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May 21, 2014

Kevin M. O'Neill  
Deputy Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549

Re: *Standards for Covered Clearing Agencies (File No. S7-03-14)*

Dear Mr. O'Neil:

The Investment Company Institute (“ICI”)<sup>1</sup> is submitting this letter in response to a proposal by the Securities and Exchange Commission (“SEC” or “Commission”) to amend Rule 17Ad-22 and adopt Rule 17Ab2-2 under the Securities Exchange Act of 1934 (“Exchange Act”) to establish standards for the operation and governance of registered clearing agencies that meet the definition of a “covered clearing agency.”<sup>2</sup> Covered clearing agencies would include registered clearing agencies that (1) have been designated as systemically important by the Financial Stability Oversight Council (“FSOC”) and for which the SEC is the supervisory agency;<sup>3</sup> (2) provide central counterparty (“CCP”) services for security-based (“SB”) swaps or are involved in activities the SEC determines to have a more complex risk profile, where in either case the Commodity Futures Trading Commission (“CFTC”) is not the supervisory agency for such clearing agency; or (3) are otherwise determined to be covered clearing agencies by the SEC pursuant to procedures under Proposed Rule 17Ab2-2.

Investment companies registered under the Investment Company Act of 1940 (“registered funds”) use SB swaps and other derivatives in a variety of ways to manage their portfolios in accordance

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<sup>1</sup> The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$ 16.8 trillion and serve over 90 million shareholders.

<sup>2</sup> Standards for Covered Clearing Agencies, 79 FR 16865 (Mar. 26, 2014), available at <http://www.gpo.gov/fdsys/pkg/FR-2014-03-26/pdf/2014-05806.pdf> (“Proposal”).

<sup>3</sup> In 2012, FSOC designated as systemically important the following clearing agencies: the Chicago Mercantile Exchange, Inc. (“CME”), The Depository Trust Company (“DTC”), Fixed Income Clearing Corporation (“FICC”), ICE Clear Credit LLC (“ICE”), National Securities Clearing Corporation (“NSCC”), and the Options Clearing Corporation (“OCC”). The SEC is the supervisory agency for DTC, FICC, NSCC and OCC.

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with the investment objectives stated in their prospectuses. Derivatives are particularly useful portfolio risk management and investment tools in that they offer registered funds considerable flexibility in structuring their investment portfolios. Uses of SB swaps and other derivatives include, for example, hedging risks arising from portfolio investments, equitizing cash that a registered fund cannot immediately invest in direct equity holdings, managing a registered fund's cash positions, and adjusting the duration of a registered fund's portfolio.

As investors in the swaps and SB swaps markets, registered funds support enhancing the risk management and customer protection standards applicable to covered clearing agencies given their "size, operation, and importance to the U.S. securities markets, the risks inherent in the products they clear, and the goals of Title VII and the Exchange Act."<sup>4</sup> As we have noted in other contexts, coordination among regulators in implementation of derivatives reform also is critical to the efficient functioning of the derivatives market by helping to alleviate duplicative and potentially conflicting regulation of transactions that are conducted on a cross-border basis (which are the majority of derivatives transactions).

Under the Proposal, the SEC proposes to establish requirements for covered clearing agencies with respect to general organization, financial risk management, settlement, central securities depositories and exchange-of-value-settlement systems, default management, segregation and portability, general business risk and operational risk management, access, efficiency, and transparency. For these requirements, the SEC generally proposes to require each covered clearing agency to establish, implement, maintain, and enforce written policies and procedures that address the applicable risks and provide a level of protection rather than imposing substantive requirements in the enumerated areas.

We have significant and serious concerns with respect to the Commission's approach in the Proposal particularly for the requirements on segregation and portability. The Commission does not define how the clearing regime and posting of margin are expected to operate, both in the normal course of business and in the event of a clearing member bankruptcy. Rather, the Commission delegates these important decisions and the determination of the type of protections provided by asset segregation and related safeguards to the clearing agencies that clear SB swaps. The Commission also looks to the broker-dealer framework as a precedent rather than separately evaluating the operation of the SB swaps market and the margining and segregation arrangements mandated by other regulators for swaps and already being used by the marketplace.

We believe that the SEC's proposed approach is inconsistent with Section 805(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") that requires the SEC to regulate central clearing organizations in a manner so as to "(i) promote robust risk

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<sup>4</sup> See Proposal, *supra* note 2, at 16872.

management, (2) promote safety and soundness, (3) reduce systemic risks, and (4) support the stability of the broader financial system.” We do not agree with the Commission that risks posed by covered clearing agencies can be sufficiently mitigated by providing them with broad discretion to adopt policies and procedures in these areas.

