



Carl B. Wilkerson
Vice President & Chief Counsel, Securities

October 25, 2019

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

Re: The Final Margin Rules for Uncleared Swaps Transactions¹ with respect to Seeded Investment Funds

Dear Mr. Kirkpatrick:

The American Council of Life Insurers (“ACLI”)² writes to request relief from the application of the final margin rules for uncleared swaps transactions (“Final Margin Rules”) with respect to initial margin (“IM”) upon investment funds initially funded with seed capital by a fund sponsor or affiliate and consolidated on the sponsor’s (or the sponsor’s group’s) financial statements (“seeded funds”) during the three year seeding period following a seeded investment fund’s launch (the “seeding period”).

Specifically, we ask that the Prudential Regulators and the commodities Futures Trading Commission take the following actions in order to provide relief to seeded funds with respect to the application of the Final Margin Rules to funds seeded in good faith:

1. Provide publicly announced compliance/examination guidance to their supervisory staff that they should deprioritize compliance with and enforcement of the Final Margin Rules

¹ Department of the Treasury Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System (the “Federal Reserve”), Federal Deposit Insurance Corporation, Farm Credit Administration and Federal Housing Finance Agency Margin and Capital Requirements for Covered Swap Entities; Final Rule, 80 Fed. Reg. 74840 (Nov. 30, 2015). Commodity Futures Trading Commission (the “Commission”), Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Final Rule, 81 Fed. Reg. 636 (January 6, 2016).

² The American Council of Life Insurers (ACLI) is a national trade association with 280 member companies that represent 95 percent of industry assets, 92 percent of life insurance premiums, and 97 percent of annuity considerations in the United States. Our members offer life insurance, annuities, retirement plans, long-term care and disability income insurance, and reinsurance that 75 million American families rely on for financial and retirement security.

with respect to seeded funds until such time as the Prudential Regulators and Commission can engage in limited rulemaking to provide relief on this topic.³

2. Engage in limited rule making exercise to exclude seeded investment funds from the definition of a consolidated group by incorporating the following language into the Final Margin Rules:

Investment funds that are managed by an investment advisor are considered distinct entities that are treated separately when applying the threshold (as long as the funds are distinct legal entities that are not collateralized by or are otherwise guaranteed or supported by other investment funds or the investment advisor in the event of fund insolvency or bankruptcy) and shall not be considered to be an “affiliate” or “margin affiliate” of any other entity for a period of three years after such investment fund commences trading.⁴

This language is drawn directly from the BCBS/IOSCO final statement on margin requirements for non-centrally cleared derivatives and is consistent with the approach taken by regulators in other jurisdictions, including the EU, Japan and Canada, with the exception that the BCBS/IOSCO language and foreign regulators have not included any time limitation on the exclusion.

The Final Margin Rules require financial entities within a corporate group that are consolidated from an accounting perspective, where the corporate group has material swaps exposure (“MSE”) to post and collect IM as long as the swap activities of the consolidated group remain above the MSE threshold. This group approach has the logical and appropriate result of capturing entities within a corporate group whose uncleared swap activity alone does not meet the MSE threshold but whose relationship to one or more large users of uncleared swaps might pose a systemic risk to the financial system. It prevents a financial entity from dividing up its uncleared swap activities among several affiliated entities under common control to evade the Final Margin Rules. However, the consolidation rule requires seeded funds that are sponsored by entities with MSE to post and collect IM during the temporary phase in which the funds are consolidated with their sponsors even though a variety of safeguards exists to limit the sponsor’s control of these funds.

As discussed below, the ACLI is requesting relief from the requirement of seeded funds that are sponsored by entities with MSE from having to post and collect IM during the seeding period given that:

³ This approach would be consistent with the approach taken by the Prudential Regulators and the Commission with respect to the delay of the compliance with the variation margin requirements of the Final Margin Rules in 2017. See Fed Supervisory Letter SR 17-3 (February 22, 2017), OCC Bulletin 2017-2 (February 23, 2017) and CFTC Staff letter 17-11 (February 13, 2017).

