MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

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Via Electronic Submission: http://comments.cftc.gov

Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Re: Proposed Rule; Advanced Notice of Proposed Rulemaking Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants RIN 3038-AC97

Dear Mr. Kirkpatrick:

Managed Funds Association ("**MFA**")[1] appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the "**CFTC**") on its proposed rule and advance notice of proposed rulemaking on "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants" (the "**Proposed Rules**")[2] related to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").[3] MFA strongly supports measures to reduce risk in the swaps markets and incentivize central clearing of clearable swaps, including the imposition of appropriate risk-based margin requirements. In this spirit, we are providing comments on the Proposed Rules that we believe will assist the CFTC in promulgating final rules that balance the need to minimize risk with the need to maintain liquidity in the uncleared swaps markets.

[1] Managed Funds Association (MFA) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent and fair capital markets. MFA, based in Washington, DC, is an advocacy, education and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and many other regions where MFA members are market participants.

[2] CFTC Proposed Rule and Advance Notice of Proposed Rulemaking on "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants", 79 Fed. Reg. 59898 (Oct. 3, 2014) (the "**Proposing Release**").

[3] Pub. L. 111-203, 124 Stat. 1376 (2010).

I. Margin Requirements Affect Buy-Side Financial Firms

The Proposed Rules place obligations on registered swap dealers ("**SDs**") and major swap participants ("**MSPs**") for which there is no prudential regulator,[4] referred to in the Proposing Release as "covered swap entities" ("**CSEs**"). CSEs would be required to comply with the minimum requirements for the calculation, mandatory bilateral exchange, and maintenance of initial margin ("**IM**") and variation margin ("**VM**") for uncleared swaps ("**Covered Swaps**").[5] Because financial end users[6] that enter into Covered Swaps with CSEs for hedging and investing purposes will, as the counterparties to the CSEs, also be subject to the minimum margin requirements, the Proposed Rules will materially affect such buy-side financial firms. As discussed in this letter and in MFA's prior comment letter in response to the CFTC's previously proposed margin rules[7], MFA urges the CFTC to evaluate and consider the aggregate effects of its Proposed Rules on financial end users and, more broadly, the uncleared swaps markets.

MFA strongly supported the adoption of an internationally uniform set of margin requirements to facilitate orderly collateral management practices and to minimize regulatory arbitrage as provided by the Basel Committee for Banking Supervision and the International Organization of Securities Commissions on September 2, 2013 (the "**Basel-IOSCO Standards**").[8] MFA appreciates that the CFTC's margin requirements in the Proposed Rules closely align with the Basel-IOSCO Standards. In particular, MFA supports the decision of the CFTC to require CSEs to post and collect VM, which both is consistent with the Basel-IOSCO Standards and reinforces the current market "best practice".

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[4] A prudential regulator means any of the following five agencies: the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Farm Credit Administration, and the Federal Housing Finance Agency (collectively referred to herein as the "**Prudential Regulators**").

[5] The term "uncleared swap" is defined in the Proposed Rules as "a swap that is not cleared by a registered derivatives clearing organization, or by a clearing organization that has received a no-action letter or other exemptive relief from the Commission permitting it to clear certain swaps for U.S. persons without being registered as a derivatives clearing organization." *See* Proposed Rules at 59928, Section 23.151.

[6] The Proposed Rules define the term "financial end user" to mean any counterparty that is not a swap entity (*i.e.*, an SD or MSP) and that is a bank holding company or other specified entity regulated entity, a private fund as defined in section 202(a) of the Investment Advisers Act of 1940, an investment company, a commodity pool, a commodity pool operator, or a commodity trading advisor, or a futures commission merchant. *See* Proposed Rules at 59927, Section 23.151 for the specific definition.

[7] *See* MFA's comments on the CFTC's Notice of Proposed Rulemaking on "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants", 76 Fed. 23732 (Apr. 28, 2011), filed with the CFTC on July 11, 2011, available at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47780. Please note that MFA has also recently submitted a comment letter to the Prudential Regulators in response to their proposed rulemaking on "Margin and Capital Requirements for Covered Swap Entities", 79 Fed. Reg. 57348 (Sept. 24, 2014), filed with the Prudential Regulators on November 24, 2014, available at: https://www.managedfunds.org/wp-content/uploads/2014/11/MFA-Letter-Prudential-Regulators-Margin-Proposal1.pdf (the "**MFA PR Margin Letter**").

[8] Available at: http://www.bis.org/publ/bcbs261.pdf.

The Proposed Rules reflect certain differences from the Basel-IOSCO Standards, however, which we believe will have disproportionate and often adverse effects on financial end users. We will discuss those differences in more detail below. Our related requests to address these differences are aimed at ensuring that the final margin requirements allow for a well-functioning market for uncleared swaps between CSEs and financial end users. Even after central clearing of swaps has become commonplace, market participants will also need a market for uncleared swaps to meet their trading needs, including entering into customized transactions. Customized swap transactions are traded on a limited basis and contain non-standardized terms, and thus, are generally not amenable to clearing. As such, it is not viable to clear such transactions, and market participants should not be penalized for managing risk with transactions that cannot be cleared.

We recognize that regulators expect margin regulation of uncleared swaps to broadly reduce unsecured counterparty credit risk and incentivize clearing.[9] We fully support these broad objectives and believe the Proposed Rules have the potential to bring consistency and transparency to margin practices in the uncleared derivatives markets. However, we believe that the Proposed Rules, while facilitating the achievement of such broad objectives and encouraging market participants to clear their swaps, must also appropriately address the particular risks posed by the relevant uncleared swap transaction. We are very concerned that if the final margin requirements do not properly reflect such risks and become too costly and punitive, the markets for uncleared swaps will become destabilized and lose their economic viability, thereby compromising the ability of market participants to manage risk effectively.

II. Comments on Proposed Rules

MFA urges the CFTC to issue final margin requirements that promote a consistent, fair, and stable global market for uncleared swaps that is commercially viable for financial end users. In particular, in this letter, MFA, among other things:

- Supports mandatory bilateral IM exchange, but requests modifications to the proposed thresholds for consistency with the Basel-IOSCO Standards;

- Supports mandatory bilateral VM exchange, but expresses concern with cash-only VM and requests certain additional modifications and clarifications;

- Expresses concern with the retroactivity of the margin requirements on pre-compliance date swaps under the same eligible master netting agreement ("**EMNA**") with post-compliance date swaps;

- Requests that the standardized IM table be more granular;

[9] According to then Secretary of the U.S. Treasury, Timothy Geithner, "imposing appropriate margin requirements on non-cleared swaps will … help create incentives for market participants to use centralized clearing and standardized contracts." Timothy Geithner, Secretary, U.S. Dept. of the Treasury, Address to the International Monetary Conference (Jun. 6, 2011). Available at: http://www.treasury.gov/press-center/press-releases/Pages/tg1202.aspx.

- Urges the CFTC to require that models used to calculate IM requirements be transparent, replicable, and predictable;

- Requests that the CFTC authorize CSEs to use IM models for calculating IM for uncleared swaps that may account for offsetting risk exposures from other products within the same risk category/asset class in a portfolio, though only to the extent that such correlated products are subject to the same EMNA;

- Seeks clarity that the requirements related to daily collection and calculation of margin amounts do not require calculations or collections to take place intraday or more than once a day;

- Encourages the CFTC to retain the segregation requirements set forth in its final segregation rules for uncleared swaps.[10] In particular, MFA requests that the CFTC modify the Proposed Rules to allow CSE customers to choose the level of protection for their IM that they deem appropriate by retaining CSE customers' right to elect individual segregation but also giving CSE customers the option to opt out of individual segregation;

- Requests that the CFTC work with the Prudential Regulators and the Securities and Exchange Commission ("**SEC**") to develop a single, harmonized, U.S. approach to cross-border derivatives regulation. In particular, MFA requests that the CFTC adopt the Cross-Border Guidance Approach;[11] provided that the CFTC also: (i) modifies the Final Cross-Border Guidance definition of "U.S. person" to exclude collective investment vehicles ("**Funds**") that are "U.S. persons" solely by virtue of having majority "U.S. person" ownership; and (ii) modifies its approach to substituted compliance in the Final Cross-Border Guidance[12] to allow substituted compliance for trades between "U.S. persons" and non-U.S. persons at such parties' mutual agreement; and

- Urges the CFTC to coordinate with its U.S. and non-U.S. regulatory counterparts (in particular, regulators in the European Union ("**EU**")) prior to implementation of the final margin rules to ensure that: (i) the details of how substituted compliance will work in practice are resolved; and (ii) regulatory conflicts are resolved that substituted compliance alone will not address.

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[10] *See* CFTC final rule on "Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy", 78 Fed. Reg. 66621 (Nov. 6, 2013), available at: http://www.gpo.gov/fdsys/pkg/FR-2013-11-06/pdf/2013-26479.pdf ("**Final 2013 Segregation Rules**").