Our views are summarized and then discussed in more detail below.

### Executive Summary

We request that the Commission propose to adopt minimum structural and operational requirements for clearing agencies that are tailored to the way in which the SB swaps market operate. Therefore, we make the following recommendations:

- The Commission should propose a specific margining regime for cleared SB swaps. It is critical for the Commission to adopt ultimately a mandatory uniform regime covering margining of cleared SB swaps that applies across all covered clearing agencies and is consistent with the structure adopted by the CFTC for cleared swaps.
- The Commission should re-propose the segregation and portability requirements in the Proposal to require that covered clearing agencies provide at a minimum the protection afforded by the model adopted by the CFTC for cleared swaps collateral with respect to the protection of cleared SB swaps collateral posted by customers.
- The Commission should prohibit covered clearing agencies from using haircutting of variation and initial margin of customers as tools to recover during times of financial stress.
- The Commission should require covered clearing agencies to have public representation (including buy-side market participants) on their boards.

### Commission Should Articulate a Uniform Margining Regime for Cleared SB Swaps

In the Proposal, the Commission does not specify whether the margin regime for cleared SB swaps must mirror the regime currently used to margin cleared swaps<sup>5</sup> or the regime used to margin

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<sup>5</sup> Under the margin structure for cleared swaps, customer-counterparties post variation margin daily with the clearing member and that margin is transferred to the clearinghouse to satisfy margin calls. The variation margin is passed through by the clearinghouse to the clearinghouse member holding or representing the customer that holds the position on the other side of the trade. Initial margin also is posted by the customer with the clearing member and then transferred to the clearinghouse. Excess margin posted by the customer is held by the clearing member in a segregated account that may not be

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listed securities options.<sup>6</sup> The Commission notes in the Proposal that its margining regime is intended to parallel the structure currently used for listed options. Despite that, the Commission also suggests in the Proposal that the margining framework for SB swaps will be different from that for listed options and cash securities.<sup>7</sup>

The netting, posting, and liquidity implications of the margining regime applicable to swaps are very different from those applicable to margining of securities, including listed options. The structure of each margining regime also may determine the segregation model that can be used and the role that the clearing agencies will have in holding customer margin and, in particular, excess customer margin. We believe it is critical for the Commission to adopt ultimately a mandatory uniform regime covering margining of SB swaps that applies across all covered clearing agencies and is consistent with the structure adopted by the CFTC for swaps. Prior to doing so, we urge the Commission to articulate clearly in a proposal the operational and bankruptcy consequences of the structure to the extent possible so that market participants can evaluate and comment on the proposed regime.

Specifically, we believe the Commission should propose to adopt the cleared swaps margining regime for the SB swaps market rather than the margin structure currently used for listed options to provide the segregation protections of the swaps model (discussed below) to SB swap customers and to

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used by the clearing member other than to be invested according to the CFTC's rules. Excess margin may be passed on to a clearinghouse if it has rules that permit clearing members to transmit customer excess.

<sup>6</sup> Margin for short options positions is held by the clearing member in the customer's margin or listed options account. The clearing member separately posts margin required under the clearing member's sponsored positions to the clearing agency. The amount that the clearing member is required to post to the options clearing agency is different from the amount of margin that the clearing member must collect from its customers. The margin posted by customers is generally not passed through to the options clearing agency to pay the mark-to-market exposure on the options (*i.e.*, the equivalent of variation margin). The clearing member typically funds its margin obligations to the options clearing agency from its own assets. The clearing member is allowed to use up to 140% of the debit balance of the initial and variation margin and excess margin posted by customers to fund its business.

<sup>7</sup> *See, e.g.*, Proposal, *supra* note 2, at 16904 ("the Commission intends to avoid requiring changes to the existing structure of cash securities and listed options markets in the United States where registered clearing agencies that provide CSD or CCP services play a central role. Transactions in the U.S. cash security and listed options markets are characterized by the following features: (i) customers of members generally do not have an account at a clearing agency; and (ii) the clearing agency is not able to identify which participants' customers beneficially own the street name positions registered in the record name of the clearing agency (or its nominee) and the clearing agency has no recourse to funds of customers of members"). *But see id.* at 16905 suggesting that clearinghouses for SB swaps should have a different structure ("because neither portability nor segregation could occur as a practical matter under the current cash securities and listed options markets structure, the Commission preliminarily believes that Proposed Rule 17Ad-22(e)(14) should apply only to a covered clearing agency that is either a security-based swap clearing agency or a complex risk profile clearing agency").

ensure consistent protection of collateral for similar instruments.<sup>8</sup> We recommend a structure in which both initial and variation margin of SB swap counterparties would be passed on to the covered clearing agency and all excess margin would be held either in a segregated account at the clearing member or at the covered clearing agency.<sup>9</sup> SB swap dealers (“SBSDs”) and broker-dealers also should not be authorized to rehypothecate or use customer margin or excess margin in the SBSD’s or broker-dealer’s business.

