with the premise that two-way initial margin requirements will necessarily mitigate systemic risk. We observed that, because two-way initial margin requirements will result in each party to a non-centrally-cleared derivative incurring credit risk to the other party for the return of initial margin, the risk mitigation benefits of requiring each party to collect initial margin are, at best, ambiguous. Moreover, requiring prudentially supervised intermediaries to post initial margin when trading with unregulated counterparties is inconsistent with the capital regimes applicable to such intermediaries and runs contrary to longstanding, sound prudential practices.[2] Further, we questioned as inappropriate and unnecessary WGMR's stated objective that initial margin requirements should be set at levels that are designed to disincentivize the execution of non-centrally-cleared derivatives so as to promote central clearing.[3]

---

[2] To reduce credit exposure to their counterparties, market participants will in many cases arrange to have their posted collateral held at third-party custodians. However, as discussed in the September Comment Letter, the size and scope of the proposed initial margin requirements could raise concerns with this practice due to the very small number of non-affiliated global custodians in the world.

[3] Mandatory two-way initial margin requirements are not necessary to promote central clearing. The market participants who will be subject to such requirements are the same as those who will be subject to mandatory clearing requirements. Going beyond mandatory clearing requirements by imposing arbitrarily high margin requirements for the purpose of creating disincentives to the use of derivatives that cannot effectively be cleared will require parties to incur basis risk when hedging bespoke risk exposures and encourage the central clearing of

The Second Consultation's proposed margin framework for non-centrally-cleared derivatives is largely similar to the one proposed by the WGMR in the Original Consultation. The most significant modifications to the Original Consultation include two constructive changes: the introduction of a €50 million initial margin threshold and a schedule for phased implementation. We understand that the WGMR introduced these modifications in order to mitigate the adverse liquidity impacts that the WGMR itself recognized and that numerous commenters had noted in response to the Original Consultation.

In our view, however, the WGMR should also consider other measures to mitigate the adverse liquidity impact of initial margin requirements. As we discuss in further detail below, such measures might include a higher initial margin threshold, a shorter liquidation horizon or a lower confidence interval. Greater flexibility to re-hypothecate or re-use initial margin should also be permitted. Particularly if a relatively broad range of market participants find it necessary to use standardized schedules to determine initial margin requirements, which we consider likely, these additional measures will be necessary to prevent a two-way initial margin framework from causing significant economic dislocations, particularly in the near-term.

If the WGMR adopts a two-way initial margin requirement, we urge the WGMR to do so in a manner that would accommodate the evolution and adoption, at the EU and/or national level, of innovative bilateral or multilateral margining arrangements that might, through appropriate netting, better mitigate the adverse liquidity, procyclicality and/or capital impacts associated with two-way initial margin requirements, while effectively mitigating systemic risk. Doing so would be consistent with the flexible approach that the WGMR has proposed in permitting firms to use models in lieu of a standard schedule of margin requirements.

In particular, industry participants are actively working to develop bilateral and multilateral margining arrangements that would permit recognition and netting of offsetting risks (such as under arrangements in which collateral is available to satisfy multiple counterparties). These arrangements would provide significant economic efficiencies while preserving essential protections. At a minimum, the WGMR should not preclude such developments or make the adoption of such an arrangement logistically insurmountable as a practical matter due to the perceived international harmonization concerns that would be presented by adopting a novel regime that would appear to be precluded by the BCBS-IOSCO final framework – even where it is consistent with the objectives of the framework. We believe it would be beneficial if the WGMR, or a similar body, continued engagement with the industry in pursuing such solutions.

In this respect, we believe that undue emphasis has been placed by the WGMR on replicating for non-centrally-cleared derivatives the margin framework that applies to centrally-cleared derivatives, and too little emphasis has been placed on what is appropriate to achieve the core objectives of the framework: mitigation of contagion risk and avoidance of procyclical conduct during periods of severe stress. These goals require the prevention of the accumulation

derivatives that lack sufficient standardization, price transparency or liquidity to be risk-managed effectively by central counterparties.

of significant undermargined credit exposures that could be destabilizing and prevent the orderly unwind of positions. Far lower levels of initial margin than those proposed in the Second Consultation would still mitigate the risk of contagion and procyclical disorderly liquidation behavior, while meeting the objectives of the WGMR. Additionally, in contrast to the period preceding the recent financial crisis, bilateral counterparties are now subject to enhanced capital, portfolio compression, credit concentration and other requirements and incentives to reduce the size, complexity and concentration of their bilateral portfolios.

Achieving the policy objectives of the bilateral margin framework does not require that individual credit losses be limited to €50 million. Nor does it require mitigation of non-systemic credit losses in a manner that imposes a drag on the economy and that makes non-centrally-cleared derivatives uneconomic and undesirable under normal market conditions, while simultaneously retaining the very procyclical and potentially destabilizing forces that the margin rules were intended to remediate in periods of severe market stress.

B. <u>The Quantitative Impact Study</u>

The Second Consultation appears to be informed by the results of the quantitative impact study ("**QIS**") conducted by the WGMR to assess the potential liquidity and other quantitative impacts associated with proposed mandatory two-way exchange of initial margin among all financial counterparties. We applaud the WGMR for recognizing the importance of grounding any margin framework on suitable empirical data and a rigorous analysis of implicit costs, liquidity impacts and related considerations. We are concerned, however, that the QIS falls short of these standards in a number of key respects:

- Ambiguity or inconsistency in the QIS instructions has, we believe, resulted in grossly understated estimates of the initial margin that would be required to be posted in a period of severe market stress.

- Similar concerns are raised by the methodology used in the QIS to establish an appropriate cap on the level of initial margin thresholds, as well as the proposed application of such thresholds on a consolidated basis.

- Aside from thresholds, the QIS did not seek data regarding other means for mitigating the adverse liquidity impact of initial margin requirements.

- The QIS estimates are further understated as a result of unrealistic projections concerning the extent to which market participants will be eligible to use approved models to compute more risk-sensitive and, as a result, generally lower margin requirements than the requirements specified in the proposed standardized schedule.

- Finally, the QIS estimates of the available supply of high-quality unencumbered collateral are not, in our view, realistic.

In our comments below, we describe these issues in further detail and recommend that the WGMR conduct a supplemental QIS and update its proposals to address the conclusions from that revised QIS.

C. Proposed Phase-In

In addition to the foregoing, we note that the Second Consultation would phase in initial margin requirements based on whether the gross notional trading activity of each of the parties to a derivative exceeded a specified threshold over the last three months of the preceding year. We believe the proposed phase-in framework would increase systemic risk and create poor incentives for market participants by fragmenting liquidity and reducing hedging opportunities. It also would do little to defray liquidity costs because it would frontload those costs into the first year of the schedule, at a time when the global economy may well still be fragile. Moreover, it would introduce new operational and transition costs because market participants would not know the parties with whom they must establish compliant documentation and operational processes until the point at which the requirements would take effect. Furthermore, because the proposed thresholds are based on gross notional trading activity, they would not be risk-sensitive. We suggest that the WGMR address these concerns by supplementing the proposed phase-in by market participant significance with gradually decreasing initial margin thresholds.