[11] *See* Proposing Release at 59916, describing this approach. *See also* CFTC final "Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations", 78 Fed. Reg. 45292 (July 26, 2013), available at: http://www.gpo.gov/fdsys/pkg/FR-2013-07-26/pdf/2013-17958.pdf ("**Final Cross-Border Guidance**").

[12] MFA also urges the CFTC to encourage the SEC and the Prudential Regulators to adopt the Cross-Border Guidance Approach with MFA's requested modifications as well.

A. Mandatory Bilateral IM Exchange

MFA supports, as a general matter, the proposed mandatory bilateral exchange of IM, as it represents a change to conform to the Basel-IOSCO Standards.[13] While we support this change to achieve the benefits of an internationally uniform set of margin requirements, we are concerned that the CFTC has introduced potentially significant discrepancies in its proposed IM requirements. In our view, introducing such discrepancies will undermine the objectives of the Basel-IOSCO Standards and the benefits of international uniformity. Moreover, these discrepancies will disadvantage financial end users in U.S. swaps markets in relation to non-U.S. markets that more closely conform to the Basel-IOSCO Standards. In particular, we are concerned that the proposed definition of "affiliate"[14] and the related proposed definition of "control"[15] could lead to affiliated treatment of funds in a firm's structure for purposes of applying the IM thresholds. We are also concerned that the Proposed Rules have inappropriately lowered the minimum threshold of trading activity in uncleared swaps that will subject a financial end user's Covered Swaps with CSEs to the proposed IM requirements. Accordingly, we request that the CFTC make certain suggested modifications and clarifications below to eliminate such discrepancies.

1. Ensure Fund-Level Application of IM Thresholds

We are concerned that the CFTC's "control" definition in the Proposed Rules would not allow separate treatment of investment funds in the same manner as described in the Basel-IOSCO Standards. Accordingly, we respectfully request that the CFTC use the same criteria in the Basel-IOSCO Standards, rather than a control definition, as the basis for determining fund-level application of IM thresholds.

The Basel-IOSCO Standards treat investment funds separately for purposes of applying the IM threshold as long as the funds are distinct legal entities that are not collateralized by or otherwise guaranteed or supported by other investment funds or the investment adviser in the event of fund insolvency or bankruptcy.[16] We believe the Proposed Rules introduce new criteria based on affiliate status and the related definition of control to determine whether a fund

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13 The Basel-IOSCO Standards require all covered entities to exchange IM with a threshold not to exceed €50 million. The IM threshold generally applies on a consolidated group basis, except with respect to investment funds meeting certain criteria that are not based on affiliate status or indicia of control. *See* Basel-IOSCO Standards at 9, footnote 10.

14 The Proposed Rules define "affiliate" to mean "any company that controls, is controlled by, or is under common control with another company". *See* Proposed Rules at 59926, Section 23.151.

15 The Proposed Rules define "control" of another company to mean: (i) ownership, control, or power to vote 25% or more of a class of voting securities of the company, directly or indirectly or acting through one or more other persons; (ii) ownership or control of 25% or more of the total equity of the company, directly or indirectly or acting through one or more other persons; or (iii) control in any manner of the election of a majority of the directors or trustees of the company. *See* Proposed Rules at 59926, Section 23.151.

16 *See supra* note 13.

counterparty should be treated as a distinct legal entity for purposes of applying the "initial margin threshold amount".[17]

In particular, the proposed 25% threshold of control in the proposed control definition is problematic for asset managers, including many MFA members, because it is a relatively low threshold that, in practice, does not translate into sufficient control to require transparency with respect to swaps exposure, for example. We strongly believe that it will be difficult, if not impossible, for funds and commodity pools in multi-tier structures to ascertain who their affiliates are under the proposed control definition. Many private funds are structured as master-feeder or other similar multi-tier structures. For these structures, the outside investors invest directly at the feeder or sub-fund level, and that fund, in turn, invests substantially all of its assets into a master or umbrella fund. Managing the application of the IM threshold to funds in typical fund structures would require an analysis of the control criteria both upstream, from an individual sub-fund (and potentially its investors) to a master fund, as well as downstream, from a master fund to the sub-fund (and potentially its investors and other sub-funds under the master fund). This analysis introduces unnecessary complexity and has the potential to create affiliate relationships for investment funds that are unexpected or unknown. For example, if a large pension fund invests in a fund, and as a result of such investment, the pension fund has the ability to vote 25% of a class of shares in the fund, then any other investments that the pension plan has which are at the same 25% or higher level will be "affiliates" of the fund. If a fund is unable to ascertain who its affiliates are because its investors' other investments outside of the fund may implicate unknown affiliates, then the fund will not be able to accurately determine whether or not it is subject to the IM requirements.

Additionally, in the fund context, it is also common to use limited partnerships that have a general partner, which represents the sponsor/managing entity. The general partner normally controls 100% of certain day-to-day voting rights, and limited partners (which generally represent the investors), normally also control 100% of certain fundamental voting rights that are not held by the general partner. In this example, prong (i) of the proposed control definition[18] would count the general partner as controlling for "affiliate" purposes, and each investor who has a 25% interest, directly or indirectly, or through a voting proxy or other similar arrangement with other investors, would also be controlling for "affiliate" purposes.

Generally, conducting risk and exposure assessments at the level of a family of funds managed by the same manager is not instructive because legally distinct funds, even when managed by the same single manager, typically have different investors and often engage in entirely distinct trading activities in different assets and markets. Any losses at one fund are borne by the investors in that fund and do not subject other funds managed by the same manager to losses. Fund managers typically do not guarantee the performance or financial obligations of the funds they manage, and do not otherwise create counterparty exposure with respect to the

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[17] The Proposed Rules define "initial margin threshold amount" as "an aggregate credit exposure of $65 million resulting from all uncleared swaps and uncleared security-based swaps between a covered swap entity and its affiliates, and a covered counterparty and its affiliates." *See* Proposed Rules at 59927, Section 23.151.

[18] *See supra* note 15.

trading activities of their funds or other clients. Further, unlike related entities in holding company or other similar structures, the different funds managed by a common manager do not typically have the kind of intercompany transactions that can create interconnectedness and tie the risks and exposures associated with one company to other companies in the same ownership structure. We strongly believe that the appropriate risk-based analysis for applying IM thresholds to investment funds is the level of the individual fund.

For these reasons, MFA respectfully requests that the final margin rules should use the same criteria as the Basel-IOSCO Standards for fund-level application of the $65 million IM threshold amount, rather than using control criteria that will likely implicate a number of entities that "control" a fund. We believe the same criteria for separate treatment of funds under the Basel-IOSCO Standards should also apply in determining whether a fund meets the requisite threshold of "material swaps exposure"[19] for a financial end user to become subject to the CFTC's IM requirements. We discuss our related concerns with the $3 billion threshold in the material swaps exposure test below. Additionally, we believe the same criteria for separate treatment of funds under the Basel-IOSCO Standards should apply, in turn, to the phase-in thresholds of average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange ("**FX**") forwards, and FX swaps with respect to a fund counterparty with material swaps exposure.[20]

For additional clarity to ensure fund-level application of these IM thresholds (*i.e.*, the $65 million IM threshold cap; the material swaps exposure threshold; and the phase-in threshold for compliance dates), we suggest that the definitions of "affiliate" and "control" in the final margin rules should expressly exclude an investment manager of a fund or an investor in a fund, provided that the individual fund counterparty meets the same criteria in the Basel-IOSCO Standards for separate treatment as a distinct legal entity.

2. Increase $3 Billion Material Swaps Exposure

The Proposed Rules would require CSEs to collect and post IM only with financial end user counterparties that have a "material swaps exposure", which is a defined term that means at least $3 billion in gross notional exposure.[21] This $3 billion threshold is substantially lower than the €8 billion threshold (which is approximately $11 billion at current exchange rates) in the Basel-IOSCO Standards.[22] MFA believes the CFTC should conform to the U.S. dollar equivalent of the €8 billion threshold of gross notional outstanding amount in the Basel-IOSCO

[19] The Proposed Rules define "material swaps exposure" for an entity as follows: "an entity and its affiliates have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps with all counterparties for June, July and August of the previous calendar year that exceeds $3 billion, where such amount is calculated only for business days." *See* Proposed Rules at 59927, Section 23.151.

[20] Proposed Rules at 59932, Section 23.159.

[21] *See supra* note 19.

[22] *See* Basel-IOSCO Standards at 9, paragraph 2.5 (setting a minimum level of non-centrally cleared derivatives activity at €8 billion of gross notional outstanding amount as necessary for covered entities to be subject to initial margin requirements).