### Commission Should Require at a Minimum Covered Clearing Agencies to Provide LSOC-Type Protection

The SB swap clearing agencies are currently not subject to rules regarding segregation and portability under existing Rule 17Ad-22.<sup>10</sup> The proposed rule on segregation and portability would apply to a covered clearing agency that is either an SB swap clearing agency or a complex risk profile clearing agency.<sup>11</sup> The proposed rule would require such a covered clearing agency to establish, implement, maintain and enforce written policies and procedures reasonably designed to enable the segregation and portability of positions of a member’s customers and the collateral provided to the covered clearing agency with respect to those positions and effectively protect such positions and related collateral from the default or insolvency of that member.

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<sup>8</sup> If the Commission determines not to propose to adopt the cleared swaps model but to propose the listed options approach, the Commission should propose to impose certain minimum standards, including (i) prohibiting the use of customer margin or excess by the clearing member; (ii) requiring customer margin and excess to be held in a segregated account or separately earmarked within an omnibus account; (iii) providing that excess collateral is held independently of the clearing member at a third party custodian or at the clearing agency; and (iv) ensuring, to the greatest extent possible, that customers do not bear “fellow customer” risk or losses due to proprietary trading of the clearing member.

<sup>9</sup> Under the structure applicable to listed options, broker-dealers finance customer positions under one set of margin requirements and post the broker-dealer’s own assets to the clearing house pursuant to a different set of margin requirements. Broker-dealers also are permitted to use customer margin to support the cost of customer financing and a portion of excess margin for the broker-dealer’s own business.

<sup>10</sup> The Commission has proposed Rule 18a-4 to address segregation requirements for SBSDs (including SBSDs that are banks) that are facilitating clearing of SB swaps for customers. The Commission has not explained, however, how the Proposal and Proposed Rule 18a-4 would work together. *See* Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 FR 70214 (Nov. 23, 2012) (“SB Swaps Segregation Rules Proposing Release”), available at <http://www.gpo.gov/fdsys/pkg/FR-2012-11-23/pdf/2012-26164.pdf> at 70276 (“proposed new Rule 18a-4 would prescribe detailed requirements for how cash, securities, and money market instruments of a customer with cleared security-based swaps must be segregated when an SBSD commingles those assets with the cash and securities of other customers”).

<sup>11</sup> Proposed Rule 17Ad-22(e)(14).

In the Proposal, the SEC describes the two methods – an omnibus account structure<sup>12</sup> and an individual account structure – by which segregation could be achieved and the advantages and disadvantages of each method. The SEC also notes a variant of the omnibus structure under which “fellow-customer risk” – the risk that another customer of the same member will default and margin or other assets of the non-defaulting customer will be used by the clearing member or clearinghouse to meet losses of the defaulting customer – is mitigated through records that reflect individual customer positions within the omnibus account.<sup>13</sup> The SEC does not, however, require covered clearing agencies to adopt any particular model of segregation. We strongly disagree with this approach and urge the Commission to re-propose this aspect of the rule to impose on covered clearing agencies, at a minimum, omnibus account structures that operationally commingle collateral related to customer positions while protecting customers legally on an individual basis.

Although we strongly support the goals of Title VII of the Dodd-Frank Act to promote clearing of standardized swaps to reduce risk in the financial system, we are concerned that implementation of the Proposal for clearing of SB swaps may result in subjecting registered funds to risks to which they have not been previously subject under the current regime for uncleared SB swaps or under the CFTC model. Registered funds that trade in uncleared swaps and SB swaps currently use tri-party arrangements to hold the collateral that they post to their counterparties. These arrangements subject their margin to neither fraud risk of the futures commission merchant (“FCM”) or broker-dealer nor fellow-customer risk.<sup>14</sup> For cleared swaps, collateral of registered funds is protected from fellow-customer risk through the legal segregation with operational commingling (“LSOC”) model for cleared swaps, which was adopted by the CFTC.<sup>15</sup>

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<sup>12</sup> An omnibus account structure is one in which all collateral belonging to all customers of a particular member is commingled and held in a single account segregated from those of the member.

<sup>13</sup> See Proposal, *supra* note 2, at 16905 (noting that this structure could be achieved either through reliance on the records of clearing members or through maintenance of separate accounts within the omnibus account by the clearing agency itself).