D. Re-Hypothecation and Foreign Exchange Transactions

The Second Consultation also requests comment regarding the circumstances under which re-hypothecation of initial margin should be permitted and the treatment of physically-settled foreign exchange ("**FX**") swaps and forwards. We also address these requests for comment below.

E. Cross-Margining and Netting

We also note that the Second Consultation would allow quantitative initial margin models to account for risk on a portfolio basis, but only taking into account derivatives approved for model use that are subject to a "single, legally enforceable netting agreement."[4] We continue to support the view expressed in our September Comment Letter that this proposal is unduly restrictive because it would appear to prohibit the use of many common cross-margining arrangements that are legally enforceable. Such arrangements ensure that the level of initial margin associated with a portfolio of correlated positions in different types of instruments reflects the overall risk of that portfolio.

---

[4] Second Consultation at p. 11-12. We also urge the WGMR to provide greater clarity on the scope of legal enforceability necessary for reliance on such netting agreements, including any necessary legal opinions. This is particularly critical given the many jurisdictions in which margin requirements will apply, which in some cases may require changes in their legal regimes to accommodate those requirements.

We recognize that questions have been raised regarding the mechanics of cross-margining in certain contexts, such as the interaction of cross-margining arrangements with segregation/customer protection regimes and deposit insurance schemes. We note, however, that frequently used structures have been developed to address these considerations.[5] In particular, market participants have developed subordination arrangements for the cross-margining of correlated centrally-cleared and non-centrally-cleared derivatives.

By way of example, assume that a customer has a portfolio composed of cleared swaps with a standalone initial margin requirement of $10 million and uncleared swaptions with a standalone initial margin requirement of $8 million, resulting in a total initial margin requirement of $18 million. Taking into account the risk offsets in the portfolio as a whole, the initial margin requirement on the combined swap/swaption portfolio should be $15 million. Under the cross-margining arrangements that are widely used by market participants, the customer would post (and the central counterparty would still have a first priority lien over) the full $10 million required to meet the standalone initial margin requirement for the cleared swaps, but the customer would only post an additional $5 million (as opposed to $8 million) to its uncleared swaption counterparty, with the counterparty taking a second lien over the $10 million posted for the cleared swaps. Other arrangements have been developed to facilitate the cross-margining of derivatives and correlated cash positions, listed options, repo and/or securities lending positions.

We reiterate the view we expressed in the September Comment Letter that the WGMR should clarify that initial margin models may take into consideration offsets between all appropriately correlated instruments subject to legally enforceable cross-margining or netting arrangements, supervisory approval of the model's assumptions and consistency with other regulatory requirements.

F. Inter-affiliate, SPV and Cross-Border Transactions

Finally, we continue to support the development of consistent global standards with regard to the application of margin requirements to transactions with affiliates, securitization and structured finance special purpose vehicles and in the cross-border context. We continue to support the views we expressed in our September Comment Letter on these topics. SIFMA also agrees with the position and supporting arguments presented by the Global Financial Markets Association ("**GFMA**") in its letter to the BCBS and IOSCO Secretariats dated March 15, 2013 that securitization vehicles should not qualify as "covered entities" for purposes of the Second Consultation.

---

[5] In the event that the WGMR has any questions or concerns regarding such structures, our members would be happy to discuss them at the WGMR's convenience.

II. RESPONSES TO SPECIFIC QUESTIONS

We have set forth below SIFMA's more detailed responses to the four specific questions raised in the Second Consultation.

A. The Quantitative Impact Study

Based on the QIS, the Second Consultation observes that the initial margin that would result from applying the near-final proposal, including the proposed €50 million threshold, to the derivatives portfolios that are expected to remain uncleared would be roughly €0.7 trillion.[6] This estimate is predicated on the assumption that all financial counterparties required to exchange initial margin would use models to calculate margin requirements. The QIS results indicate that use of a standardized schedule to compute initial margin requirements could result in 6 to 11 times more collateral than a model-based computation.[7] The QIS results also indicate that the €0.7 trillion required for models-based initial margin would comprise 8% of available assets eligible under the near-final proposal, while use of the standardized margin schedule would increase this percentage to 86% of available assets.[8]

Based on our members' experience as respondents in the QIS, we believe that these estimates are not accurate. Our inquiries have indicated that respondents found the instructions for the QIS ambiguous, and therefore open to misinterpretation and inconsistent interpretation by respondents. The instructions were also based on questionable assumptions about market dynamics. We describe these concerns in the following five key areas: (1) the effect of market stress on the amount of initial margin required; (2) the effect of the proposed €50 million threshold on the amount of initial margin required; (3) the effect of other means of reducing liquidity impacts of initial margin requirements; (4) the extent to which initial margin models can be expected to be utilized; and (5) the extent to which initial margin requirements are likely to consume available, high-quality, unencumbered assets.

1. The QIS Did Not Account for Increases in Initial Margin During a Period of Severe Market Stress

The Second Consultation explains that "margin levels should be sufficiently conservative to avoid procyclicality, even during periods of low market volatility," and that the "requirement that initial margin be set consistent with a period of stress is meant to limit procyclical changes in the amount of initial margin required."[9] Having therefore adopted a requirement intended to address procyclicality, the Second Consultation does not further address

---

6 Second Consultation at p. 26.

7 *Id.*

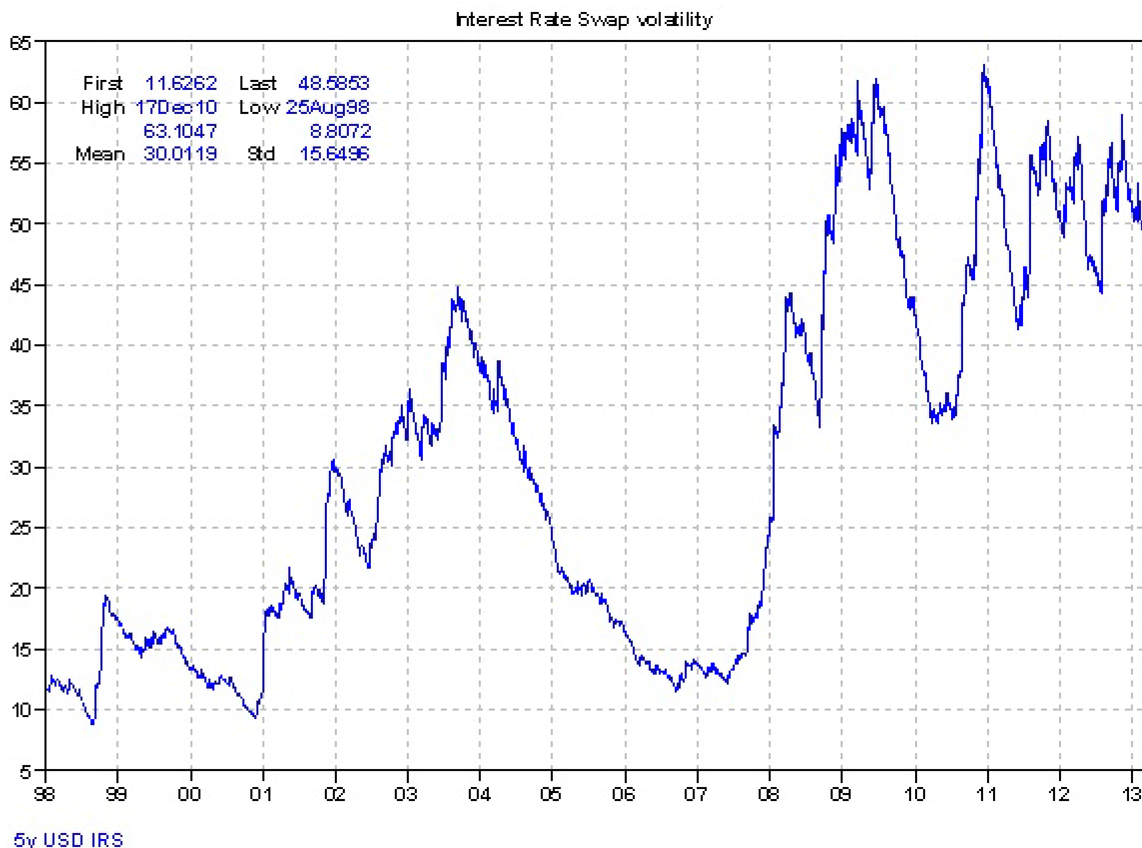
8 *Id.* at p. 27.