Standards (which is approximately $11 billion at current exchange rates) as the minimum threshold level of trading activity in uncleared swaps, uncleared security-based swaps, FX forwards, and FX swaps for the IM requirements to apply. We acknowledge that the CFTC and the Prudential Regulators lowered the minimum threshold based on their analyses of sample cleared swaps data since the publication of the Basel-IOSCO Standards.[23] However, we are very concerned that the lower threshold of $3 billion introduces a substantial discrepancy. We believe this discrepancy will competitively disadvantage financial end users in U.S. swaps markets in relation to non-U.S. markets that do conform to the €8 billion threshold in the Basel-IOSCO Standards, and create other competitive distortions through selective trading relationships to avoid such disadvantageous discrepancies. Therefore, we respectfully recommend that the CFTC's final margin rules should conform to the agreed threshold in the Basel-IOSCO Standards.[24] As data collection on uncleared swaps develops on an international level, we suggest that the CFTC should coordinate with other U.S. and non-U.S. regulators to assess such data and determine whether or not a uniform adjustment of the €8 billion threshold is warranted.

B. Mandatory Bilateral Exchange of Variation Margin

MFA applauds the CFTC for making a conforming change to the Basel-IOSCO Standards by requiring CSEs both to post and to collect VM for Covered Swaps with financial end users. We believe this requirement will reinforce the current market "best practice" for collateral management.[25] To support this practice, most market participants already have efficient contractual arrangements and extensive operational infrastructure for bilateral VM exchange. Thus, the CFTC's proposal would not be imposing a material incremental burden or a change from "best practice" for CSEs by requiring CSEs to deliver VM to their counterparties. In addition, requiring CSEs to post VM on uncleared swaps would create symmetry between the cleared and uncleared swaps markets.

While we strongly support mandatory bilateral exchange of VM, we have several specific concerns with the proposed VM requirements and their disparate impact on financial end user counterparties to Covered Swaps with CSEs. To address our concerns, we request and explain below certain modifications and clarifications for the final margin rules.

1. Cash-Only VM

The Proposed Rules would limit eligible collateral for VM to cash only, either denominated in U.S. dollars or the currency in which payment obligations under the swap are

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23 *See* Proposing Release at 59905 (explaining that their analyses of actual initial margin requirements for a sample of cleared swaps indicates that there are a "significant number of cases in which a financial end user counterparty would have a material swaps exposure level below $11 billion but would have a swap portfolio with an initial margin collection amount that significantly exceeds the proposed permitted initial margin threshold amount of $65 million", thus justifying the lower threshold for the uncleared market).

24 MFA made the same request to the Prudential Regulators. *See* MFA PR Margin Letter at 8.

25 MFA understands that one-sided variation margin arrangements are an exception to established market practices for collateral arrangements.

required to be settled.[26] While MFA understands the CFTC's objectives of simplifying and standardizing the exchange of VM,[27] MFA believes that those objectives are fully consistent with also permitting U.S. Treasury securities to be posted as eligible collateral for VM. Posting U.S. Treasuries as VM is a common practice in the over-the-counter ("**OTC**") derivatives markets and, from a risk perspective, U.S. dollar collateral and U.S. Treasury collateral (subject to the appropriate haircuts to address possible changes in risk-free rates) are generally seen as fungible. This risk-based fungibility is evidenced by the fact that the applicable discount rate for OTC derivatives positions margined by U.S. Treasuries is the same as it is for OTC derivatives margined by U.S. dollars – the U.S. overnight indexed swap (OIS) rate.

The proposed cash-only VM requirement would introduce another substantial discrepancy with the Basel-IOSCO Standards that would competitively disadvantage financial end users in the U.S. swaps markets in relation to non-U.S. markets, which generally provide more flexibility as to the permitted types of eligible collateral to meet VM requirements. Additionally, the exclusion of U.S. Treasuries from the list of eligible VM would effectively relegate many of the financial end users that currently post U.S. Treasuries as VM to the U.S. Treasury repurchase agreement ("**repo**") markets. The U.S. Treasury repo markets have become an increasingly illiquid and, thus, an increasingly unreliable source of cash funding – particularly for term funding. By effectively requiring financial end users, who frequently hold OTC derivatives with terms greater than one month, to transform their U.S. Treasury collateral into U.S. dollars in the repo markets, the CFTC would be setting up, even for those firms that hold and could readily post on a long-term basis U.S. Treasury collateral, a potential term mismatch between longer-term derivatives and shorter-term available funding.[28] Such a mismatch could, due to repo market illiquidity arising from pressures on bank balance sheets, require financial end users to sell prematurely their OTC derivatives positions because of an inability to raise cash against their U.S. Treasuries at economic rates. Such required premature selling is precisely the sort of dislocation that the Dodd-Frank Act intended to avoid. In this regard, we note that Section 4s(e)(3)(C) of the Dodd-Frank Act provides that the CFTC and the Prudential Regulators "shall" permit the use of noncash collateral that the regulators determine to be consistent with (i) preserving the financial integrity of markets trading swaps and (ii) preserving the stability of the U.S. financial system.[29] Authorizing U.S. Treasuries as eligible collateral for VM would be consistent with both these goals.

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[26] *See* Proposed Rules at 59932, Section 23.156(b).

[27] *See* Proposing Release at 59913 (explaining that cash-only VM is "designed to reinforce the concept that VM is paid and to reduce the potential for disputes to arise over the value of assets being used to meet the margin requirement"; also noting that the International Swaps and Derivatives Association, Inc. ("**ISDA**") Standard Credit Support Annex ("**SCSA**") provides for the sole use of cash as eligible collateral for VM). With respect to the ISDA SCSA, MFA notes that it is not widely adopted by market participants.

[28] In this connection, we also acknowledge that the CFTC would authorize the use of collateral transformation agreements as a means to obtain cash to meet margin requirements, which would not diminish our concerns. *See* Proposing Release at 59913 (permitting counterparties to pledge assets that do not qualify as eligible collateral with a lender in a separate arrangement, such as a collateral transformation agreement, and then using the cash or other eligible collateral received from that separate arrangement to meet the minimum margin requirements).

[29] *See* Proposing Release at 59899.

2. Frequency of VM Collection

Under the Proposed Rules, a CSE must collect or pay VM with financial end user counterparties each business day until an uncleared swap is terminated or expired.[30] MFA seeks clarification that VM collection and calculation would only occur once daily based on the prior day's closing price. Potential intraday VM collection and calculation would introduce significant operational complexity and require a build-out of many of our members' existing collateral management systems. Since we do not believe that the CFTC intends such intraday collection of VM, we would appreciate clarity in this regard.

3. Retroactivity for Netting Arrangements

To obtain the benefits of portfolio netting of VM, CSEs would have to apply the proposed VM requirements to uncleared swaps that were entered into prior to the applicable compliance date under the same EMNA as new Covered Swaps.[31] The justification for this retroactive application is unclear, as it would cause the partial frustration of the economic terms of pre-compliance date trades. MFA requests authorized grandfathering of pre-compliance date trades entered into under the same EMNA with new Covered Swaps, which would preserve the ability to net the margin for the two pools of trades (*e.g.*, if the margin for one pool is 10 and the other is -10 (determined separately), then margin posted is $0). Otherwise, counterparties will need separate EMNAs (typically documented with ISDA Master Agreements and Credit Support Annexes) for their pre-compliance date trades and their Covered Swaps that become subject to the new margin requirements. We are concerned that this outcome entails resulting documentation burdens and costs. In addition, it would limit a counterparty's ability to net all uncleared swap trades with a particular CSE upon a potential default.

MFA appreciates that the Proposed Rules clearly permit netting of VM under an EMNA and, to a more limited extent, netting of IM under an EMNA using a model to calculate required IM amounts.[32] Effective netting agreements lower systemic risk by reducing both the aggregate requirement to deliver margin and trading costs for market participants. In addition, by allowing counterparties to net margin when they have an enforceable netting agreement in place, the Proposed Rules allow swap market participants to continue current "best practices" with regard to the collateralization of uncleared swaps.

However, the Proposed Rules limit the efficacy of netting as a risk reduction tool by requiring CSEs to establish new EMNAs for pre-compliance date trades to avoid the retroactive application of the new margin requirements to such trades executed under the same EMNA with

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[30] *See* Proposed Rules at 59928, Section 23.153(b).

[31] *See* Proposed Rules at 59928, Section 23.153(c).

[32] *See id.* (for variation margin) and Proposed Rules at 59929, Sections 23.154(b)(2) and 23.154(b)(3)(v) (for initial margin models).

new Covered Swaps. Separate EMNAs would also undermine the critical recognition of risk offsets within a portfolio that would be permitted in the Proposed Rules for calculating IM.[33]

If the retroactive application of the CFTC's new margin rules is a necessary condition for netting VM and IM for uncleared swaps, then the CFTC's final rules should explicitly require the consent of a CSE's financial end user counterparty should the CSE wish to net margin at the cost of retroactive application of the CFTC's margin rules. A consent right would give financial end users an important option to assess the impact of retroactive application of the new margin requirements on their portfolios. Without a consent right for financial end user counterparties, the Proposed Rules will empower CSEs with the ability to make unilateral decisions that could materially and adversely affect buy-side financial firms and their collateral management practices.[34]

C. Calculation of Initial Margin

The CFTC should promote margin practices that are fair and understood by all market participants. IM should be determined in a transparent way that allows both parties to an uncleared swap to determine independently the applicable IM collection amounts. The ability of financial end user counterparties, as customers of CSEs, to replicate IM models enables them to anticipate how margin might change over the life of the swap and how much they should hold in reserve. Such replicability is fundamental to conducting capital planning and underlies a customer's ability or inability to devote its resources strategically to other investments or obligations.