<sup>14</sup> Under the Investment Company Act of 1940 (“ICA”), registered funds are required to custody their assets in accordance with Section 17 of the ICA. Nearly all registered funds use a U.S. bank custodian for domestic securities although the ICA permits other limited custodial arrangements. In addition to Section 17, the ICA contains six separate custody rules for the different types of possible custody arrangements: Rule 17f-1 (broker-dealer custody); Rule 17f-2 (self custody); Rule 17f-4 (securities depositories); Rule 17f-5 (foreign banks); Rule 17f-6 (futures commission merchants); and Rule 17f-7 (foreign securities depositories). Foreign securities are required to be held in the custody of a foreign bank or securities depository. Rule 17f-1 permits registered funds to use a broker-dealer custodian, but the rule imposes conditions that are difficult in practice to satisfy.

<sup>15</sup> Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 77 FR 6336 (Feb. 7, 2012), available at <http://www.gpo.gov/fdsys/pkg/FR-2012-02-07/pdf/2012-1033.pdf> (“LSOC Adopting Release”). Although the proposed risk management procedures and proposals for segregation and portability requirements for clearinghouses issued by the Board of Governors of the Federal Reserve System (“Board”) were similar to the SEC’s general approach and were intended to be flexible depending upon “the applicable legal

We believe that protection of market participants should not be sacrificed in the interest of clearing SB swaps. One critical component of protecting market participants, such as registered funds, is to ensure that the SEC provides the necessary protections for customer collateral held by clearing members, including broker-dealers, and clearing agencies. Unfortunately, the SEC's current approach of leaving the segregation model to the discretion of the covered clearing agencies coupled with reliance on existing Exchange Act Rule 15c3-3 and Proposed Exchange Act Rule 18a-4 do not achieve that goal. Exchange Act Rule 15c3-3 allows broker-dealers (including SBSBs that are broker-dealers) to rehypothecate customer margin and excess up to 140% of the debit balance, and Proposed Exchange Act Rule 18a-4 contemplates that SBSBs (rather than the clearing agencies) will maintain the customer assets in the same manner as broker-dealers do with respect to listed options.<sup>16</sup>

To ensure certainty and simplicity, we urge the SEC to impose the same requirements for the protection of customer collateral on SB swap clearing agencies that the CFTC imposes for swap clearinghouses. Inconsistent rules adopted by the SEC and the CFTC with respect to the protection of collateral of cleared SB swaps and swaps would impose significant and unnecessary costs and burdens on market participants.<sup>17</sup> For registered funds, the additional costs ultimately would be borne by fund shareholders.

Registered funds typically trade swaps and SB swaps from the same desk or desks. This is particularly true of credit default swaps ("CDS") in connection with which index swaps and certain tranching CDS are already subject to clearing under the LSOC model. Under the SEC's proposed approach, the system of clearing single name CDS or tranches comprising an index potentially could be different from and significantly less protective of the rights of customers than the system for clearing CDS indices. Moreover, if the SEC does not adopt LSOC as a minimum level of protection for collateral, it would produce an odd result in which customers of clearing agencies for which the CFTC is the supervisory authority could choose to have their SB swaps collateral protected by LSOC while

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framework," we note that the Board is in a very different position in terms of the applicability of its regulations than the SEC. Unlike the SEC, the Board does not have primary jurisdiction over a derivatives clearing organization.

<sup>16</sup> Although we do not entirely understand how the Commission intends Proposed Rule 18a-4 to operate, the structure of the Proposed Rule 18a-4 and the accompanying discussion in the SB Swaps Segregation Rules Proposing Release suggest that the SBSB would hold customer margin and excess directly or in a good control location but would be allowed to rehypothecate the customer assets up to 140% of the debit balance although it also must hold cash and/or qualified securities computed in accordance with the reserve formula in a special reserve account to counterbalance this use.

<sup>17</sup> The SEC's proposed approach also is inconsistent with the Dodd-Frank Act's requirement that the SEC coordinate its regulatory approach with that of the CFTC and the prudential regulators. Section 712(a)(2) of the Dodd-Frank Act ("the Securities and Exchange Commission shall consult and coordinate to the extent possible with the Commodity Futures Trading Commission and the prudential regulators for the purpose of assuring regulatory consistency and comparability, to the extent possible").

customers of clearing agencies for which the SEC is the supervisory authority would depend on the protection chosen by the clearing agencies for their SB swaps collateral.<sup>18</sup>

Finally, we understand that the adoption of an LSOC-type model for segregation may require amendments to Rule 15c3-3 and the SEC's segregation proposal for SB swaps.<sup>19</sup> We suggest that the SEC permit customer assets – both margin and excess margin – to be segregated and excess margin to be held at the covered clearing agency (as is possible under LSOC). In addition, we recommend that the SEC propose to amend Rule 15c3-3 and Proposed Rule 18a-4 to prohibit use by an SBSB that is a broker-dealer or by a stand-alone SBSB of customer assets held as margin or excess margin for SB swaps. This approach is designed to mitigate losses to SB swap customers upon an SBSB's default and bankruptcy and decrease the opportunities for defalcations and misuse by the SBSB during times of stress. We believe a different structure than has traditionally been applied to broker-dealers is appropriate for the SB swaps market because more customer assets (in the form of customer collateral) will be held by a clearing member than in the traditional broker-dealer context.

