1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

September 13, 2012

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants* *(RIN 3038-AC97)*

Dear Mr. Stawick:

The Investment Company Institute ("ICI")[1] is submitting this letter in response to the re-opening of the comment period by the Commodity Futures Trading Commission ("CFTC" or "Commission") for its proposed margin rules for uncleared swaps in light of efforts by the Basel Committee on Banking Supervision ("BCBS") and the International Organization of Securities Commissions ("IOSCO") to develop harmonized international margin standards for uncleared swaps.[2] After the financial crisis in 2008, the G20 countries agreed to provide greater oversight and transparency of the swaps markets. In addition to the G20 commitments, there have been efforts by international regulators for greater coordination and harmonization of derivatives markets reforms. As participants in the swaps markets worldwide, ICI members strongly support international efforts to implement consistent global standards for margin requirements for non-centrally cleared derivatives.

---

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds ("ETFs"), and unit investment trusts ("UITs"). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $13.3 trillion and serve over 90 million shareholders.

[2] *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants,* RIN 3038-AC97, 77 FR 41109 (July 12, 2012), *available at* http://www.gpo.gov/fdsys/pkg/FR-2012-07-12/pdf/2012-16983.pdf. *See Margin Requirements for Non-Centrally-Cleared Derivatives*, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, July 2012, *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD387.pdf ("Consultation Paper").

In April 2011, pursuant to section 731 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the Commission proposed margin requirements for swap dealers ("SDs") and major swap participants ("MSPs") that are not subject to oversight by a U.S. prudential regulator.[3] In response, we submitted a comment letter to the Commission explaining in detail our concerns with the proposed margin rules and recommending a number of revisions to address those issues.[4] This letter is intended to supplement our prior submission to the Commission in view of the Consultation Paper, which represents the initial proposal by international regulators to establish international minimum standards for margin requirements for uncleared derivatives. As we noted in the July 2011 ICI Letter, regulatory coordination is critical to the swaps markets in which transactions may occur in different countries and involve participants from multiple jurisdictions. Significant inconsistencies and differences among the regulators' requirements may result in fragmentation of markets and regulatory arbitrage. Lack of coordination among regulators also will result in overlapping and potentially conflicting rules for swaps market participants, and the uncertainty created for market participants could affect their willingness to hedge their risks in the swaps markets.

We believe that the international regulators' proposed requirements in several key areas are instructive and consistent with our previous suggestions to the Commission. We, therefore, urge the Commission to work closely with the BCBS and IOSCO as they finalize the global standards and to adapt its requirements to reflect the emerging global consensus on margin requirements for uncleared swaps to the extent possible.[5] We also recommend that the Commission seek to reach agreement with international regulators on the cross border application of derivatives regulations, including margin requirements.[6] As discussed in more detail in our letter to the Commission, under the Commission's proposed guidance on the cross-border application of the swaps provisions, market participants would

---

[3] Section 731 of the Dodd-Frank Act established a bifurcated approach to margin requirements and requires each SD and MSP that is subject to oversight by a U.S. prudential regulator to meet margin requirements established by the applicable U.S. prudential regulator. We separately submitted a comment letter in response to the margin proposal by the U.S. prudential regulators. *See* Letter from Karrie McMillan, General Counsel, ICI, to Gary K. Van Meter, Acting Director, Farm Credit Administration, Alfred M. Pollard, General Counsel, Federal Housing Financing Agency, Mary J. Miller, Assistant Secretary for Financial Markets, U.S. Department of the Treasury, Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation, Jennifer J. Johnson, Secretary, Federal Reserve Board, dated July 11, 2011.

[4] *See* Letter from Karrie McMillan, General Counsel, ICI, to David A. Stawick, Secretary, CFTC, dated July 11, 2011 ("July 2011 ICI Letter").

[5] We support efforts by the CFTC, as directed by the Dodd-Frank Act, to continue to collaborate with the Securities and Exchange Commission and the U.S. prudential regulators in finalizing U.S. margin requirements for uncleared swaps.