The Proposed Rules contemplate the use of approved IM models or standardized amounts using the table in the Proposed Rules.[35] MFA strongly supports the choice that the Proposed Rules would provide counterparties for using either calculation method, which is consistent with the Basel-IOSCO Standards. Within a trading relationship between a CSE and a financial end user, we believe that the counterparties should be authorized to vary the choice by product type. We discuss below our specific concerns with certain proposals for calculating IM, and explain our related requests for changes to ensure that the final margin rules promote fairness and transparency, and address particular product risks.

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[33] *See* Proposing Release at 59912 (noting that the proposed standardized initial margin requirement allows for the recognition of risk offsets through the use of the net-to-gross ratio in cases where a portfolio of uncleared swaps is executed under an EMNA; the net-to-gross ratio must be applied only to swaps subject to the same EMNA; the calculation is performed across transactions in disparate asset classes within a single EMNA); *see also* Proposed Rules at 59929, Section 23.154(b)(3)(v) (allowing initial margin models to reflect offsetting exposures for uncleared swaps that are governed by the same EMNA by incorporating empirical correlations within broad risk categories).

[34] Typically, counterparties will negotiate heavily for unilateral legal rights with respect to trading contracts. Unlike a negotiation where a party might grant a concession in return for benefit, if the CFTC's margin rules require retroactive application of margin rules when a CSE elects to net margin under an EMNA, CSEs will have gained a unilateral right without their counterparties receiving any consideration for such right.

[35] *See* Proposed Rules at 59929, Section 23.154; *see also* Proposed Rules at 59930, Section 23.154(c)(1) (standardized initial margin schedule).

1. More Granularity Needed for Standardized Table

As proposed, the standardized table in the Proposed Rules lacks sufficient granularity by product type within asset classes. While we appreciate the simplicity and predictability provided by the standardized approach to calculating IM amounts, we are concerned that it does not properly account for the diversity of products within asset classes and the different risk characteristics of such products. For example, the proposed table has a single category for equity swaps, which would place a long out-of-the-money call option on a highly liquid equity security in the same category as a long total return swap on an illiquid security. In this example, the equity option and the total return swap would each be subject to an initial margin requirement of at least 15% of notional exposure, quite likely an inappropriately high initial margin requirement for the out-of-the-money equity option, but potentially a more appropriate initial margin requirement for the total return swap. As a result, we request that the CFTC revise the standardized table to properly account for the variety of uncleared swaps by increasing the number of subcategories within each asset class and by modifying the table to account for delta weighting.

To assist the CFTC in modifying the standardized table to provide more granularity by product type in the final margin rules, we have included as Annex A to this letter a proposed sample of a standardized IM table grid.[36] The sample standardized IM grid annexed hereto is not an exhaustive revision and does not propose to address all concerns relating to the proposed standardized table. Rather, it seeks to enhance the usefulness and reliability of the standardized method for calculating IM for uncleared derivatives with embedded optionality, as described below.

More specifically, where the buyer and seller have asymmetric risk/reward profiles under products with embedded optionality, such as credit default swaps ("**CDS**"), the margin requirements for those products should be more granular to avoid over-posting or under-posting of IM. More granularity would be consistent with existing market practice that reflects differences in the risk profile between the party acquiring protection from the debtor's default under the terms of a CDS, for example, and the party providing protection. In the case of a CDS transaction, the risk profile of the protection buyer is lower than the risk profile of the seller given the seller's contingent payout obligation if a credit event is triggered. The prospective default of a buyer therefore presents a lower systemic risk than the prospective default of a seller, and a buyer should accordingly be subject to lower IM requirements. For example, the buyer of a CDS should be subject to an IM requirement which is a lower proportion of the notional exposure compared to the seller, while the seller should be subject to an IM requirement that is a higher proportion of the notional exposure. MFA therefore recommends that, where appropriate, the standardized IM table in the final margin rules should differentiate between the risk profiles of parties buying protection under a derivative contract (lower risk) and parties selling such protection (higher risk).

[36] MFA also included the same sample initial margin grid or schedule to the Basel-IOSCO Working Group in response to its first Consultative Document, because the proposed initial margin schedule in Appendix A thereto similarly lacked sufficient specificity. *See infra* note 38.

2. Required IM Model Transparency

Allowing CSEs to use approved proprietary models to determine IM requirements introduces a potential impediment to transparency, because the Proposed Rules do not require CSEs to disclose the functionality and parameters of the IM model to their financial end user counterparties. MFA strongly believes that it is important that the CFTC require the CSE's IM model to be transparent, replicable, and predictable and require the CSE to disclose the model (including assumptions and calculation methodologies) to its counterparty. Transparency of the IM model directly correlates to the counterparty's ability to replicate any determination of the IM amount, which is critical to a party's capacity to model for, anticipate, and adjust to changes in its obligations. Such transparency also ensures that the IM model will be objective (*i.e.*, arrive at the same "base" IM amount for identical contracts, as computed without regard to the counterparty's identity or creditworthiness), and allow a party to identify clearly any additional IM amounts that the parties have agreed may be applied to reflect the relative creditworthiness of the parties. Therefore, MFA encourages the CFTC to clarify in the final margin rules that the CSE must provide sufficient information about its approved IM model to its counterparty to ensure that: (1) there are no variations from a baseline model on the IM amount required by the party for identical contracts; and (2) any additional IM that the counterparty must post to reflect its relative creditworthiness is identifiable.

In the absence of transparent, replicable, and predictable IM models, the potential for material and frequent disputes between parties increases. In addition, without such transparency, replicability, and predictability, a counterparty will need to hold excess assets in reserve in case it needs to post such assets as collateral to account for an unanticipated IM change. Reserving such excess collateral is an inefficient use of the counterparty's assets, but is necessary because, if the counterparty does not hold such excess assets, an unanticipated IM change could result in such counterparty's default as it may not have adequate collateral available to it in order to satisfy the unexpected demand for further IM.

Therefore, to prevent such disputes and margin inefficiencies, MFA requests that the CFTC require transparency as to the functionality and parameters of the IM model used, as discussed above, and ensure that it (and any credit-based adjustment that may be agreed by the parties) is replicable and predictable to prevent such undesirable outcomes.

3. Risk Offsets and Portfolio Margining under IM Models

MFA strongly agrees with the proposal that quantitative IM models may recognize offsetting risk exposures within but not across broad risk categories or asset classes of uncleared swaps or a netting set of uncleared swaps covered by the same EMNA.[37] Within a given risk category/asset class (*e.g.*, interest rate), market participants have EMNAs that cover different products within the same risk category/asset class. For example, in the interest rate asset class, the EMNA can cover futures, cleared swaps, uncleared swaps, Treasury repo, *etc.* In the final margin rules, we respectfully urge the CFTC not to overlook or to undermine EMNAs that

[37] *See* Proposed Rules at 59929, Section 23.154(b)(3)(v).

include multiple economically correlated and offsetting products within a given asset class. We request that the CFTC authorize CSEs to use IM models for calculating IM for uncleared swaps that may account for offsetting risk exposures from other products within the same risk category/asset class in a portfolio, but only to the extent that such correlated products are subject to the same EMNA. We thus respectfully urge the CFTC to include in its final margin rules a specific statement that IM models may account for risk offsets across cleared and uncleared derivatives as well as across correlated non-derivative instruments, provided such instruments are within the same risk category/asset class (*i.e.*, FX or interest rate, equity, credit, or commodities) and are covered by the same EMNA. As discussed in prior MFA comment letters,[38] such EMNAs account for risk offsets among different types of financial instruments within asset classes, rather than merely among uncleared derivatives within asset classes. Portfolio margining under such EMNAs is permitted under existing regulatory regimes and is consistent with current market practice in the derivatives markets.

4. Frequency of IM Calculation and Collection

Under either the standardized approach or the IM model approach, the Proposed Rules require calculation of the required IM collection amount on a daily basis.[39] The Proposed Rules also require that a CSE comply with the IM collection and posting requirements with respect to any Covered Swap beginning "[o]n or before the business day after execution of an uncleared swap" until such uncleared swap is terminated or expires.[40] MFA seeks clarification that IM calculation and collection would only occur once daily based on the prior day's pricing. Intraday posting of collateral is burdensome for both parties to a contract and would represent a substantial shift in current market practice.