*Omnibus Account Structure (without LSOC Features) Is Inconsistent with Protection Provided by Dodd-Frank Act*

We believe an omnibus account structure (*i.e.*, under which customer initial margin and excess margin assets are commingled) without providing for the identification and recordkeeping features of LSOC is not consistent with the Dodd-Frank amendments to the Exchange Act regarding the segregation of assets held as collateral for cleared SB swaps. Section 3E(e) of the Exchange Act prohibits any clearing agency that has received any money, securities, or property for deposit in a separate account(s) to hold, dispose of, or use any such money, securities, or property as belonging any person

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<sup>18</sup> For example, CME and ICE Clear Credit would not be subject to the SEC's proposed standards for covered clearing agencies because the CFTC is their supervisory agency. We understand that CME and ICE Clear Credit allow their SB swap customers (with their FCMs) to choose to use a swaps (4d(f)) account or a securities account. ICE Clear Europe, which has not been designated by FSOC, would be subject to the SEC's proposed standards and could choose to adopt the omnibus account structure for clearing of SB swaps.

<sup>19</sup> Rule 15c3-3 requires that a broker-dealer promptly obtain and maintain physical possession or control of all fully-paid securities and excess margin securities of a customer. Fully-paid securities are securities held in a cash account and margin equity securities carried in a margin or special account that have been fully paid. Excess margin securities are a customer's margin securities having a market value in excess of 140% of the total of the debit balances in the customer's non-cash accounts. As part of their obligation to maintain physical possession or control of customers' fully paid and excess margin securities, broker-dealers are required to deposit into a reserve account at a bank an amount equal to their net monetary obligation to customers or in respect of the customers' securities positions. Securities held subject to a lien to secure obligations of the broker-dealer are not within the broker-dealer's physical possession or control. Rules 8c-1 and 15c2-1 allow broker-dealers to rehypothecate customer securities in a manner that allows those securities to be subject to a lien or liens but by an amount that exceeds the customer's aggregate indebtedness to the broker-dealer. See SB Swaps Segregation Rules Proposing Release, *supra* note 10.



other than the swap customer of the broker, dealer, or SBSB. In other words, the clearing agency must not use the collateral of one customer to cover the obligations of another customer or the obligations of the broker-dealer or clearing agency.

As described in the Proposal by the Commission, an omnibus account may expose a customer to fellow-customer risk and, possibly, to loss as a result of a clearing member's proprietary positions because individual customer positions are not required to be identified to the clearing agency. Under the omnibus structure, losses by one customer are subsidized automatically because a clearing agency does not have transparency into the ownership of the assets.

In discussing the two possible methods of segregation at the clearing agency level, the SEC notes that an omnibus account structure may be more efficient when porting positions and collateral for a group of customers subject to a defaulting member "when there has been no customer default or where customer collateral is legally protected on an individual basis"<sup>20</sup> as in LSOC. Given these provisos, it is unclear under what scenario a clearing agency could efficiently port customer positions when it has no transparency into the identity of the different owners of the assets. The benefit of "efficient porting" as noted by the Commission is marginal at best unless the omnibus account structure is modified to at least provide LSOC provisions. Therefore, we urge the Commission to propose to require that covered clearing agencies adopt, at a minimum, the LSOC approach/model.

#### *LSOC Provides Key Protection to Customer Collateral*

The LSOC model of segregation provides important protections to SB swap customers of clearing members. The CFTC, in adopting LSOC for the protection of cleared swap customer collateral, quotes the CME as stating that LSOC provides "greater protection of cleared swaps customer collateral against fellow-customer risk" than the futures (omnibus) model and "is more likely to facilitate portability of cleared swaps customer positions"<sup>21</sup> than the futures (omnibus) model.<sup>22</sup>

Under the LSOC model adopted by the CFTC, each FCM and derivatives clearing organization ("DCO") must segregate on its books and records the cleared swaps of each individual customer and related collateral positions. Operationally, each FCM and DCO is permitted to hold or commingle the relevant collateral in one account. Each FCM and DCO must ensure that such account

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<sup>20</sup> See Proposal, *supra* note 2, at 16905.