⁴ This approach would be consistent with the rule adopted by the Prudential Regulators and the Commission to amend the definition of “eligible master netting agreement” in the Final Margin Rules in order to bring the Final Margin Rules into compliance with the QFC Rules adopted by the Prudential regulators with respect to certain qualified financial contracts entered into by global systemically important banking institutions. See 83 Fed. Reg. 50805-50813 (October 10, 2018) and 83 Fed. Reg. 60343-60347 (November 26, 2018).

1. There are multiple contractual, structural, fiduciary and regulatory safeguards to prevent the use of seeded funds by a sponsor to avoid or evade the requirements of the Final Margin Rules with respect to the sponsor's own obligations.
2. Seeded funds that do not separately exceed the MSE threshold do not pose systemic risk to the financial system during the seeding period.
3. Seeded funds, as financial entities, are required to post variation under the Final Margin Rules.
4. Such relief would harmonize the Final Margin Rules with the intent of the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions ("BCBS/IOSCO") "Margin requirements for non-centrally cleared derivatives" (the "framework") and provide US fund sponsors with a level playing field vis-a-vis their global counterparts.
5. Such relief would be consistent with the Federal Reserve's treatment of seeded Funds under the Volcker Rule.
6. Requiring seeded funds to post IM during the seeding period poses a significant operational challenge to both fund sponsors and their trading counterparties, with little benefit in terms of systemic risk reduction.

1. There are multiple contractual, structural, fiduciary and regulatory safeguards to prevent the use of seeded funds by a sponsor to avoid or evade the requirements of the Final Margin Rules with respect to the sponsors own obligations.

When the Final Margin Rules were adopted, the rules release (the "Release") addressed commenters' concerns regarding the definition of "affiliate" by adopting an accounting consolidation standard rather than a control standard.⁵ The Prudential Regulators declined to exclude seeded funds in the adopting rules release because in their view managers could use these vehicles to evade the purposes and intent of the Final Margin Rules.⁶

The Release indicates that margin affiliates are included in calculations of MSE and the initial margin threshold amount ("IMTA") as a simplified means to prevent companies from using shell companies

⁵ The Final Margin Rules use an accounting consolidation standard, defining as an "affiliate" and as a "margin affiliate" any company that consolidates with another company on the other company's financial statements, or that is consolidated with the other company on the financial statements of a third company, under applicable accounting standards 80 Fed. Reg. 74840, 74899 ("Affiliate"); 81 Fed. Reg. 636, 697 ("Margin affiliate"). The term "margin affiliate" used in this letter refers to both definitions.

⁶ 80 Fed. Reg. 74840, 74860; 81 Fed. Reg. 636, 647.

and netting sets without economic basis to evade margin requirements.⁷ As discussed below, the structural, fiduciary and contractual features of seeded funds provide crucial safeguards not addressed or recognized by the Final Margin Rules that would prevent fund sponsors and/or fund managers from using seeded funds to evade their own obligations with respect to IM. Further, additional regulatory safeguards are in place to address an entity that uses seeded funds in an abusive, evasive manner, allowing the Prudential Regulators or the Commission to rely on their anti-evasion authority to prevent such activity.

For several reasons, seeded funds should not raise anti-evasion concerns. Seeded funds are created for a bona fide business and economic purpose, are typically overseen by an independent board (or equivalent) and are always managed by an investment advisor having fiduciary duties to the entity in accordance with a specified investment program. Further, seeded funds are distinct legal entities and, unlike arrangements often present among corporate affiliates, are not collateralized by or otherwise supported by the fund sponsor (apart from the fund sponsor's initial contribution of seed capital) or any other entity (apart from such entity's initial contribution of seed capital).

Additionally, all seeded funds are distinct legal entities that are managed by an investment manager pursuant to an investment management agreement that, among other things, requires the assets of the fund to be managed in accordance with predetermined, specified investment guidelines, objectives and strategies and not capriciously at the desire of the fund sponsor or manager. To suggest that a fund under such circumstances should be treated like any other corporate affiliate is inconsistent with these overriding structural, fiduciary and contractual safeguards.