[6] The CFTC and other international regulators may be considering different approaches to margin requirements. For example, the Consultation Paper proposes that the margin requirements in a jurisdiction should be applied to a legal entity established in that local jurisdiction, which could result in counterparties being subject to two separate margin regimes. *See Consultation Paper*, supra note 2, at 28-30

be required to comply with duplicative and/or conflicting requirements without real and meaningful coordination among global regulators.[7] We discuss our recommendations in more detail below.

I. Two-Way Margin

To better protect counterparties and the swaps markets more generally, we strongly urge the Commission, as we did in the July 2011 ICI Letter, to adopt final rules to require SDs and MSPs ("covered swap entities") to post initial and variation margin to their non-covered swap entity counterparties at the same level and in the same manner as required for the counterparty. This fundamental requirement is consistent with the proposed global standard as proposed by the BCBS and IOSCO under which entities that engage in non-centrally-cleared derivatives would be required to exchange, on a bilateral basis, initial and variation margin in mandatory minimum amounts. According to the Consultation Paper, there is "broad consensus within the BCBS and IOSCO that all covered entities engaging in non-centrally-cleared derivatives must exchange initial and variation margin."[8] We recommend that the CFTC amend its proposal, which would not require covered swap entities to post margin to their counterparties in those instances when their counterparties were required to post margin.

Two-way margin is an essential component of managing risk for swaps transactions as well as for reducing systemic risk. The collection of two-way margin helps to protect the individual counterparties to a swap transaction. The purpose behind collecting margin is to cover exposures by ensuring that counterparties can meet their financial obligations. The collection of two-way initial margin is the most effective risk reduction tool against residual counterparty credit risk. Two-way exchange of initial margin provides each counterparty protection against the future replacement cost in case of a counterparty default. Initial margin also helps to protect a party to a swap transaction from future credit risk posed by its counterparty.

The daily collection of variation margin also serves to remove current exposure from the swaps markets for all participants and prevent exposures from accumulating. Two-way exchange of variation margin will provide protection to market participants against the market value losses that could otherwise build up at covered swap entities (entities that engage in the most significant amount of swap transactions), which could threaten systemic stability. Furthermore, requiring a covered swap entity to post initial margin to a non-covered swap entity counterparty promotes central clearing by removing an incentive – avoidance of posting initial margin – for a covered swap entity to structure a transaction, where possible, so that it need not be cleared.

---

[7] *See* Letter from Karrie McMillan, General Counsel, ICI, and Dan Waters, Managing Director, ICI Global, to David A. Stawick, Secretary, CFTC, dated August 23, 2012.

[8] *Consultation Paper*, supra note 2, at 14.

For all of these reasons, ICI urges the CFTC to avoid being an outlier among regulators internationally in not requiring equivalent two-way margin obligations for both counterparties to a swap transaction. We believe the objectives of the global regulators to reduce systemic risk and promote central clearing by imposing a two-way margin requirement are in line with Section 731 of the Dodd-Frank Act, which requires that margin requirements offset the greater risk to the covered swap entity and financial system arising from the use of swaps that are not cleared.

II. Use of Thresholds

In proposing a two-way margin requirement, the BCBS and IOSCO stated that it may be desirable to apply different thresholds for initial margin (the amount under which a firm would have the option of not collecting initial margin) to different types of derivatives market participants. As we discussed in detail in the July 2011 ICI Letter, we believe strongly that registered funds should be permitted to use thresholds and not to post margin under certain thresholds. Use of thresholds should not be limited to entities that are subject to capital requirements established by a prudential regulator or a state insurance regulator. As highly regulated, financially sound swap counterparties and in recognition of the stringent securities regulation to which they are subject, the CFTC should permit regulated funds to use an initial margin threshold below which they are not required to post collateral.