<sup>21</sup> See LSOC Adopting Release, *supra* note 15, at 6349.

<sup>22</sup> The Commission also notes that "neither portability nor segregation could occur as a practical matter under the current cash securities and listed options markets structure." See Proposal, *supra* note 2, at 16905

is separate from any account holding FCM or DCO property or holding property belonging to a non-cleared swap customer.

In addition, the DCO must develop rules that specify a “waterfall” of funds that is used to satisfy defaults (as also is contemplated by the Proposal). The CFTC’s rules specifically address the extent to which, under a simultaneous default of an FCM and one of its cleared swap customers (“double default”), the margin held at a DCO of non-defaulting swap customers of a defaulting FCM may be used by the DCO as part of its waterfall. Under the CFTC rules, a clearinghouse may not, as part of its waterfall, allow the DCO to access the collateral of the non-defaulting cleared swap customers to address losses due to a defaulting swap customer upon a default of the clearing member. This requirement provides significant protection to swap customers, such as registered funds.

We believe LSOC (properly structured) would protect cleared SB swap customer collateral by: (i) ensuring that customer assets, including excess margin assets, are held at the clearing agency and not the clearing member; (ii) providing for clear identification of customer assets; and (iii) mitigating or virtually eliminating the risk that a clearing agency would access the collateral of non-defaulting cleared SB swap customers as a result of a double default under the waterfall provisions. As recognized and noted by the Commission, fellow-customer risk is of a “particular concern because customers may have limited ability to monitor or to manage the risk of their fellow customers.”<sup>23</sup> Although customers of clearing members engage in due diligence of their broker-dealers and FCMs before selecting their clearing members and continue to monitor their clearing members, it is not possible to monitor or manage the risks of other fellow customers. We do not believe that registered funds (as well managed and regulated entities) should be required to be subject to risks of other customers.

The Commission also notes that implementing omnibus models that would protect customers on an individual basis may require a covered clearing agency to rely on the records of its members or maintain its own books reflecting customer-level interest in the customer’s portion of collateral. Although we acknowledge the risk of inadequate or inaccurate reporting or recordkeeping is inherent in any custodial or trading relationship, we believe these risks can be mitigated by requiring the clearing members to report daily to their clearing agencies. We also suggest that the Commission propose an LSOC-type rule that requires broker-dealers to provide information about each customer’s excess margin. We believe that such reporting should substantially mitigate the risks to customers and to the SEC by avoiding insolvency situations in which insufficient records make it an almost insurmountable challenge to confirm the amount and location of customer margin.

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<sup>23</sup> *Id.*

*LSOC is Compatible with Existing Bankruptcy Regime*

The efficacy of any segregation regime depends upon whether the applicable bankruptcy regime allows customer assets to be returned to the particular customer upon the bankruptcy of the intermediary holding the assets. In the United States, bankruptcies of SBSDs implicate the U.S. Bankruptcy Code (“Code”), the Securities Investor Protection Act (“SIPA”) and banking regulations. Although LSOC was designed to operate in tandem with the Code and, in particular, the commodity broker provisions, we believe that LSOC as applied to SB swaps can be structured to work within the confines of the stockbroker liquidation provisions of the Code and SIPA, which are the two regimes applicable to SBSDs regulated by the Commission.

The Dodd-Frank Act amended the stockbroker liquidation provisions of the Code (*i.e.*, §741) to treat SB swaps as a “security” and accounts holding cleared SB swaps as “securities accounts” for purposes of the Code<sup>24</sup> but did not amend SIPA under which substantially all U.S. broker-dealers are liquidated. As a result, for stand-alone SBSDs, the SB swap counterparty would appear to be a customer and the SBSD would appear to be a “stockbroker” under the provision with respect to claims in regard to cleared SB swaps. The SB swap counterparty, therefore, would have priority status ahead of the general creditors of the SBSD as a customer under the Code, and an SB swap counterparty’s claims with respect to the “in-the-money” amount of the SB swap would be entitled to priority status. Depending upon the documentation and status of the SB swap counterparty, it also may have a right to close out the SB swap outside of the automatic stay.<sup>25</sup>

The Dodd-Frank Act did not address the treatment of SB swaps and the related customer cash and securities margin upon the liquidation of an SBSD that also is dually registered as a broker-dealer. SIPA contains its own definitions of “security” and “customer.” When a broker-dealer enters into liquidation under SIPA, the customer securities and the reserve account are generally available for distribution to customers. In addition, in connection with SIPA proceedings, the receiver typically ports customer positions and related margin to a solvent broker-dealer or clearing member.