While a sponsor to a seeded fund has influence on the fund beyond that of a passive, unaffiliated investor, a seeded fund is not the same as a corporate affiliate. For example, seeded funds that are registered as management companies under the Investment Company Act of 1940 (the "ICA") (e.g., mutual funds) are overseen by an independent board of directors/trustees and managed by a registered investment advisor that has fiduciary duties of care and loyalty to the fund and *all* investors in the fund. Similar features are present for unregistered funds (e.g., hedge funds and private equity funds) relying on an exemption from registration under Section 3(c)(1) or 3(c)(7) of the ICA.

Further, most seeded funds rely on one of two de minimis usage exemptions from registration as a commodity pool under the U.S. Commodity Exchange Act – Rule 4.5 with respect to registered investment funds and Rule 4.13(a)(3) with respect to unregistered investment funds.⁸ To the extent that a seeded fund's use of derivative products exceeds the de minimis thresholds set forth in these two rules, the fund must register with the Commission as a commodity pool and report additional information to the Commission with respect to the relevant pool's use of commodity interests (thus

⁷ 80 Fed. Reg. 74840, 74863; 81 Fed. Reg. 636, 651.

⁸ For benefit of the Prudential Regulators – a commodity pool that relies on either Rule 4.5 or Rule 4.13(a)(3) must satisfy one of the following de minimis tests:

- 5% test: the aggregate initial margin and premiums required to establish commodity interest positions do not exceed 5% of the liquidation value of the Fund's portfolio, after taking into account unrealized profits and losses on such positions. (4.5 accounts may exclude "bone fide hedging" transactions.)
- Net notional value test: the aggregate net notional value of commodity interest positions, determined at the time the most recent position was established, does not exceed 100% of the liquidation value of the Fund's portfolio, after taking into account unrealized profits and losses on such positions.

giving the Commission even greater ability to ensure that the seeded fund is not being used to evade the requirements of the Final Margin Rules).

2. Seeded funds do not pose systemic risk to the financial system during the seeding period.

Investment funds at the seeding phase tend to be small and, as a result, do not typically have uncleared swaps exposure that would present significant risk to a swap counterparty or the financial system. Despite not being guaranteed by their plan sponsor, such funds are treated as having MSE as if they did pose a systemic risk to the financial system.⁹ It is also worth pointing out that funds seeded by sponsors that do not belong to corporate groups with MSE but that otherwise are of similar size and pursue similar strategies during the seeding period would not be subject to these IM posting requirements.

As an odd result, when such funds grow larger and have more of a market impact, the sponsor's percentage ownership in them drops; they cease to be margin affiliates; and they no longer have to post IM unless their individual notional amount of uncleared derivatives crosses the MSE threshold.

Sampling the members of the ACLI, the majority of entities that responded were concerned about this issue. Even if it did not directly impact them at the current time, they acknowledged the chilling effect the Final Margin Rules would have on their future product offerings in terms of drag to performance and operational costs. Using a small sampling of insurance companies, consolidated families of insurance companies averaged 8 in scope seeded funds, with an average AUM of \$96mm and an average notional exposure of \$32mm.

3. Seeded funds already post variation under the Final Margin Rules.

Seeded funds remain subject to the variation margin requirements of the Final Margin Rules and will still be required to post at a minimum the required regulatory collateral on a daily basis, thus mitigating any risk such funds might pose to the overall financial system.

⁹ Dollar amounts for IM posted by any individual investment fund will vary based on strategy, use of derivatives and the size of the fund. However, it is expected that most of such funds will post IM in amounts below \$1 million – and in many cases below \$100,000 – at any given time.

4. The Requested Relief would harmonize the Final Margin Rules with the intent of the BCBS/IOSCO Framework and provide US fund sponsors with a level playing field vis-a-vis their global counterparts.