9 *Id.* at p. 13.

the topic. Nor did the instructions to the QIS direct respondents to estimate the difference in initial margin amounts during periods of normal and high market volatility, or to specify their assumptions regarding the level of market stress modeled.

There are two serious flaws with the approach. The first is a methodological flaw. Because the QIS's instructions did not provide clear guidance to respondents regarding whether, and how, to estimate initial margin amounts consistent with a period of stress, firms took inconsistent approaches. In many cases, respondents simply used their current modeling approach, without adjusting the lookback period, the weighting of historical data or other model parameters to enable them to estimate the initial margin amount during a period of severe market stress. As a result, we believe that the €0.7 trillion estimate for required initial margin derived from the QIS significantly underestimates the amount of initial margin that will actually be required and the potential for that amount to increase during a period of severe market stress.

We have illustrated this difference through the chart below showing the volatility level for a 5-year USD interest rate swap:



If a firm was collecting initial margin for a 5-year USD interest rate swap in September 2008, the greatest "period of stress" that it could include would have been the previous peak of 45% established in 2003. However, by early 2009, the volatility level would

have increased to 62%, a 38% increase over the previous peak. More likely, the firm would have weighted more recent historical data more heavily than five-year-old data from 2003, and instead based the amount of initial margin it collected on a roughly 25% volatility assumption; in such a case, the increase in volatility to 62% by early 2009 would have represented a 148% increase. Since the level of initial margin collected using a risk-sensitive model is proportional to the market volatility level, the increase in volatility observed from late 2008 to early 2009 would have implied a 38-148% increase in the initial margin level. Applying such an increase to the QIS estimate would result in a requirement to collect an additional €266 billion to €1.036 trillion in initial margin during a period of stress, in addition to the €700 billion already estimated to be required under normal market conditions.

We note that the increase in volatility for credit default swaps was even more pronounced in the 2007-2009 period and could well be more pronounced in this and other asset categories in future periods.

Thus, setting initial margin at a level consistent with a period of market stress establishes a floor for required initial margin. But it does not, by itself, establish a ceiling. As participants in the WGMR are well aware, the severity and character of future crises are not bound by past crises, and the level of the disparity in market volatility will be directly proportional to the resulting procyclical impact of increasing margin requirements. As the above example illustrates, a firm that had incorporated a historical period of financial stress into the model it used to set initial margin in the fall of 2008 would still have been required to collect a significantly greater amount of initial margin over the next six months as the firm's model adjusted to account for the unprecedented levels of volatility in the late 2008-early 2009 period. If the firm did not account for the increasing level of market volatility in its model, its model could not be said to have been "risk-sensitive," as contemplated by the Consultations. In a framework that requires dynamic readjustment of initial margin computations, procyclicality is an irreducible characteristic of the use of risk-sensitive models.

One might respond to this criticism by observing that, even if procyclicality cannot be limited completely by incorporating a period of market stress into the historical data used to set initial margin requirements, doing so should at least mitigate procyclicality during all but the most unexpectedly stressful periods. But, it is precisely during unexpectedly stressful periods that we most need to avoid regulatory requirements and market practices that are procyclical and, as a result, destabilizing. The least desirable outcome for a margin framework would be one that imposes liquidity demands that restrain growth during normal market conditions and also exacerbates instability by requiring procyclical conduct during periods of significant market stress. Preventing the type of destabilizing calls for additional margin that occurred during the 2007-2009 financial crisis must be among the most critical objectives of any new margin framework.

Effective mitigation of procyclicality requires more fundamental changes in approach. As we advocated in the September Comment Letter, and continue to believe, the imposition of a rigorous variation margin regime, without an initial margin requirement, would

be the most prudent approach, because it would simultaneously be an effective mitigant of credit risk, minimize the illiquidity impacts of initial margin and avoid procyclicality. We are not aware of an alternative approach that as effectively balances these three considerations and satisfies the animating and ultimate objective of the statutory proposals underlying the Consultations, *i.e.*, the mitigation of the risk of a reoccurrence of the kind of financial instability we experienced in the period from 2007 to 2009.

An alternative approach to the foregoing might be to require use of a standardized margin schedule. That approach, however, would very significantly worsen the adverse liquidity impact of initial margin requirements by a factor of 6 to 11 times, according to the QIS, consuming an unsustainable 86% of the unencumbered, high-quality assets estimated to be available.[10]

Another approach that would address the liquidity concerns raised by the schedule-based alternative and avoid procyclical effects would be to require a static, model-based approach. Under this approach, margin levels for existing derivatives would not increase as a result of post-execution changes to volatility observations, but rather the model would use a static empirical data set that is updated only prospectively on a periodic basis with respect to subsequently executed derivatives.[11]

Finally, in order to realize the liquidity benefits of any model-based approach by making models universally available, we encourage supervisors to facilitate the development and coordinated approval of one or more standardized initial margin models for use by all market participants subject to margin requirements. Such models would be subject to baseline requirements, model approvals, change controls, supervisory oversight and updating protocols administered in a coordinated manner by regulators around the world. While any such models may be somewhat less risk-sensitive than the most sophisticated proprietary models, their widespread availability and direct, coordinated oversight would provide significant benefits during normal market conditions and periods of market stress.