In addition, MFA believes that the CFTC should modify the timing specified in the Proposed Rules to: (1) focus on the time at which a collateral taker makes a demand for a transfer of collateral; and (2) provide that such transfer must be made promptly following the demand, subject to standard settlement periods and any applicable grace period.

We believe that focusing on the time of demand by the collateral taker is appropriate because settlement periods for certain types of eligible collateral for IM permitted by the

[38] *See* MFA's supplemental comments on the Prudential Regulators' Notice of Proposed Rulemaking on "Margin and Capital Requirements for Covered Swap Entities; Reopening of Comment Period", 77 Fed. Reg. 60057 (Oct. 2, 2012), filed with the Prudential Regulators on November 26, 2012, at 8, available at: https://www.fdic.gov/regulations/laws/federal/2011/11c55ad79-supp.pdf; and *see* MFA's accompanying letter to the Prudential Regulators on portfolio margining arrangements, also filed with the Prudential Regulators on November 26, 2012, available at: https://www.fdic.gov/regulations/laws/federal/2011/11c55ad79-supp-2.pdf. *See also* MFA's comment letters to the Basel-IOSCO Working Group on Margining Requirements for Non-Centrally Cleared Derivatives in response to both Consultative Documents, available at: https://www.managedfunds.org/wp-content/uploads/2012/09/Basel-IOSCO-Margin-Proposals-MFA-Final-Letter.pdf (at 9-11); and https://www.managedfunds.org/wp-content/uploads/2013/03/Basel-IOSCO-Second-Consultative-Document-on-Margin-Requirements-MFA-Final-Letter.pdf (at 7-8).

[39] *See* Proposed Rules at 59929, Section 23.154(a).

[40] *See* Proposed Rules at 59928, Section 23.153(a) and (b).

Proposed Rules are longer than one day. However, we also appreciate that for systemic risk purposes it is important that once a collateral taker makes a demand for transfer of collateral, its counterparty complete such transfer promptly. Therefore, MFA suggests that the CFTC stipulate that once a collateral taker makes a demand for collateral, that its counterparty must complete such transfer of collateral by no later than the expiry of the standard settlement period for the collateral following the date of the relevant demand, subject to any *bona fide* dispute that may exist in respect of the collateral demand[41] and any applicable grace period.

We believe that it is necessary to reference standard settlement periods, rather than prescribing a set period of time, to facilitate use of the wide range of eligible collateral permitted for IM under the Proposed Rules and to provide sufficient time to transfer collateral following a demand.[42] Using standard settlement periods also gives parties the flexibility to account for operational and practical difficulties involved in transferring different types of collateral across time zones. In practice, collateral arrangements often provide for shorter settlement periods than the standard settlement period, but MFA considers that a shorter time period should be a matter of contractual negotiation between counterparties based on the type of collateral permitted under the relevant collateral arrangement and any particular operational efficiencies that may exist between the two counterparties in question.

Lastly, MFA notes that the Proposed Rules would require a CSE to recalculate and collect IM from its counterparty within the required time frame after the parties execute a new uncleared swap.[43] Given that it is possible for two parties to execute multiple contracts during a business day, the requirements in the Proposed Rules suggest that the parties would have to recalculate and collect IM each time (*i.e.*, multiple times during the same business day). Such an approach would be unduly burdensome. Therefore, MFA recommends that the Proposed Rules provide for recalculation or collection of IM no more frequently than once per day.

D. Proposed Rules on Segregation of Mandatory IM

1. Recommend Optional Individual Segregation

MFA recommends that the CFTC retain the segregation requirements set forth in the Final 2013 Segregation Rules. In particular, MFA requests that the CFTC modify the Proposed Rules to retain CSE customer optionality by continuing to give CSE customers the right to have their IM held in individual segregation arrangements, but also allowing CSE customers to opt out of individual segregation if they would like to do so.

In general, MFA supports measures aimed at increasing protections for customer assets posted as collateral for Covered Swaps. Therefore, we strongly supported the Final 2013

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[41] *See* Proposed Rules at 59932, Section 23.158 (requiring CSEs to execute margin documentation with each counterparty that complies with the requirements of Section 23.504, which provides that swap trading documentation must include a valuation dispute resolution process, among other requirements).

[42] *See* Proposed Rules at 59928, Section 23.152.

[43] *Id.*

Segregation Rules,[44] and we similarly appreciate the CFTC's efforts to provide robust protection in the Proposed Rules by requiring that CSEs must hold IM that they collect from their counterparties in individual segregation arrangements at an independent custodian.[45] We believe that this segregation model is robust because it protects the IM posted by a CSE's customers not only from the CSE's default, but also from the default of another customer of that CSE (*i.e.*, fellow customer risk). By requiring customers' posted IM to be held at a custodian that is not an affiliate either of the CSE or its counterparty, MFA believes that the proposed individual segregation arrangements would protect each customer's IM and ensure the stability and integrity of the Covered Swaps market.

However, although MFA is supportive of individual segregation arrangements, we recognize that, for cost or other reasons, certain customers may prefer to have a CSE hold their IM pursuant to other segregation arrangements. For example, some customers may prefer to retain their existing IM segregation arrangements for Covered Swaps, elect omnibus segregation, or affirmatively waive altogether segregation of their IM. We believe that it is important for customers to be able to choose the appropriate level of segregation for their IM based on their desired balance between their IM protection needs and their cost concerns. The CFTC provided such customer optionality in the Final 2013 Segregation Rules,[46] and MFA respectfully requests that the CFTC retain such optionality in their final margin rules with respect to mandatory IM. In particular, we recommend that the CFTC continue to give CSE counterparties the right to elect individual segregation for IM they post on Covered Swaps, while also permitting customers affirmatively to waive or opt out of such individual segregation arrangements if they so choose.[47]

MFA notes that the foregoing approach would ensure that the segregation requirements in the Proposed Rules remain aligned with the Dodd-Frank Act and the corresponding SEC proposed rules, which give the customer the right to require, at its election, that its SD/MSP counterparty hold its assets separate from the SD's/MSP's assets at an independent third-party custodian.[48] It would also align the CFTC segregation requirements with the approach that MFA recommended to the Prudential Regulators.[49] As the CFTC knows, many market participants

[44] *See* MFA letter to the CFTC on its "Notice of Proposed Rulemaking on Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy", dated (Jan. 31, 2011), available at: http://www.managedfunds.org/wp-content/uploads/2011/06/1.31.11-CFTC.Uncleared.Swap-Segregation.Final_.MFA_.Letter.pdf.

[45] *See* Proposed Rules at 59932, Section 23.157(b).

[46] *See* Final 2013 Segregation Rules at 66636-6, Sections 23.701(d) and (f).

[47] For the avoidance of doubt, MFA does not take a position on the requirement in the Proposed Rules that where a CSE posts IM to its counterparty such counterparty must similarly hold that IM at an independent custodian. *See* Proposed Rules at 59932, Section 23.701(a).

[48] *See* Sections 724(c) and 763(d) of the Dodd-Frank Act. *See also* SEC proposed rules on "Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers", 77 Fed. Reg. 70214 (Nov. 23, 2012), available at: http://www.gpo.gov/fdsys/pkg/FR-2012-11-23/pdf/2012-26164.pdf, which the SEC proposed in response to the requirements of the Dodd-Frank Act.

[49] *See* MFA PR Margin Letter, *supra* note 7, at 17-18.

transact with counterparties that are entities regulated by the Prudential Regulators, CSEs regulated by the CFTC, and/or security-based swap dealers or major security-based swap participants regulated by the SEC. Therefore, many market participants will be subject to the segregation rules adopted by each such regulatory authority that govern the entities and uncleared OTC derivative transactions subject to their regulation. Because many market participants will be subject to multiple U.S. segregation regulatory regimes, MFA emphasizes the importance of U.S. regulators ensuring the consistent treatment of IM posted on OTC derivatives transactions across the U.S. derivatives market. Accordingly, we request that the CFTC provide such optional individual segregation to align its approach with that of the SEC and with our recommended approach to the Prudential Regulators.

2. Mandatory Tri-Party Agreements for Individual Segregation Arrangements

The Proposed Rules seem to imply that the individual segregation and custodial arrangements in Section 23.157 must be in the form of a tri-party agreement among the CSE, the counterparty, and the unaffiliated custodian. For the sake of clarity, MFA would appreciate it if the CFTC would explicitly provide in the final margin rules that, where a CSE's counterparty elects individual segregation, the IM that the counterparty posts on Covered Swaps must be held pursuant to a tri-party agreement.

Specifically, Section 23.157 provides a number of criteria that the required custody agreement must meet.[50] For example, if applicable, the custodial agreement must include the posting party's directions as to the ability of the independent custodian to substitute or redirect the investment of any of the posting party's IM.[51] Given that under the Proposed Rules, the posting party could be either the CSE or its counterparty, such substitution and reinvestment directions would only be "legal, valid, binding, and enforceable"[52] under applicable law if the two potential posting parties and the custodian are all parties to the same custodial agreement.