The Final Margin Rules differ from the recommendations set out in the BCBS/IOSCO's Framework. While the BCBS/IOSCO recommends that the IMTA be measured on a consolidated group basis to "prevent the proliferation of affiliates and other legal entities within larger entities for the sole purpose of circumventing the margin requirements" (see Commentary at 2(ii)), BCBS/IOSCO excludes all investment funds noting that, "[i]nvestment funds that are managed by an investment advisor are considered distinct entities that are treated separately when applying the threshold as long as the funds are distinct legal entities that are not collateralised by or are otherwise guaranteed or supported by other investment funds or the investment advisor in the event of fund insolvency or bankruptcy." (See Requirement 2 at FN 10). By not excluding seeded funds under the rules applied in the U.S., funds seeded by U.S. sponsors are disadvantaged as compared to their non-U.S. equivalents.

Financial Regulators in Europe, Canada, Japan, Hong Kong and Australia have adopted BCBS/IOSCO's Framework with respect to all investment funds that are not collateralized, supported or otherwise guaranteed by the sponsor with MSE.¹⁰ For example, on October 4, 2016, the Joint Committee of the European Supervisory Authority published a regulatory technical standard in which they adopted the BCBS-IOSCO Framework stating:

While the thresholds should always be calculated at group level, investment funds should be treated as a special case as they can be managed by a single investment manager and captured as a single group. Where the funds are distinct pools of assets and they are not collateralised, guaranteed or supported by other investment funds or the investment manager itself, they are relatively risk remote from the rest of the group. Such investment funds should therefore be treated as separate entities when calculating the thresholds. This approach is consistent with the BCBS-IOSCO framework.¹¹

¹⁰ See *Margin Requirements for Non-Centrally Cleared Derivatives* by the Office of the Superintendent of Financial Institutions of Canada effective as of June 2017. <http://www.osfi-bsif.gc.ca/Eng/Docs/e22.pdf>. The JFSA published the final Japanese margin rules on March 31, 2016 by way of amendments to the Cabinet Office Ordinance concerning Financial Instruments Business, etc. as one of the subordinate regulations of the Financial Instruments and Exchange Act. The Australian Prudential Regulation Authority (APRA) adopted the BCBS-IOSCO Framework through the Banking, Insurance, Life Insurance and Superannuation (prudential standard) determination No. 1 of 2017 Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives.

¹¹ Paragraph 13 of COMMISSION DELEGATED REGULATION (EU) 2016/2251 of 4 October 2016 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty. 2016 O.J. L340/11 <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R2251&qid=1566229674235&from=EN>

This European guidance was published after the Final Margin Rules were adopted and so did not give the Prudential Regulators or the Commission time to consider this point for harmonization.

5. The Requested Relief would be consistent with the Federal Reserve's treatment of seeded funds under the Volcker Rule.

The request relief is consistent with the treatment of seeded funds under the Volcker Rule. In answers to frequently asked questions published on July 16, 2015, the Federal Reserve elected to exclude seeded funds from the requirements of the Volcker Rule during a three year seeding period.¹² Our suggested adjustments would level the playing field between banks and life insurance and asset management firms by providing all three types of business the opportunity to seed funds without confronting a host of complex regulatory challenges.

6. The operational burden of requiring seeded funds to post IM during the seeding period poses a challenge to both fund sponsors and their trading counterparties.

Under the Final Margin Rules, seeded funds will need to negotiate and complete complex margin documentation and develop compliance infrastructure to handle the posting and receiving of IM at a cost not commensurate with their risk to the financial system. Because of their small size, such funds may be less able to complete the required documentation and infrastructure as counterparties and custodians address similar documentation across their client base – faced with a bottleneck, such counterparties and custodians are likely to prioritize larger AUM clients.