2. <u>The QIS Did Not Accurately Estimate the Effect of, or Provide a Methodological Basis for, the Proposed €50 Million Threshold</u>

As part of the QIS, respondents were asked to estimate the amount of initial margin that would be consumed based on assumed initial margin thresholds ranging from €0 to €50 million. We have two concerns with this approach. Our first concern is that information regarding other threshold amounts was not sought, nor did the QIS evaluate the relative credit

---

[10] *Id.* at p. 36.

[11] To the extent that a firm wished to portfolio margin a derivative subject to a lower initial margin amount with one that is subject to a higher amount, the portfolio would be required to use the modeling methodology that resulted in the higher margin requirement.

exposure and liquidity impacts of various thresholds. Our second concern is that thresholds were proposed to be applied, without evaluation, on a consolidated basis.

In our view, the QIS should have sought information regarding the credit risk and liquidity impacts of thresholds in excess of €50 million. By selecting the maximum threshold for which data was sought by the QIS, €50 million, we infer that the WGMR intended to use a high threshold to best mitigate the liquidity impact of initial margin requirements. If that is indeed the case, then it is not clear to us why data was not sought regarding the effects of higher thresholds. While a €50 million threshold might reflect market practice in circumstances where initial margin was not required to be, but which in the future could be required to be, collected from more creditworthy counterparties, that does not mean that it is necessarily an appropriate threshold for a mandatory two-way initial margin requirement across all financial counterparties.

Moreover, as the Second Consultation observes, the amount of initial margin that would be required by a standardized schedule is not very sensitive to the application of the €50 million threshold because the required initial margin amounts would be so much larger than the thresholds.[12] To the extent the standardized approach is used to limit procyclicality or as a result of the absence of model approvals, understanding the effect of higher thresholds is even more critical.

As noted above, the initial margin threshold is to be applied on a consolidated basis. This proposed requirement was not well-understood by QIS respondents. At least several large respondents responded to the QIS by applying the threshold on a netting set basis, since that is how thresholds are administered under current market practice. Our members estimate that the level of initial margin required would increase by over 50% when applying the threshold on a consolidated group to consolidated group basis, as would be required under the Second Consultation, rather than on a netting set basis. In other cases, respondents applied the threshold in aggregate across their own consolidated group's trading with an individual legal entity counterparty, while others applied the threshold across trading by their own consolidated group with the consolidated group of their counterparty. This disparity in responses means that the QIS simultaneously significantly overestimated the extent of the impact of the €50 million threshold and correspondingly underestimated the actual amount of initial margin that would be exchanged using the €50 million threshold.

The fact that firms do not apply thresholds on a consolidated basis is not surprising. Allocating a single threshold across multiple legal entities, likely spanning multiple jurisdictions with multiple regulators, would not be a simple task for firms or their regulators. Counterparties are likely to have difficulty reaching agreement on an allocation of the threshold, particularly in situations where the relative creditworthiness of different legal entities within a consolidated group changes over time. One can also imagine situations in which home and host country regulators do not agree on the appropriateness of a particular allocation. Certainly, applying a consolidated threshold is not consistent with legal entity-specific capital requirements

---

[12] Second Consultation at p. 36.

or the separate resolution of individual legal entities in their respective insolvencies. In this regard, from a policy perspective, it is difficult to see why applying separate thresholds to separate netting sets should raise significant concerns, so long as credit support is not provided to one or both entities in a way that would result in contagion to other affiliates within the group.

It also does not seem necessary to adopt fundamental changes to the mechanics of initial margin thresholds solely in order to prevent firms from circumventing margin requirements through the proliferation of affiliates. Generally speaking, the likelihood that a firm would be able successfully to reduce its initial margin requirements by splitting its trading with a counterparty across multiple affiliates is very low. Fragmenting positions in this way would reduce the size of any given netting set, likely having the effect of increasing initial margin requirements unless the split is based solely on asset class. It also would have the effect of increasing capital requirements, both due to the minimum capital requirements applicable to each affiliate and because of the increase in credit exposure to the counterparty. Each affiliate trading with the counterparty will also be required to be licensed by the relevant regulator in that counterparty's jurisdiction. It would be surprising if regulators permitted the licensing of additional affiliates whose sole purpose is to circumvent initial margin requirements through additional thresholds. Finally, in some jurisdictions, counterparty credit risk limits that apply on a consolidated basis would already prevent a firm from gaming initial margin thresholds to increase its credit exposures to unsustainable levels.

In light of these considerations, we believe that a direct prohibition on evasion of initial margin requirements by trading through multiple affiliates or using multiple netting sets should be sufficient. Such a prohibition would address the issue animating the WGMR's proposal while also avoiding the adverse consequences of applying a consolidated threshold in circumstances where legitimate reasons exist for trading through multiple affiliates or using multiple netting sets. For example, different affiliates within a commonly-owned group may trade derivatives for different reasons, such as where one affiliate is engaged in a dealing business and another is engaged in asset management activities. The rationale for consolidated application is even weaker for entities that are separately regulated and subject to separate capital requirements, with no inter-affiliate credit support arrangements. It is not necessary to adopt a blunt and difficult to administer prophylactic requirement in order to address observable group concentrations that can directly be addressed if and as they arise.

3. The QIS Did Not Assess Other Means for Reducing the Adverse Liquidity Impact of Initial Margin Requirements

While the QIS sought information on the extent to which an initial margin threshold would mitigate the adverse liquidity consequences of mandatory two-way initial margin, it did not seek data on the impact of other means to mitigate such consequences. In particular, the QIS asked respondents to calculate initial margin levels using models reflecting potential future exposures consistent with a one-tailed 99% confidence level over a 10-day liquidation horizon, but did not ask for information regarding the effect of calibrating models using a shorter liquidation horizon or lower confidence level.

Using a shorter liquidation horizon could, in many cases, reduce the adverse liquidity impact of initial margin requirements without resulting in materially increased risk. Doubling the liquidation horizon for non-centrally-cleared derivatives relative to the five-day liquidation horizon that is most commonly used for centrally-cleared derivatives is not necessary or appropriate to reflect the increased risk of non-centrally-cleared derivatives. Indeed, for many asset classes of non-centrally-cleared derivatives, current market practice is to use a close-out period shorter than ten days. The Second Consultation does not address this discrepancy nor explain why a ten-day horizon is appropriate for all non-centrally-cleared derivatives.

Using a lower confidence level could also have similar benefits. We recognize that the confidence level applicable to centrally-cleared derivatives is set at 99% or higher under U.S. and European regulations, as compared to the 95% confidence level that is more common for non-centrally-cleared derivatives under current market practice.[13] However, the higher confidence level for centrally-cleared derivatives reflects the greater role that initial margin plays as a default resource for central counterparties than for prudentially regulated counterparties to non-centrally-cleared derivatives, which are required to hold capital sufficient to cover losses estimated with a higher level of confidence than that used to set initial margin requirements. Setting the confidence level at 99% for initial margin requirements for non-centrally-cleared derivatives does not take into account the loss absorbency provided by capital.