III. Calculation of Margin

The Commission proposed that covered swap entities be permitted to calculate margin using several different quantitative portfolio margin models, but not proprietary models. In the July 2011 ICI Letter, we recommended that the CFTC instead adopt a system of calculating initial margin that would permit the counterparty to choose between a covered swap entity's proprietary model and a standardized table that specifies minimum initial margin as a percentage of the notional amount of a swap or security-based swap (with percentage ranges assigned to broad asset classes). Our suggested approach is consistent with the proposal by the BCBS and IOSCO, which would permit the required amount of initial margin to be calculated by reference either to a quantitative portfolio margin model (subject to certain conditions) or a standardized margin schedule based on a percentage of notional exposure by asset class. Providing the counterparty with the option between a quantitative portfolio margin model or a standardized table or schedule would promote greater uniformity and transparency for market participants and be easier to administer operationally than the approach proposed by the Commission.

IV. Forms of Margin

The CFTC's proposal would limit the categories of eligible collateral to cash, U.S. Treasuries and, for initial margin only, certain government securities. Consistent with recommendations of the international regulators and our recommendations in the July 2011 ICI Letter, the CFTC should

expand the proposed list of eligible collateral to allow counterparties to a swap transaction the flexibility to agree upon the appropriate collateral that may be posted for a particular swap.

The BCBS and IOSCO proposed a broader set of eligible collateral, in part, in recognition of the advantages to such an approach (such as minimizing the potential liquidity impact of the margin requirements). The Consultation Paper provides that the assets collected as collateral should be highly liquid. They should be able to hold their value in a time of financial stress to ensure that the assets can be liquidated in a reasonable amount of time to generate proceeds that could sufficiently protect the collecting entities from losses in the event of a counterparty default.[9] The Consultation Paper includes a non-exhaustive list of eligible collateral as examples: cash; high quality government and central bank securities; high quality corporate bonds; high quality covered bonds; equities included in major stock indices; and gold.[10]

For registered funds, restricting collateral to a narrow range of permitted assets may force funds to hold for collateral purposes lower-yielding securities at an increased cost to fund shareholders and/or assets that do not correspond to the fund's investment objectives. Moreover, forcing funds to post a limited range of assets for collateral could result in making it difficult for funds to be compared to an appropriate benchmark. For example, neither a municipal fund nor an equity fund generally would hold U.S. Treasuries other than for collateral purposes. Doing so may result in the performance of such funds lagging behind their relevant benchmark. Moreover, the restrictive collateral requirement may cause a fund, for collateral purposes, to hold more cash than necessary.

V. Daily Valuation of Margin

The CFTC requested comment on whether it should be more specific with regard to how frequently margin assets should be valued. ICI recommends that the Commission require at least daily valuation of margin as suggested by the BCBS and IOSCO. Daily valuation of margin will help ensure that accurate exposures are being covered. Without frequent valuation of margin, counterparties will not be able to calibrate the amount of margin to the value of the swap positions. Therefore, we recommend that the CFTC require the daily valuation of margin assets.

* * *

---

[9] This approach is similar to that taken by the staff of the Securities and Exchange Commission with respect to the types of assets that may be used by a fund to "cover" its obligations under certain transactions that may be deemed to create leverage. *See Merrill Lynch Asset Management*, SEC No-Action Letter (pub. avail. July 2, 1996), *available at* http://www.sec.gov/divisions/investment/imseniorsecurities/merrilllynch070196.pdf

[10] This list is similar to the list of highly-liquid collateral provided in the European Market Infrastructure Regulation for margin purposes.

We appreciate the opportunity to supplement our comments to the Commission's proposal on margin requirements for uncleared swaps in light of the work by international regulators in this area. We believe that the CFTC should incorporate the recommendations elaborated above and adapt its final rules in line with the views of international regulators. If you have any questions on our comment letter, please feel free to contact me at (202) 326-5815, Sarah Bessin at (202) 326-5835, or Jennifer Choi at (202) 326-5876.

Sincerely,

/s/

Karrie McMillan
General Counsel

cc: The Honorable Gary Gensler
The Honorable Jill E. Sommers
The Honorable Bart Chilton
The Honorable Scott D. O' Malia
The Honorable Mark Wetjen

Gary K. Van Meter, Farm Credit Administration
Alfred M. Pollard, Federal Housing Financing Agency
Mary J. Miller, U.S. Department of the Treasury
Robert E. Feldman, Federal Deposit Insurance Corporation
Jennifer J. Johnson, Federal Reserve Board