In addition, some of MFA's members have already negotiated tri-party agreements with respect to the IM they post for OTC derivatives transactions. We believe all CSE counterparties should have the right to these protections. If a CSE's counterparties to Covered Swaps are not parties to the custodial agreement (*i.e.*, are not in contractual privity with the unaffiliated custodian), then the CSE essentially maintains exclusive control over its counterparties' IM. This control is what allows potential misuse and misappropriation of customer IM and restricts customers' ability to protect their rights to their IM.

Therefore, because tri-party custodial arrangements protect CSEs' counterparties and are necessary to ensure the legal validity of the proposed requirements in Section 23.157, MFA requests that the CFTC confirm in their final margin rules that the proposed individual segregation arrangements must be governed by tri-party custodial agreements.

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50 *See* Proposed Rules at 59932, Section 23.157(c).

51 *See id*., Section 23.157(c)(2).

52 *Id*., Section 23.157(c)(3).

E. Advanced Notice of Proposed Rulemaking on Cross-Border Application of Margin Requirements

MFA believes that it is important for U.S. regulators to develop a single, harmonized, U.S. approach to cross-border derivatives regulation, including with respect to margin rules for uncleared OTC trades. Therefore, to facilitate such U.S. regulatory harmonization, we urge the CFTC to continue to use the Cross-Border Guidance Approach;[53] provided that the CFTC:

(i) Modifies its definition of "U.S. person" from the Final Cross-Border Guidance to exclude Funds that are "U.S. persons" solely by virtue of having majority "U.S. person" ownership;[54]

(ii) Modifies its substituted compliance approach from the Final Cross-Border Guidance[55] by allowing substituted compliance for CFTC swap rules that apply to trades between "U.S. persons" (using our suggested modification of the definition) and non-U.S. persons at such parties' mutual agreement; and

(iii) Prior to implementation of the final margin rules, coordinates with its U.S. and non-U.S. counterparts (in particular EU regulators) to ensure that prior to implementation of the final margin rules: (1) the details of how substituted compliance will work in practice are resolved; and (2) regulatory conflicts are resolved that substituted compliance alone will not address.

MFA strongly supports a rational and proportionate approach to the extraterritorial application of the Proposed Rules that avoids subjecting counterparties to duplicative or conflicting rules with respect to their Covered Swap transactions. Therefore, we appreciate that the CFTC is taking a thoughtful approach to these issues by issuing an advanced notice of proposed rulemaking on the cross-border application of the Proposed Rules ("**Cross-Border ANPR**"), and providing three possible cross-border approaches for public comment.[56] However, after reviewing the three proposed cross-border approaches, we are concerned about the material substantive differences among the CFTC rules (including the Proposed Rules), the Prudential Regulators' Proposed Rules,[57] and the SEC rules (including the SEC Proposed Rules).[58] We are

[53] *See supra* note 11.

[54] To clarify, if, for example, a Fund is: (1) organized in the U.S. or has a U.S. principal place of business, and (2) has majority "U.S. person" ownership, we believe that the Fund should remain a "U.S. person".

[55] To facilitate a single, harmonized U.S. approach to cross-border derivatives regulation, MFA also urges the CFTC to encourage the SEC and Prudential Regulators to adopt the Cross-Border Guidance Approach using MFA's suggested modifications as well.

[56] *See* Proposing Release at 59915-18, which describes the following three approaches: (i) the Cross-Border Guidance Approach (see the Final Cross-Border Guidance for further detail on this approach, *see supra* note 11); (ii) the Prudential Regulators' Approach (see the Prudential Regulators' Proposed Rules for further detail on this approach, *see infra* note 56); and (iii) the Entity-Level Approach.

[57] *See* the Prudential Regulators' Notice of Proposed Rulemaking on "Margin and Capital Requirements for Covered Swap Entities", 79 Fed. Reg. 57348 (Sept. 24, 2014), available at: http://www.gpo.gov/fdsys/pkg/FR-2014-09-24/pdf/2014-22001.pdf ("**Prudential Regulators' Proposed Rules**").

also concerned about the conflicts that exist between U.S. derivatives rules and foreign derivatives regulations that are comparable.

In light of the global nature of the OTC derivatives market, MFA makes certain recommendations below with respect to the Cross-Border ANPR that we believe will foster greater U.S. derivatives regulatory harmonization and facilitate continued trading of OTC derivatives on a global basis.

1. Developing a Single, Harmonized U.S. Cross-Border Approach

MFA recommends that the CFTC continue to use the Cross-Border Guidance Approach by retaining its existing definition of "U.S. person";[59] provided that, the CFTC modifies the definition to exclude Funds that are "U.S. persons" solely by virtue of having majority "U.S. person" ownership.

As the CFTC knows, Section 2(i) of the Commodity Exchange Act ("**CEA**"), as amended by Section 722 of the Dodd-Frank Act, provides that the CFTC's swap rules "shall not apply to activities outside the United States unless those activities . . . have a direct and significant connection with activities in, or effect on, commerce of the United States".[60] In addition, Section 4s(e)(2)(A) of the CEA, as amended by Section 731 the Dodd-Frank Act, requires the CFTC, SEC, and Prudential Regulators, to adopt rules jointly regarding margin requirements for CSEs related to uncleared swaps.[61] In the Proposing Release, the CFTC cites these statutory mandates as guiding their determination as to the appropriate cross-border scope of the Proposed Rules.[62] However, despite the CFTC, SEC, and Prudential Regulators all seeking to implement the mandates of the Dodd-Frank Act in respect of the same U.S. derivatives market, it remains possible that each U.S. regulator will adopt a final cross-border approach that is different in scope, and thus, would lead to different regulatory outcomes. Therefore, as a first step towards U.S. derivatives regulatory harmonization, MFA urges the CFTC to continue to utilize its final

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58 *See supra* note 46. *See also* SEC "Proposed Rules; Proposed Interpretations on "Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants", 78 Fed. Reg. 30968 (May 23, 2013), available at: http://www.gpo.gov/fdsys/pkg/FR-2013-05-23/pdf/2013-10835.pdf ("**SEC Cross-Border Rules**").

59 *See* Final Cross-Border Guidance at 45316-17, which defines "U.S. person", in relevant part, as: (i) any legal entity organized or incorporated in the U.S. or having its principal place of business in the U.S.; (ii) any privately-offered alternative investment fund that is majority-owned by U.S. persons; and (iii) other legal entity where all of the owners have limited liability and that is directly or indirectly majority-owned by U.S. persons.

60 *See* Proposing Release at 59915-16.

61 *See id*. at 59898, citing Section 4s(e)(2)(A) of the CEA, which specifically provides that the Prudential Regulators, CFTC, and SEC, "shall jointly adopt rules for swap dealers and major swap participants, with respect to their activities as a swap dealer or major swap participant, for which there is a prudential regulator imposing . . . both initial and variation margin requirements on all swaps that are not cleared by a registered derivatives clearing organization."

62 *See id*. *See also supra* note 60.

"U.S. person" definition but to modify it to exclude Funds that are "U.S. persons" solely by virtue of having majority "U.S. person" ownership.[63]

a. Concerns with Prudential Regulators' Approach

MFA does not believe that either the Prudential Regulators' Approach or the Entity-Level Approach provide appropriate solutions to the cross-border application of U.S. derivatives rules (including the Proposed Rules). In our view, both of these approaches give too much deference to the foreign regulatory regime to which a non-U.S. CSE ("**Foreign CSE**") is subject, which could result in Covered Swaps with a substantial U.S. nexus being subject to a foreign jurisdiction's margin rules.

Under the Prudential Regulators' Proposed Rules, margin requirements would not apply to any "foreign non-cleared swap or foreign non-cleared security-based swap" ("**Non-Covered Swap**"), which is defined as any uncleared OTC derivatives transaction where neither party is:

(i) An entity organized under the laws of the United States or any State, including a U.S. branch, agency, or subsidiary of a foreign bank;

(ii) A branch or office of an entity organized under the laws of the United States or any State; or

(iii) A CSE that is controlled, directly or indirectly, by an entity that is organized under the laws of the United States or any State.[64]

This definition establishes what constitutes a substantial U.S. nexus for purposes of determining whether the uncleared OTC trade is a Non-Covered Swap, and thus, is excluded from being subject to the Prudential Regulators' Proposed Rules. Therefore, in terms of determining the cross-border application of the Prudential Regulators' Proposed Rules, this definition serves the same function as the CFTC's[65] and SEC's[66] "U.S. person" definitions.