We note that, given the complementary relationship between margin and capital, using a shorter liquidation horizon and/or lower confidence level would not necessarily leave the system less protected. Both capital and initial margin are intended to cover potential future exposure estimated at a given confidence level and with a given liquidation horizon. The long liquidation horizon and high confidence interval in the current proposal inherently express a strong preference for covering potential future losses with initial margin instead of capital. A reduction in the liquidation horizon and confidence level for initial margin would result in a firm holding additional capital against its potential future exposure, thereby simply implying movement along the continuum toward substituting capital for margin as a resource to cover potential future losses. In our view, this shift would result in a more balanced approach, with beneficial effects on liquidity and the mitigation of funding risk.

In addition, it would not be appropriate to select a longer liquidation horizon and higher confidence level for non-centrally-cleared derivatives for the sole purpose of encouraging firms to enter into centrally-cleared derivatives. As we explained in our September Comment Letter, imposing arbitrarily high margin requirements for the purpose of creating disincentives to the use of derivatives that cannot effectively be cleared will require parties to incur basis risk when hedging bespoke risk exposures and encourage the central clearing of derivatives that lack sufficient standardization, price transparency or liquidity to be risk managed effectively by central counterparties.

---

[13] The QIS revealed that the average confidence interval under current market practice is 96.2%, which we believe reflects an averaging of the more commonly used 95% confidence level with higher confidence levels used in a minority of cases. *See* Second Consultation at p. 31.

In light of these considerations, it is not clear to us that adopting an initial margin threshold is a better way to mitigate adverse liquidity consequences than making modifications to model parameters, nor why some combination of a threshold and modified parameters might not be preferable to an approach relying solely on an initial margin threshold. More extensive data is necessary to assess the trade-offs between these approaches.

4. The Second Consultation Placed Undue Emphasis on Models-Based Initial Margin Amounts

As noted above, the QIS estimated that initial margin amounts required under a standardized schedule would be 6 to 11 times larger than the amount required under initial margin models. Yet, it appears that the WGMR did not take into consideration the possibility that significant segments of the market might be required to use a standardized schedule. In this regard, the Second Consultation simply stated that "it is not possible to anticipate the scope of model approvals."[14] We believe that, for a number of reasons, the QIS greatly overestimated the availability and use of approved models, resulting in a massive underestimation of the amount of initial margin that would be required to be exchanged under the Second Consultation.

Model development and approval can take significant time and resources. This is magnified by the fact that, under the Second Consultation, approval must be granted separately by each regulator of each entity (including each entity within a holding company group subject to consolidated periodical supervision) using the model.[15] Additionally, while regulated firms often have approved models for capital computation purposes, those models may not necessarily meet the standards applicable to initial margin models.

Moreover, unregulated firms and even regulated firms that are not subject to quantitative prudential requirements will not have approved models. We are not aware of any process through which such firms can obtain model approvals. Many of those firms may not have the infrastructure and personnel resources necessary to develop their own models, or the governance processes necessary to maintain models. Such firms will therefore be required to use the standardized schedule, a third-party model or rely on their counterparties' models. Since the firms that are most likely to use standardized schedules are unregulated firms that trade primarily with prudentially regulated dealers, such dealers are likely to bear a disproportionate share of the costs of the requirements.

Furthermore, using proprietary initial margin models will in many cases be inconsistent with the objective of minimizing disputes because initial margin models based on

---

[14] *Id.* at p. 35.

[15] *Id.* at p. 11. As noted in our September Comment Letter, we believe that an exception to this principle should be adopted in the case of the subsidiary of a holding company subject to consolidated supervision where the initial margin model to be used by the subsidiary has been approved by the subsidiary's consolidated supervisor, provided that the consolidated supervisor has adopted requirements for model supervision consistent with international standards.

value-at-risk calculations differ across institutions and may be difficult to replicate.[16] It would therefore be extremely difficult to develop robust mechanisms for resolving disputes about how much margin should be collected by a party using a proprietary initial margin model.

Unpredictability in counterparty computations of initial margin requirements would also make firms reluctant to trade in markets, such as the inter-dealer broker market, where trading takes place on an anonymous basis. Such markets are critical sources of liquidity, and reducing their efficacy could meaningfully curtail the ability of dealers and other market participants to hedge their exposures cost effectively, particularly in less liquid markets.

We continue to believe that the best solution to these issues is a robust variation margin regime, without requiring mandatory two-way exchange of initial margin. However, if two-way initial margin is required, it would be best for counterparties to agree on a single model to satisfy their respective initial margin obligations. This approach would be the most equitable one, and avoid the need for the parties to use the standardized schedule and suffer the significantly greater liquidity drain it entails. For it to work in practice, however, both parties will want a high degree of transparency with respect to the model, and will also need to take common approaches to the data, time periods, stress implementation and other inputs to the model. This is consistent with the principle, which we strongly support, of minimizing the potential for disputes. Yet, reaching agreement on a common modeling technique on a bilateral basis will be very difficult. In addition, any required disclosure of model information that is among the most proprietary that an institution possesses also presents inherent obstacles.

In our view, the best way to address these considerations would be for the BCBS and IOSCO to facilitate the development and supervisory approval of one or more standardized models in order to satisfy global initial margin standards. This would be similar to the approach that the U.S. Securities and Exchange Commission (the "**SEC**") and U.S. self-regulatory organizations have historically taken to permit portfolio margining of equity products.[17] While we are not suggesting that the specific modeling techniques currently used in that context should be adopted here, we do believe that there is merit to the overall approach of approving a standardized model. Doing so would streamline the model approval process, significantly reduce disputes, and be economically efficient.[18] Standardized model design could also incorporate features to limit procyclicality.

---

[16] In this regard, we note that not all initial margin models follow the same methodology. For example, sensitivity-based models represent a viable alternative to value-at-risk models, and therefore should be considered when adopting a standardized model approach as suggested above.

[17] *See* FINRA Rule 4210(g).

[18] In addition, after the initial development and approval of one or more standardized models, market conditions may change or other developments may occur that may necessitate revisions to such standardized models. It is key that the BCBS and IOSCO, together with national regulators, continue to engage in dialogue with market participants on an ongoing basis to facilitate this process.

5. The QIS Overestimated the Supply of Eligible, Unencumbered Assets

The QIS sought to estimate the ratio of initial margin requirements to the total amount of unencumbered assets identified as being eligible to satisfy initial margin requirements.[19] The Second Consultation notes that, in some cases, respondents either did not report the total amount of available unencumbered assets or they misinterpreted the question to be seeking information limited to the unencumbered assets available to the respondent that had been posted by its counterparties, which submissions were excluded from the QIS's analysis.[20]

Our members have indicated that these are not the only errors that were made in responding to this part of the QIS. Some respondents simply reported the total amount of available unencumbered assets without regard to whether those assets might qualify as eligible collateral. Including these submissions in the final results would significantly overstate the supply of eligible, unencumbered assets. This error is due in large part to the fact that the Original Consultation did not provide much specificity with respect to the types of assets that would be eligible. For instance, market participants have questions regarding what constitutes a "high-quality" government security, corporate bond or covered bond, or which indices qualify as "major stock indices." There are also questions regarding whether assets would need to satisfy a lesser standard to qualify as initial margin than variation margin. To address these ambiguities in the context of the QIS while also recognizing that the WGMR sought to establish high-level principles for collateral eligibility that would be applied by national supervisors,[21] we have suggested that a supplemental QIS seek more detailed data on the types of assets that might be available, so that the WGMR could judge for itself whether those assets might be eligible as collateral.