Regardless of potential uncertainties in the insolvency laws, the fate of SB swap counterparties that are customers of a clearing member SBSD in either a stockbroker liquidation or a SIPA proceeding will depend primarily upon (i) the availability of assets to satisfy customer claims and (ii) the ability to

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<sup>24</sup> The Dodd-Frank Act excluded claims of SB swap counterparties with respect to non-cleared SB swaps from these protections except to the extent that the customer-counterparty has a claim for the return of margin for which the SEC has established a customer protection or segregation requirement.

<sup>25</sup> It is not clear whether customer positions at a bankrupt SBSD could be ported to another solvent SBSD.

identify customer assets to facilitate porting of customer positions to a solvent clearing member.<sup>26</sup> Adoption of a sound and workable segregation regime is essential to ensuring that SB swap counterparties are protected in bankruptcy.<sup>27</sup>

*Covered Clearing Agencies Should Provide Individual Segregation as an Option*

In the Proposal, the Commission describes the individual account structure, which “may also provide a high degree of protection from the default of another customer of a member, as a customer’s collateral is intended to be used to cover losses associated solely with the default of that customer.”<sup>28</sup> We agree and believe the Commission should propose to require covered clearing agencies to provide individual segregation as an option for customers. Providing this option would clearly be consistent with the requirement in Section 3E(b)(2) of the Exchange Act that prohibits use of one SB swap customer’s assets for margining, securing or guaranteeing trades or contracts of another SB swap customer.

Under this model, each broker-dealer and clearing agency would maintain separate individual accounts for each customer and the relevant collateral. After a double default, the clearing agency would be permitted to access the collateral of the defaulting SB swap customers but not the collateral of the non-defaulting customers. As noted by the Commission, in the event of a member failure, clear and reliable identification of a customer’s collateral may promote portability of an individual customer’s positions and collateral or expedite their return to the customer.<sup>29</sup> In the event of a bankruptcy of a clearing member, this collateral and excess margin would be held away from the SBSB and would be

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<sup>26</sup>In the event of an insolvency of a clearing member that is subject to a stockbroker liquidation under § 741 of the Code or a broker-dealer liquidation under SIPA, customer assets associated with a particular customer would be used to pay down outstanding debit balances owed by that customer to the SBSB or broker-dealer. The remaining assets in the possession or control of the SBSB or broker-dealer, including those held at a good control locations (such as a clearing agency), would be pooled, and each customer would share pro rata in the pool of customer property up to the full amount of such customer’s net equity claim.

<sup>27</sup> An LSOC-type structure would provide greater protections to SB swap customers than the current segregation structure applicable to broker-dealers under Rule 15c3-3, which essentially relies on the combined sufficiency of: (i) cash and high quality securities in a special reserve account and (ii) fully-paid securities and excess margin above 140% being held by the broker-dealer or at a safe “control location,” to satisfy claims. In our experience, this approach has not always resulted in there being sufficient assets to meet customer claims because, among other things, the ownership of assets has been difficult to determine and the regime relies on different rules and statutes that use different definitions of “customer.” See, e.g., *In the Matter of Bevill, Bresler & Schulman, Inc., First Federal Savings & Loan Association of Lincoln v Bevill, Bresler & Schulman, Inc.; Security Pacific Clearing & Service Corporation*, 59 B.R. 353 (D.NJ 1986).

<sup>28</sup> See Proposal, *supra* note 2, at 16905.

<sup>29</sup> *Id.*

identifiable as belonging to the SB swap customer. As a result, the collateral and excess margin would not be applied by the clearing agency with respect to a close-out of a defaulting member's positions or by a defaulting member itself to cover other customer obligations or obligations of the SBSB.

We have consistently taken the view that the individual segregation model would potentially provide the maximum protection for customer collateral.<sup>30</sup> Now that LSOC has been implemented successfully for cleared swaps, individual segregation should be an additional option available to customers of clearing members such as registered funds. We believe the market and market participants are ready for this next step in collateral protection. In this regard, the CFTC, when it adopted LSOC, noted that although LSOC was a critical step in protecting customers and their collateral, the CFTC intends to consider actively seeking notice and comment on a proposal to allow individual protection of client assets.<sup>31</sup>

The Commission notes that maintaining individual accounts can be operationally and resource intensive for a covered clearing agency and could impact the overall efficiency of its clearing operations. We believe that, rather than allowing the different covered clearing agencies to make that determination individually, the Commission should evaluate the costs and benefits of this option through a proposed rulemaking.