Unlike larger entities that are not consolidated, seeded funds may not be able to take advantage of the IMTA, or such relief may be limited, because of potential fiduciary conflicts as between the fund, the investment advisor, the ultimate parent and other affiliates of the parent. This may be particularly acute for life insurance companies with fiduciary duties to mutualized policyholders or shareholders. For example: determining an equitable division of the IMTA relief between the ultimate parent's hedging activity and the seeded fund's derivatives activity (in a list of funds that will constantly change) may be difficult to determine (or monitor) as the parent owes fiduciary duties to one group, while the fund investment advisor may owe them to different groups of investors in its various seeded funds. During this time period, investors in the seeded funds may be effectively bearing costs of IM because of uncleared OTC derivatives activity in entities and funds they did not invest in (without corresponding benefits).

It is worth emphasizing that the operational complexities of complying with the Final Margin Rules will present an ongoing set of challenges rather than just an initial hurdle at the appropriate phase-in date for these rules. As seeded funds gather outside investors or are wound down and cease to be consolidated with their sponsors and new funds are seeded, reallocations of the shared IMTA will need to be renegotiated.

¹² See Question 16 of Volcker Rule - Frequently Asked Questions. Available at: <https://www.federalreserve.gov/supervisionreg/faq.htm#5>

Exacerbating these technical challenges, many companies that are consolidated for financial purposes remain distinct operationally. As a result, they may not have the ability to easily share the exposure information required to manage the IMTA. Even if they are able to share in the IMTA, the constant burden of having to renegotiate documentation to support the allocation of the IMTA between an ever-changing group of seeded funds will impose burdens on both the seeded funds and their trading counterparties.

Further, MSE calculations under the Final Margin Rules are required to be performed during June, July and August for implementation in January. If an insurance company sponsored a new fund today, it would look to whether the Affiliate group had MSE during such time frame. Although the entity did not exist, a fund would be immediately in scope for trading IM and would not have an opportunity to fall out of scope until the second following January, more than 15 months later. This is despite the fact that the fund in question may have only been consolidated for a short period.

In conclusion, the ACLI along with other industry bodies such as SIFMA AMG first brought the issue of seeded funds to the attention of the Prudential Regulators and the Commission as a part of a number of issues raised with respect to the Final Margin Rules.¹³ We are revisiting this issue now to ensure that the Prudential Regulators and Commission are fully aware of the multiple contractual, structural, fiduciary and regulatory safeguards to prevent the use of seeded funds by a sponsor to avoid or evade the requirements of the Final Margin Rules. Additionally, with respect to the sponsor's own obligations and to emphasize the regulatory developments globally with respect to this issue so that the Prudential Regulators and Commission might take advantage of this opportunity for harmonization.

The ACLI has been supportive of the regulatory initiative to increase systemic financial stability by requiring the posting and collection of margin for uncleared swaps. Indeed, most of our members have been required by state insurance law to exchange variation margin with their counterparties long before the Final Margin Rules came into place.

The relief we seek would align U.S. regulations on this issue more closely with the analogous regulations of the E.U. and other international regulators. More practically, it will provide some additional relief in lessening the significant work to be done by banks, insurers and asset managers to implement the final phases of the Final Margin Rules. Indeed, BCBS/IOSCO recognized the daunting task before the industry in adding a Phase 6 to the rule and clarifying that documentation need not be in place before relevant parties near the IMTA.

As ACLI members prepare to meet the requirements under Phase 5 of the Final Margin Rules, we ask that the Prudential Regulators reconsider a minor aspect of the Final Margin Rules that we believe will place an undue operational burden on insurance companies that provide seed capital to investment funds, with little benefit in reduced systemic risk.

¹³ See ACLI Submission on Prudential Regulators' Reproposed Rule on Margin and Capital Requirements for Covered Swap Entities (November 24, 2014) and ACLI Submission on CFTC Request for Supplemental Comment on Proposed Rule Governing Margin and Collateral for Uncleared Swap Transactions (September 14, 2012).

We greatly appreciate your attention to this issue. If any questions develop, please let me know.

Sincerely,

Carl B. Wilkerson

Carl B. Wilkerson