Application of the proposed collateral haircuts has also led to substantial difficulties.[22] In particular, both Consultations call for an additional 8% haircut for cash collateral denominated in a currency other than the currency of the underlying exposure. Respondents had trouble determining how this haircut was to be applied, *i.e.*, how they should allocate cash to different exposures for the purpose of determining when the haircut applies. As

---

[19] Second Consultation at p. 36.

[20] *Id.*

[21] We also observe that leaving lists of eligible collateral assets to be developed at the national level necessarily will require coordination between regulators to prevent wide divergence in standards and to address conflicts that might arise when parties in different jurisdictions that have adopted different lists trade with each other.

[22] In addition to the specific haircut issues discussed above, we note that the standardized haircut schedule proposed under the Second Consultation is inconsistent with current bilateral market practice, particularly with regard to the corporate bond and equity asset classes. We recommend that the WGMR consult with national regulators on more appropriate haircuts before finalizing its framework in this regard.

a result, the QIS estimate for the supply of eligible, unencumbered assets does not accurately account for the application of this proposed haircut.

The 8% cross-currency haircut will encourage market participants to settle collateral in each currency independently, which would essentially spread cross currency settlement risk (known as Herstatt risk in the FX market) throughout the entire over-the-counter ("**OTC**") derivatives market. We believe that the WGMR would want to avoid such a result. As described in our September Comment Letter, market participants have developed a documentation template, the ISDA Standard Credit Support Annex (the "**SCSA**"), that computes collateral requirements in each currency within the portfolio, consistent with the intent of the WGMR proposal, but uses net single currency settlement to avoid Herstatt risk, plus a currency conversion process to ensure that collateral, once settled, is risk-aligned to the underlying derivative currency. The SCSA accrues interest at the relevant interest rate in that underlying derivative currency.[23] We believe that the SCSA offers the best possible solution to a variety of risk concerns in the OTC derivatives market, and has been received positively in discussion with international supervisors and regulators. However, we are concerned that the Consultations could be interpreted to subject parties using the SCSA to the 8% haircut, and therefore would request that WGMR make clear that parties who are using an SCSA should not be subject to the 8% cross-currency haircut.[24]

We also note that the proposed 8% haircut is in many cases unreflective of the underlying risk it is intended to address. Not all exchange rates exhibit a level of volatility sufficient to merit the 8% haircut – for instance, pegged exchange rates exhibit almost no volatility – whereas the volatility for others can be greater than 8%. An alternative to this "one-size-fits-all" haircut is therefore necessary if cross-currency risk arising from mismatches between collateral and exposures is to be addressed in a risk-sensitive manner.

6. <u>The WGMR Should Conduct a Supplemental QIS and Explore Additional Modifications to its Proposal</u>

In light of the flaws in the QIS, such as those described above, we urge the WGMR to conduct a supplemental QIS before finalizing its proposed framework. As part of this supplemental QIS, we recommend that the WGMR:

- Clarify how respondents should incorporate a period of financial stress into their model-based initial margin estimates and the length of the historical observation period respondents should use;

---

[23] *See* September Comment Letter at p. 18-19.

[24] Adopting this exception would also help address derivatives that are inherently multi-currency in nature, such as a currency swap or a quanto swap, and which would therefore otherwise always be subject to the 8% haircut. The SCSA addresses such derivatives by requiring that they always be collateralized in USD, which we believe is the lowest risk solution.

- Ask respondents to estimate the potential increase in initial margin requirements during a period of severe market stress and provide a description of the methodology and assumptions used to prepare that estimate;

- Seek estimates of the initial margin requirements that would apply based on assumed thresholds ranging from €50 million to €450 million, in increments of €100 million;

- Clarify how initial margin thresholds are intended to apply on a consolidated basis and seek a comparison of the amounts that would be exchanged depending on whether the threshold is applied in that manner or to each individual netting set;

- Seek estimates of the initial margin requirements that would apply using models based on potential future exposure reflecting a 95% confidence level;

- Seek estimates of the initial margin requirements that would apply using models based on potential future exposure reflecting a 5-day liquidation horizon;

- Seek data on the aggregate amount of unencumbered financial assets available to respondents, and ask respondents to categorize those assets; and

- Clarify how the proposed 8% cross-currency haircut is intended to apply (including by incorporating an exception to the haircut in the case of counterparties that have an SCSA in place).

In addition, we recommend that the WGMR begin discussions, in consultation with market participants, regarding how it might foster the development of standardized initial margin models, perhaps provided by a market utility, and the minimum regulatory parameters that should apply to such models.

B. Phased-In Implementation

SIFMA appreciates the WGMR's recognition of the significant policy changes embodied in the Second Consultation. These changes, particularly the proposed mandatory two-way exchange of initial margin, would require substantial modifications to the current market practices of market participants with regard to operations, documentation, liquidity planning and a host of other activities. The ability of market participants to adequately plan for the implementation of new margin requirements is further complicated by the large number of separate regulatory requirements applicable to such entities, particularly new capital rules. We therefore welcome and support the WGMR's efforts to adopt a phase-in for margin requirements

with the aim of reducing transition costs. Nonetheless, we believe there are serious problems with the phase-in arrangements proposed in the Second Consultation that could severely hinder their effectiveness in achieving the WGMR's stated goals.

1. Phase-In for Variation Margin

The Second Consultation would require that variation margin requirements take effect on January 1, 2015. We generally support a two-year phase-in for the requirement to exchange variation margin. Given current market practice relating to variation margin, our members believe that two years represents an appropriate amount of time to allow market participants to update systems and documentation in order to come into compliance with new requirements in this area.

However, we are concerned that fixing the date for the beginning of variation margin requirements now, before those requirements have been formally adopted by national regulators, would not provide market participants with adequate time to plan and implement the necessary documentation and operational changes. For example, the Second Consultation would require that parties have "rigorous and robust dispute resolution procedures in place,"[25] but does not specify what minimum characteristics are necessary for dispute resolution procedures to be considered "rigorous and robust." Presumably, this determination will be left to national regulators. Until national regulators finalize and adopt their individual rules, market participants will not be able to establish the documentation necessary to comply with applicable variation margin requirements, including corresponding dispute resolution mechanisms. To address this type of issue, we recommend that the requirement to exchange variation margin become effective two years from the date that a critical mass of national regulatory authorities have adopted rules regarding that requirement.