Covered Clearing Agencies Should be Prohibited from Using Haircutting of Variation and Initial Margin of Customers as Recovery Tools

Proposed Rule 17Ad-22(e)(3)(ii) would require a covered clearing agency to establish, implement, maintain and enforce written policies and procedures reasonably designed to ensure it establishes plans for the recovery and orderly wind-down of the covered agency necessitated by credit losses, liquidity shortfalls, losses from general business risk, or any other losses. The SEC does not propose any guidance regarding the content of such plans.

We request that the SEC specifically prohibit covered clearing agencies from using certain "recovery tools" to continue operating during times of financial stress. In particular, we object to the use of variation margin and initial margin haircutting as recovery tools because margin of non-defaulting customers of clearing members could be used to support the recovery of a covered clearing agency. Variation margin haircutting contemplates the clearing agency reducing pro rata the amount that the clearing agency would be obligated to pay participants with in-the-money (net) positions while

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<sup>30</sup> We have not advocated previously for individual segregation as the single model for cleared swaps because we were concerned in the context of the CFTC rules of the potential costs and operational burdens on market participants, particularly as fundamental changes were being made to the swaps market as a result of the Dodd-Frank Act.

<sup>31</sup> In addition, we note that the derivatives regulation in Europe – the European Markets Infrastructure Regulation or EMIR – requires clearinghouses to offer individual segregation as an option to customers.

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continuing to collect in full from those participants with out-of-the money (net) positions. Losses, therefore, are allocated to participants who have experienced a gain and have not contributed to a participant default. Initial margin haircutting would result in the clearing agency writing down initial margin provided by non-defaulting participants who then would be required to replenish the initial margin.

We believe these tools would impose unfairly the costs of recovery of a covered clearing agency on entities that did not contribute to the losses or the default and do not have the ability to manage the risks of the covered clearing agencies. There have been suggestions that systemically important CCPs use these tools for recovery. We do not believe it is appropriate to focus exclusively on the survival of a CCP (notwithstanding its systemic importance) at the expense of customers of clearing members (such as registered funds). Appropriation of customer collateral in this manner may jeopardize market participants' underlying belief in the fairness of the financial system. We believe that there are other legitimate tools (*e.g.*, increased capital contribution by a CCP to its guaranty fund) that could assist CCPs in times of financial stress.

#### Commission Should Require Covered Clearing Agencies to Have Public Representation on Boards

The Commission does not propose to require a covered clearing agency's policies and procedures to provide for governance arrangements that also support the objectives of participants' customer, securities issuers and holders and other stakeholders. In the Proposal, the Commission asks whether it should consider such a requirement. We believe it is imperative that the boards of directors of covered clearing agencies include a representative of customers of clearing members.

As participants in the SB swaps market, ICI members have a strong interest in ensuring that this market operates in a manner that treats all market participants fairly. To that end, we recommend that the covered clearing agencies be required to include representatives of both sell-side and buy-side market participants on their boards of directors. To benefit from a diverse group of market participants, some equities clearing organizations and stock exchanges already include investor representatives on their boards. For example, the board of the Depository Trust and Clearing Corporation is made up of 20 directors of whom 13 are from market participants, including international broker-dealers, custodian and clearing banks and investment institutions.

We believe that stakeholder involvement in the governance of covered clearing agencies would minimize conflicts of interests by balancing the commercial interests of covered clearing agencies with the interests of stakeholders. Examples of such conflicts that may be checked by stakeholder participation include situations where covered clearing agencies seek to maximize their profits to the detriment of buy-side market participants. Given the importance of the board of directors of a covered

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clearing agency in monitoring and controlling conflicts of interest, it is imperative that the composition of boards of covered clearing agencies include stakeholder representatives.

For similar reasons, we believe that the risk committees of covered clearing agencies also should include a wide range of client representatives. As risk committees will be responsible for making decisions capable of having profound effects on the SB swaps market, market participants have a strong interest in ensuring adequate and diverse stakeholder representation on risk committees as well as transparency as to the committees' decision-making processes.

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We appreciate the opportunity to provide comments on the SEC's proposal to enhance standards for covered clearing agencies. We strongly urge the Commission to propose for comment a uniform margining regime for cleared SB swaps and re-propose for comment the segregation and portability provisions to require specifically covered clearing agencies to provide at a minimum the LSOC model for the protection of customer collateral for cleared SB swaps. If you have any questions on our comment letter, please feel free to contact me at (202) 218-3563, Sarah Bessin at (202) 326-5835, or Jennifer Choi at (202) 326-5876.

Sincerely,

/s/

Dorothy M. Donohue  
Acting General Counsel

cc: The Honorable Mary Jo White  
The Honorable Luis A. Aguilar  
The Honorable Daniel M. Gallagher  
The Honorable Kara M. Stein  
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The Honorable Mark Wetjen

The Honorable Scott D. O'Malia