However, in the case of Funds, we are concerned that the Prudential Regulators' Approach equates having a substantial U.S. nexus solely with being organized in the U.S. In

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63 MFA recognizes that the public comment period recently closed on the Prudential Regulators' Proposed Rules, which sets forth the Prudential Regulators' Approach to cross-border application of its margin rules for non-cleared OTC transactions. *See supra* note 57. We stress that we think harmonization by U.S. regulators of their cross-border proposals is of paramount importance. Therefore, if the CFTC determines to alter its final cross-border approach, MFA would support the Prudential Regulators and SEC harmonizing their final cross-border rules with the CFTC's modified approach. MFA has made comments to the Prudential Regulators to this effect. *See supra* note 7, MFA PR Margin Letter at 19-21.

64 *See* Prudential Regulators' Proposed Rules at 57395, Section __.9(b).

65 *See supra* note 59.

66 *See* SEC Cross-Border Rules at 31207, § 240.3a71–3(a)(7), which proposes to define "U.S. person", in relevant part, as any legal entity organized or incorporated in the U.S. or having its principal place of business in the U.S.

particular, we are concerned that, unlike the "U.S. person" definitions applied under either the Final Cross-Border Guidance or the SEC Cross-Border Rules, the Prudential Regulators' definition effectively classifies Funds organized outside of the U.S. but with a U.S. principal place of business (*e.g.*, Funds with a U.S.-based manager) as foreign entities.

Both the CFTC and SEC incorporated principal place of business tests into their "U.S. person" definitions because they recognized that the principal place of business is an important proxy for determining the jurisdiction to which a market participant has a substantial nexus.[67] In particular, in the case of Funds, the CFTC appreciated that a Fund's place of organization might be different from the location of the people or entities that actually direct and control the Fund and its activities.[68] Therefore, the CFTC and SEC both included a "principal place of business" test in their "U.S. person" definitions, and the CFTC provided substantial guidance around determining where a Fund's principal place of business is (*e.g.*, the location of the Fund's manager).[69]

MFA's concerns with respect to the "U.S. person" status of Funds with a U.S. principal place of business are of particular concern when a Fund is trading derivatives contracts with a foreign counterparty. Specifically, as discussed in subsection 3 below, if Funds with a U.S.-based manager are not considered "U.S. persons" subject to U.S. derivatives regulation, even though they have a substantial U.S. nexus, they will likely be required to margin their Covered Swaps in accordance with the foreign margin rules to which their Foreign CSE counterparty is subject. MFA does not believe any Fund with a U.S.-based manager should be required to comply with a foreign regulator's margin rules by virtue of the Fund not being considered subject to U.S. regulation. In particular, MFA notes that, for purposes of the U.S. trading, clearing, and other risk mitigation rules already in effect, the Funds managed by U.S.-based managers are treated as "U.S. persons" and have invested considerable resources establishing the infrastructure to allow them to transact as such. Therefore, for purposes of U.S. derivatives regulation, MFA thinks it is inappropriate to adopt the Prudential Regulators' Approach because it does not regulate Funds with a U.S. principal place of business the same as Funds organized in the U.S.

b. Concerns with Entity-Level Approach

MFA thinks that margin requirements for Covered Swaps should remain a transaction-level requirement, and thus, we do not support the Entity-Level Approach.[70]

As described in the Proposing Release, the Entity-Level Approach would apply the Proposed Rules at the firm level of a CSE, rather than with respect to a CSE's individual Covered Swaps on a transaction-by-transaction basis.[71] The Entity-Level Approach would apply

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67 *See* Final Cross-Border Guidance at 45309-12 and SEC Cross-Border Rules at 30996-97.

68 *See id*.

69 *See id*.

70 *See* Proposing Release at 59917.

71 *See id*.

the proposed margin requirements to all CSEs depending on the CSEs' "U.S. person" status, regardless of whether or not its counterparty is a "U.S person".[72] In addition, the Entity-Level Approach would permit substituted compliance where a Foreign CSE enters into a Covered Swap with a Fund that it organized or has its principal place of business in the U.S. ("**U.S. Fund**").[73]

As mentioned above, U.S. Funds are currently treated as "U.S. persons" for purposes of CFTC swap rules that are already in effect. Therefore, these Funds have already invested considerable resources to establish the infrastructure to allow them to comply with such a requirement as a transaction-level requirement. We think it would be burdensome for market participants to have to alter their existing infrastructure.

MFA understands that the regulatory conflicts that result from adoption by the CFTC of the Cross-Border Guidance Approach make it palatable to consider other options. In particular, we recognize that there have been concerns that the CFTC Cross-Border Approach does not give sufficient deference to other jurisdiction's comparable regulatory regimes However, MFA does not believe that switching to the Entity-Level Approach is necessary to resolve these conflicts.

Rather, we are of the view that the CFTC could resolve these same conflicts by retaining the CFTC Cross-Border Approach and modifying its "U.S. person" definition and substituted compliance approach as discussed herein. Thus, we would urge the CFTC not to adopt either the Prudential Regulator Approach or the Entity-Level Approach, but instead to retain the CFTC Cross-Border Approach with our suggested modifications, which would allow the margin requirements to remain a transaction-level requirement and not require "U.S. persons" to alter their existing infrastructure.

c. Support for Cross-Border Guidance Approach with Elimination of Majority "U.S. Person" Ownership Test

In light of the foregoing concerns with the Prudential Regulators' Approach and the Entity-Level Approach, MFA urges the CFTC to adopt its Cross-Border Guidance Approach using our suggested modifications as discussed herein, and to encourage the Prudential Regulators and the SEC to align the cross-border scope of their margin and other derivatives rules with this approach as well.

In particular, we urge the CFTC to retain its final "U.S. person" definition but modify the definition to exclude Funds that are "U.S. persons" solely by virtue of having majority "U.S. person" ownership. We do not believe that defining a non-U.S. Fund as a "U.S. person" solely because of the proportion of its U.S. investors is consistent with the stated aims of the Dodd-Frank Act. In our view, majority "U.S. person" ownership alone is not indicative of whether the activities of a non-U.S. Fund with a non-U.S.-based manager would have a direct and significant effect on the U.S financial system. Therefore, MFA respectfully requests that, as it relates to

[72] *See id*.

[73] *See id*.

Funds, the CFTC limit the "U.S. person" definition to Funds that would remain "U.S. persons" even if they did not have majority "U.S. person" ownership (*e.g.*, Funds organized in the U.S. or with a U.S.-based manager).

MFA also notes that the "U.S. person" definition (using our suggested modifications) would continue to capture Foreign CSEs registered in the U.S. as well as non-U.S. dealers that are guaranteed by a "U.S. person" or are affiliate conduits.[74] Therefore, MFA believes that using the "U.S. person" definition with our suggested modification also most appropriately reflects what constitutes a substantial U.S. nexus for Foreign CSEs. Given that the CFTC has regulatory jurisdiction over the "swaps" market, which is a substantial portion of the U.S. OTC derivatives market, and its definition once modified with our suggested changes would ensure that "U.S. persons" are subject to U.S. regulation, we think this modified "U.S. person" definition is the appropriate starting point for U.S. regulatory purposes.

2. International Harmonization and Modification of Existing Substituted Compliance Regime

MFA supports the CFTC continuing to apply substituted compliance with respect to its swaps rules as set forth in the Cross-Border Guidance Approach;[75] provided that, the CFTC modifies its approach to allow substituted compliance for trades between "U.S. persons" (as defined using our suggested modification of the definition) and non-U.S. persons at such parties' mutual agreement. In addition, we emphasize that it is important that, prior to implementation of the final margin rules, the CFTC coordinates with its U.S. and non-U.S. counterparts (in particular EU regulators) to ensure that that: (i) the details of how substituted compliance will work in practice are resolved; and (ii) regulatory conflicts are resolved that substituted compliance alone will not address.

MFA strongly supports an internationally coordinated approach to derivatives regulation that ensures consistent regulation, reflects the global nature of the derivatives markets, and promotes competition and innovation. However, it is increasingly evident that the scope of various U.S. and international derivatives reforms will, to a certain extent, be duplicative.

As discussed previously, MFA greatly supports the international framework provided by the Basel-IOSCO Standards and the efforts of regulators to harmonize the substance of their respective margin rules at the international level. In addition, we appreciate that the Cross-Border ANPR reflects the CFTC's efforts to construct a thoughtful solution that would resolve all potential regulatory conflicts, and thereby, prevent the derivatives markets from being impaired. However, a significant number of questions remain, and conflicts exist, with respect to

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[74] *See* Final Cross-Border Guidance at 45359, providing that an "affiliate conduit" is a non-U.S. person: (i) that is majority-owned, directly or indirectly, by a "U.S. person; (ii) that controls, is controlled by, or is under common control with a "U.S. person"; (iii) in the regular course of business, engages in swaps with non-U.S. third parties to hedge or mitigate risks of its U.S. affiliates; and (iv) the financial results of which are included in the consolidated financial statements of a "U.S. person".