2. Phase-In for Initial Margin

Under the Second Consultation, covered entities would become subject to the initial margin requirements based on a measure of their aggregate month-end average notional amount of non-centrally-cleared derivatives for the last quarter of the preceding year, beginning in 2015 for entities with over €3.0 trillion notional and in 2019 for all other covered entities over a *de minimis* notional threshold of €8 billion. The proposed phase-in therefore begins with a fixed date, which raises the same concerns noted above in regard to the variation margin phase-in. We accordingly recommend that any phase-in for initial margin should become effective at the expiration of a defined period following the date as of which a critical mass of national regulators have adopted the relevant rules.

We also emphasize that, for the reasons discussed in Part II.A above, the development of static model parameters and the design and approval of one or more standardized models are in many respects necessary prerequisites to an effective initial margin framework that

[25] Second Consultation at p. 14.

does not give rise to an undesirable reduction in liquidity, procyclical conduct, increase in disputes, or all three. We therefore urge the WGMR to take steps to foster these developments before establishing a fixed date for the first phase of initial margin requirements.

We emphasize that, in asking the WGMR to address these considerations, our goal is not to delay initial margin requirements. If a high priority is placed on finalizing relevant national rules and making headway toward the design and approval of one or more standardized models, a significant delay may not be necessary. On the other hand, putting initial margin requirements into force before these considerations are addressed would not, in our view, be prudent.

Independent of the appropriate effective date, serious practical difficulties would arise under the proposed phase-in because the determination of whether a covered entity became subject to initial margin requirements vis-à-vis its counterparty would depend on whether either, or both, entity(ies) exceeded the relevant notional trading volume threshold over the immediately preceding three months. In other words, entities would not know that they or their counterparties are covered entities, or that they exceed the proposed notional amounts, until January 1st of a given year. Nevertheless, under the Second Consultation, they would be required to immediately begin exchanging margin on that same day. This result does not appear to have been intended.

A more fundamental issue with the proposed phase-in schedule would arise because the vast majority of large financial institutions would become subject to the initial margin requirements on the first phase-in date. While this may appear to be a positive feature of the proposal, it would also have the effect of frontloading the liquidity impact of the margin requirements into the very beginning of the schedule. This would cause the brunt of the macroeconomic effect of the requirements to be felt even as the global economy might still be relatively fragile.

We are also concerned about the incentives that the proposed phase-in schedule is likely to foster. At a minimum, applying the requirements to one group of market participants but not others during the phase-in would impede the WGMR's stated goal of maintaining a level playing field for market participants, free from regulatory arbitrage.[26] In addition, because of the significant competitive disadvantages that would result if one firm were subject to initial margin requirements while its competitors were not, those firms that fall within the first class of market participants subject to initial margin requirements would likely seek ways to trade without becoming so subject. The WGMR appears to envision that this incentive will encourage firms to elect to centrally clear their derivatives. However, given that, by January 1, 2015, mandatory clearing requirements will likely have already been applied to most derivatives that are sufficiently standardized to be suitable for central clearing, such an incentive would essentially amount to subjecting the most systemically significant firms to increased basis risk. An even more likely result is that the firms that become subject to initial margin requirements at an earlier stage would instead seek to trade with firms that are not yet covered, because those transactions would not yet be subject to the rules. In effect, then, the proposed schedule would likely

[26] *See id.* at p. 3, 18.

fragment liquidity, and potentially increase the cost of hedging for the most systemically significant firms. These incentives may also skew market pricing.

Additionally, those firms that do not fall within the first class of market participants subject to the requirements would likely seek to stay below the thresholds and delay becoming subject to the requirements as long as possible. The proposal would therefore discourage such firms from providing liquidity or pursuing optional hedging strategies, resulting in increased illiquidity and market risk to market participants.

We also question whether distinguishing between market participants based on the gross notional amount of their trading activity, without more, is the best way to capture those participants whose trading activity is the most systemically significant. As the members of the WGMR are well aware, the notional size of a derivatives portfolio is not an accurate proxy for the risk of the portfolio.

One possible alternative to the proposed phase-in would be to pair the proposed categorization of market participants based on notional trading activity with gradually decreasing initial margin thresholds. Under such an approach, covered entities would become subject to the requirements gradually over several years, starting with those entities with the largest outstanding notional activity and gradually expanding coverage until the final date. At the same time, the threshold would decrease in each period, starting from several multiples of the final threshold and gradually reducing to that final threshold. The addition of a phase-in for the initial margin threshold would mitigate the liquidity impact of initial margin requirements during the earlier phases of implementation and allow regulators to observe changes in available liquidity (and associated economic effects) over time as thresholds decrease, so that adjustments, if necessary, could be made.

We emphasize that WGMR members should seek to use the phase-in period, both the period during which the scope of market participants subject to initial margin requirements expands as well as the period before they go into effect, as an observation period over which additional empirical data should be gathered and the requirements can be re-calibrated as appropriate. This approach would be consistent with the one that the BCBS has taken with respect to liquidity requirements.[27]

C. <u>Physically-Settled FX Forwards and Swaps</u>

SIFMA agrees with the position and supporting arguments presented by GFMA's Global FX Division in their letter to the BCBS and IOSCO Secretariats dated March 15, 2013. In that letter, the Global FX Division recommends exempting deliverable FX swaps and forwards from any margin regime that requires the exchange, collection or posting, of initial margin between transacting parties on a mandatory basis, noting that this market should not be

---

[27] *See* BCBS, Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring, p. 40-41 (December 2010).

bifurcated based on tenor for the purpose of applying any such mandatory initial margin regime. The Global FX Division also notes in its letter that replacement cost risk associated with deliverable FX swaps and forwards is appropriately mitigated without the need for a requirement to exchange variation margin between transacting parties on a mandatory basis, while recommending that if such products are not exempted from a mandatory variation margin requirement, variation margin should only be required as a result of supervisory guidance and not national regulation.

D. Re-Hypothecation or Re-Use of Initial Margin

Under the Second Consultation's proposed margin framework, initial margin would be exchanged on a gross, rather than net, basis. To mitigate the risk that the party posting initial margin will be exposed to loss if its counterparty defaults, the Second Consultation would generally prohibit the re-hypothecation, re-pledge or re-use of collateral held as initial margin. However, the Second Consultation requests comment regarding whether re-hypothecation should be permitted in circumstances where (i) collateral can only be re-hypothecated to finance/hedge customer, non-proprietary positions, (ii) the pledgee treats re-hypothecated collateral as customer assets and (iii) the applicable insolvency regime allows customer first priority claims over the pledged collateral.

We believe that, based on its consideration of its counterparty's creditworthiness and the relative costs and risks of segregation arrangements, a party posting initial margin should be permitted to elect among any of three options: (i) permitting the collecting party to hold the margin without restriction on re-hypothecation or re-use; (ii) permitting the collecting party to hold the margin, but only with limited rights to its re-hypothecation or re-use; or (iii) requiring initial margin to be held, at the posting party's expense, by a third-party custodian. Providing such optionality is appropriate, in our view, in light of the sophistication of participants in the non-centrally-cleared derivatives market. National regulators may, of course, adopt implementing regulations defining the scope of counterparties sufficiently sophisticated to make such an election.