[75] *See supra* note 11.

the cross-border intersection of derivatives rules adopted by U.S. and foreign regulators (*e.g.*, the EU rules under the European Markets Infrastructure Regulation ("**EMIR**")[76]).

For example, in the case of U.S. Funds trading derivatives contracts with EU counterparties or non-U.S. Funds trading with U.S. counterparties,[77] it appears that direct regulatory conflicts between U.S. and EU derivatives regulations will result. These types of cross-border transactions are a significant volume of business in both the cleared and uncleared derivatives markets. Therefore, it is critical that U.S. and EU regulators recognize the derivatives regulations of each other's jurisdictions as comparable and bilaterally allow substituted compliance for derivatives trades involving parties from each jurisdiction (where the parties mutually agree as to which regime is applicable) to prevent regulatory fragmentation within the global OTC derivatives markets

Specifically, because of the global nature of the derivatives market and the need to ensure that cross-border OTC derivatives transactions continue to take place, we strongly urge the CFTC to use the Basel-IOSCO Standards as an example and promote a similarly harmonized and coordinated approach with respect to U.S. and non-U.S. substituted compliance regimes. In particular, we emphasize the need for the CFTC to continue to maintain an open dialogue with their U.S. and non-U.S. counterparts, and work actively to develop harmonized and coordinated substituted compliance regimes to facilitate resolution of overlapping or intentionally divergent derivatives requirements as they arise.

3. Equivalence Issue Related to Article 13 of EMIR

MFA notes that certain regulatory conflicts between U.S. and EU derivatives requirements exist that the CFTC substituted compliance regime alone would not resolve.[78] In particular, below we summarize a key regulatory conflict that would arise for Funds related to Article 13 of EMIR that the CFTC must work with U.S. and EU authorities to address.[79]

In broad terms, Article 13 of EMIR allows the European Commission ("**EC**") to declare margin (and certain other) rules of a third country relating to OTC derivative contracts to be

[76] Regulation (EU) 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories (Jul. 4, 2012), available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF.

[77] For the avoidance of doubt, MFA clarifies that by "U.S. Funds, we mean Funds organized in or with a principal place of business in the U.S., and by "non-U.S. Funds", we mean all Funds that are not "U.S. Funds".

[78] MFA emphasizes that the below regulatory conflict is one of many that arise due to the interaction and overlap of the U.S. and EU derivatives rules. We could provide examples of a number of other conflicts that arise depending of the specific rule at issue and the jurisdiction of organization of the counterparties to the trade. Therefore, MFA emphasizes that it is important that the CFTC identify and resolve all conflicts related to the cross-border application of the Proposed Rules prior to implementation.

[79] *See* MFA Discussion Paper on Equivalence Issues under Article 13(3) of the European Market Infrastructure Regulation, dated June 3, 2014, available at: https://www.managedfunds.org/wp-content/uploads/2014/06/MFA-Discussion-Paper-on-Article-13-EMIR-Equivalence-Final-6-3-14.pdf, describing the issue in greater detail.

"equivalent" to the relevant provisions of EMIR.[80] Similar to substituted compliance regimes in the U.S., following an EC equivalence declaration with respect to a jurisdiction's derivatives rules, where an EU counterparty enters into a derivatives contract with a counterparty that is "established" in that equivalent jurisdiction, the EU counterparty will be deemed to be in compliance with EMIR if it is complying with the equivalent jurisdiction's derivatives regulations.[81]

While it is broadly expected that the EC will declare U.S. derivatives rules, including the Proposed Rules, to be equivalent to EMIR, the notion of being "established" in the U.S. presents difficulties for Funds that fall under the CFTC "U.S. person" definition.

As mentioned, many Funds are organized outside the U.S. as a legal matter (*e.g.*, their place of incorporation is the Cayman Islands). Because these Funds are managed by U.S.-based managers, these Funds are "U.S. persons" when trading swaps and are appropriately subject to U.S. derivatives regulations.[82] However, notwithstanding the Final Cross-Border Guidance, the EC has indicated that for purposes of EMIR it does not view these Funds as being "established" in the U.S. because their legal place of incorporation is outside of the U.S. Instead, the EC would require the Fund and its EU counterparty to comply with the EMIR margin rules with respect to the Covered Swap.

The result of the U.S. and EU each asserting jurisdiction over the uncleared trade would be that the Fund and its EU counterparty would be subject to both the Proposed Rules and the similar margin requirements under EMIR with respect to their Covered Swap, which will almost certainly conflict with each other once final. Therefore, in practice, the Fund and EU counterparty might no longer be able to enter into uncleared trades with each other.

MFA emphasizes that this fact pattern is reflective of a significant volume of business in the uncleared OTC derivatives market. Therefore, we emphasize that it is important that the CFTC work on resolving this issue and other derivatives regulatory conflicts that arise from the cross-border application of the Proposed Rules and the CFTC Cross-Border Approach to allow counterparties to continue to trade derivatives contracts on a cross-border basis.

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80 *See* Article 13(2) of EMIR.

81 *See* Article 13(3) of EMIR.

82 *See supra* note 11. MFA notes that the applicable U.S. derivatives regulations include, among other things, rules regarding mandatory clearing, mandatory trade reporting, required trading on swap execution facilities or derivatives contract markets, other risk mitigation requirements, and ultimately margin requirements for uncleared derivatives contracts.

MFA appreciates the opportunity to comment on the Proposed Rules and respectfully submits these comments for the Prudential Regulators' consideration. If the Prudential Regulators or their staffs have any questions, please do not hesitate to call Laura Harper, Carlotta King, or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President, Managing Director & General Counsel

cc:

The Hon. Timothy G. Massad, Chairman
The Hon. Mark P. Wetjen, Commissioner
The Hon. Sharon Y. Bowen, Commissioner
The Hon. J. Christopher Giancarlo, Commissioner

SEC:
The Hon. Mary Jo White, Chairman
The Hon. Luis A. Aguilar, Commissioner
The Hon. Daniel M. Gallagher, Commissioner
The Hon. Michael S. Piwowar, Commissioner
The Hon. Kara M. Stein, Commissioner

Members of Basel-IOSCO Working Group on Margining Requirements, including representatives of U.S. Prudential Regulators:
Mr. Michael Gibson, Board of Governors of the Federal Reserve System (**Prudential Regulator**)
Mr. Bobby Bean, Federal Deposit Insurance Corporation (**Prudential Regulator)**
Mr. Sean Campbell, Board of Governors of the Federal Reserve System (**Prudential Regulator)**
Mr. Nicolas Gauthier, European Commission
Mr. John Lawton, U.S. Commodity Futures Trading Commission
Mr. Thomas McGowan, U.S. Securities and Exchange Commission
Mr. Matthew Osborne, UK Financial Services Authority
Ms. Heather Pilley, UK Financial Services Authority
Mr. Graham Young, Bank of England
Mr. Kurt Wilhelm, U.S. Office of the Comptroller of the Currency (**Prudential Regulator**)

Annex A

SAMPLE INITIAL MARGIN STANDARDIZED TABLE

Product Category	Initial Margin Calculation Basis
Equities	Options: • X% of the premium paid on the derivative contract; or • X% of the notional value of the derivative contract; or • X% of the premium premium paid on the derivative contract *multiplied by* delta Swaps: • X% of the notional value of the derivative contract Other Factors: • Higher % where the underlier is an equity security by a non-G7 issuer
Interest Rates	Options: • X% of the premium paid on the derivative contract; or • X% of the notional value of the derivative contract; or • X% of the premium premium paid on the derivative contract *multiplied by* delta Swaps: • X% of the notional value of the derivative contract Other Factors: • Higher % where the underlier relates to non-G7 countries • Higher % where the underlier relates to emerging markets
Credit Default Swaps	For Buyer of Protection: Nil, or, if agreed between the parties, X% of the notional value of the derivative contract, graduated % possibly reflecting CDS spreads (*i.e.*, lower % for tighter spreads), for example, on the basis of the following spread tiers: • 0 – 250 bps • 251 – 500 bps • 500 – 1050 bps / 0 – 20 points upfront • 1050 – 2500 bps / 21 – 50 points upfront • 2500 bps / > 50 points upfront For Sold Protection: • X% of the notional value of the derivative contract

Product Category	**Initial Margin Calculation Basis**
FX	Options: • X% of the premium paid on the derivative contract; or • X% of the notional value of the derivative contract; or • X% of the premium paid on the derivative contract *multiplied by* delta Swaps: • X% of the notional value of the derivative contract Other Factors: • Higher % where the underlier is a currency of a non-G7 country Higher % where the underlier is a currency of a non-G21 country • Higher % where the underlier is a currency of an emerging markets country
Commodities	Options: • X% of the premium paid on the derivative contract; or • X% of the notional value of the derivative contract; or • X% of the premium paid on the derivative contract *multiplied by* delta; or • standardized portfolio of risk (SPAN) margin for the nearest futures or options contract + X% Swaps: • X% of the notional value of the derivative contract