With respect to the first alternative, we recognize the WGMR's concern that full re-hypothecation or re-use of initial margin could undermine the benefits of two-way initial margin requirements because the non-defaulting party might be exposed to a loss on the initial margin it has posted that outweighs the risk mitigated by the initial margin it has collected. We generally agree with this concern, and it is one of the reasons why we believe that two-way initial margin should not be required in the first place. But there are, in our view, several circumstances under which a firm may elect this alternative without undermining the regime as a whole. For instance, if a firm is subject to a capital regime that requires it to hold capital against the unsecured exposure it has for return of initial margin, then it should be able to absorb losses on that margin already; allowing such a firm to grant its counterparty full rights to re-hypothecation and re-use might be necessary for the firm to trade in a cost-effective manner. Further, when a prudentially regulated firm trades with an unregulated firm, it will both collect initial margin from the unregulated firm and, almost certainly, require the initial margin it posts

to be held by a third-part custodian; thus, even if the unregulated firm were to default due to losses on initial margin it had posted to others, that default would not undermine the effectiveness of the initial margin regime vis-à-vis the prudentially regulated firms with which it trades.

The second alternative, in turn, is validated by decades of experience with the regulation of securities broker-dealers by the SEC. Under SEC rules, a broker-dealer may re-hypothecate securities pledged to it by a customer to secure a margin loan by the broker-dealer. However, the broker-dealer is prohibited from re-hypothecating those securities in a manner that would permit them to be commingled with the proprietary securities of the broker-dealer, and may not re-hypothecate securities for a sum that exceeds the aggregate indebtedness of customers to the broker-dealer. In addition, customers receive a first priority claim with respect to customer property in the insolvency of the broker-dealer. The SEC recently proposed to apply a similar regime to OTC derivatives.[28] Under this proposal, security-based swap dealers would be permitted to re-hypothecate or re-use initial margin collected for security-based swaps with customers as margin for security-based swaps with another dealer to hedge the customer transactions.[29] Customers that do not wish to have their assets held under such a regime could elect individual segregation or no segregation at all.

In setting forth the conditions for limited re-hypothecation or re-use under this second alternative, the WGMR should clarify the conditions under which re-hypothecation or re-use would be permitted. In particular, requiring that "the pledgee treats re-hypothecated collateral as customer assets" and that customers have first priority claims over "pledged collateral" uses terminology that is not relevant in a jurisdiction where collateral is exchanged through the transfer of title. Instead, it would be more appropriate to require that the collecting party reflect in the posting party's account the full value of any collateral that is re-hypothecated, so that in the event of the collecting party's insolvency, the posting party has an auditable claim against the estate of the collecting party for the value of the collateral and, where specified under applicable national law, priority over unsecured creditors in an insolvency proceeding for the collecting party.

We acknowledge that not all jurisdictions have the legal framework necessary for such an exception from limits on re-hypothecation or re-use, but we urge BCBS and IOSCO participants to undertake efforts to foster the legislative changes necessary to adopt such an exception. Doing so would help to mitigate the adverse liquidity impact of initial margin

---

[28] *See* Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers; Proposed Rule, 77 Fed. Reg. 70214 (Nov. 23, 2012).

[29] *Id.* at 70351-52. SIFMA has provided comments to the SEC on its proposed rules, including raising concerns with the proposal's limitations on re-hypothecation to only transactions involving other dealers and only for use in certain types of derivatives transactions, rather than for use in other products that may be used to hedge and to finance the purchase of cash positions to hedge for the customer-facing transaction. *See* SIFMA Comment Letter on SEC Proposal dated February 22, 2013, p. 48.

requirements, without unduly exposing customers to the risk of losing initial margin posted to dealers.

Finally, we propose that parties have the right to require segregation of initial margin at a third-party custodian. As a result, counterparties who believe that this most protective (but most costly) regime provides the best balance of costs and benefits would retain the option for their property to be held in this manner.

III. CONCLUSION

Globally consistent margin rules are necessary if regulatory reform of the derivatives markets is to be effective and avoid market fragmentation. We continue to support the adoption of robust, two-way variation margin requirements, which would simultaneously be an effective mitigant of credit risk, minimize illiquidity impacts and avoid procyclicality. On the other hand, we do not believe that it would be appropriate to adopt initial margin requirements, at least until the BCBS and IOSCO first make an informed evaluation of their potential impact, based on a supplemental QIS that addresses the many serious flaws in the initial QIS.

If the BCBS and IOSCO nonetheless decide to adopt initial margin requirements, then we urge the adoption of model parameters that are updated periodically and with prospective effect to subsequently executed derivatives and facilitation of the design and approval of one or more universally available standardized initial margin models, so as to limit the inherent adverse consequences of initial margin requirements. We also recommend that the BCBS and IOSCO modify their proposal to permit initial margin models to account for risk on a portfolio basis for a broader range of instruments subject to both legally enforceable netting and cross-margining arrangements, where doing so does not result in non-compliance with other applicable regulatory requirements. Unless these steps are taken, SIFMA is concerned that the proposed margin requirements would introduce new and unnecessary risks to the global economy and market stability.[30]

Finally, we observe that some national regulators have already proposed rules implementing margin requirements for non-centrally-cleared derivatives, which are not fully

[30] Additionally, while we have sought to focus our comments, where possible, on the specific topics with respect to which the WGMR solicited feedback in the Second Consultation, we are concerned more generally that the WGMR describes the Second Consultation as presenting a “near-final” framework in circumstances where more detailed, but nonetheless important, elements of the framework have not been sufficiently developed. For example, in noting that derivatives transactions “with zero credit risk” require zero initial margin and may be excluded from the initial margin calculation, the Second Consultation cites, as an example of this case, the exposure that the writer of a European call option has to an option purchaser that has paid the option’s premium at inception. Second Consultation at p. 15. If, however, that call option is subject to standard credit support arrangements, including the exchange of variation margin, then the option writer will effectively be required to finance the purchaser’s premium and thereby will, in fact, have credit risk to the purchaser. Details such as this should be considered more fully before adopting a final framework. Accordingly, we urge the WGMR not to rush the finalization of global margin standards, so as to avoid the need for national regulators to re-visit key details at a time when harmonizing those details will be much more difficult.

consistent with the Consultations. Once the BCBS and IOSCO have adopted their final framework, it is critical for those national regulators to re-propose their rules, with whatever modifications are necessary to conform to the final BCBS-IOSCO framework. The ensuing public comment and consultation period is necessary to ensure that interested constituencies have an opportunity to provide feedback on the technical details that the BCBS and IOSCO leave for specification at the national level.

* * *

We would be pleased to provide further information or assistance at the request of the WGMR. Please do not hesitate to contact the undersigned, or Edward J. Rosen (+1 212 225 2820) or Colin D. Lloyd (+1 212 225 2809) of Cleary Gottlieb Steen & Hamilton LLP, outside counsel to SIFMA, if you should have any questions with regard to the foregoing.

Respectfully Submitted,

Kenneth E. Bentsen, Jr.
Acting President and CEO
Securities Industry and Financial Markets Association