Managed Funds Association
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

February 22, 2013

Via Electronic Submission: http://www.sec.gov/rules/proposed.shtml

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549–1090

Re: Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security- Based Swap Participants and Capital Requirements for Broker-Dealers (RIN 3235–AL12; File No. S7-08-12)

Dear Ms. Murphy:

Managed Funds Association[1] welcomes the opportunity to provide comments to the Securities and Exchange Commission (the "**Commission**") on its 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" (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 aimed at reducing risk in the security-based swaps ("**SBS**") market, including the imposition of appropriate risk-based margin and capital requirements, and the implementation of segregation requirements that increase protection of customer collateral. Our members are customers to Commission-regulated security-based swap dealers ("**SBSDs**") and major security-based swap participants ("**MSBSPs**", and together with SBSDs, "**SBS Entities**")[4] and our members are fiduciaries to the investors

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 all other regions where MFA members are market participants.

2 77 Fed. Reg. 70214 (November 23, 2012), available at: http://www.gpo.gov/fdsys/pkg/FR-2012-11-23/pdf/2012-26164.pdf ("**Proposed Rule Release**").

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

4 These terms have the meanings set forth in the joint final entity rules and interpretations adopted by the Commission and the CFTC that further define the terms swap dealer, security-based swap dealer, major swap participant and major security-based swap participant. *See* Commission and CFTC joint final rule; joint interim final rule; interpretations on "Further Definition of 'Swap Dealer,' 'Security-Based Swap Dealer,' 'Major Swap Participant,' 'Major Security-Based Swap Dealer' and 'Eligible Contract Participant'", 77 Fed. Reg. 30596 (May 23, 2012), and corrected by 77 Fed. Reg. 39626 (July 5, 2012), available at: http://www.gpo.gov/fdsys/pkg/FR-2012-05-23/pdf/2012-10562.pdf.

whose money they manage. Therefore, it is critical that the Commission reduce the risks that our private fund manager members and their respective investors will encounter and strengthen the protections available to them.

In addition, we appreciate the Commission's thoughtful approach to the Proposed Rules and its efforts to consider, and to the extent practicable, harmonize the Proposed Rules with comparable regulations issued by other U.S. and international regulators.[5] In this spirit, we are providing our views on the Proposed Rules to assist the Commission in adopting comparable, robust and balanced final rules that will promote efficiency, competition and capital formation[6] while also protecting customers, liquidity and the overall functioning of the SBS market.

I. Executive Summary

The Proposed Rules place obligations on SBS Entities for which there is no prudential regulator. Since the Proposed Rules will affect how SBS Entities trade SBS with, and protect the collateral of, their customers, MFA urges the Commission to evaluate and consider how the Proposed Rules will materially affect customers and the broader SBS markets.

In particular, the Commission should ensure that the Proposed Rules on margin requirements ("**Proposed Margin Rules**"), and their interplay with the Proposed Rules on capital requirements ("**Proposed Capital Rules**"), allow for a well-functioning market for non-cleared SBS. The Proposed Margin Rules have the potential to bring consistency and transparency to margin practices for non-cleared SBS. We fully support these broad objectives. However, we believe that the Proposed Margin Rules, while promoting the benefits of such broad objectives and encouraging market participants to clear their SBS, should appropriately address the particular risks posed by the relevant non-cleared SBS transaction. If the Commission's final margin rules for non-cleared SBS ("**Final Margin Rules**") do not properly reflect such risks, we are very concerned that the markets for non-cleared SBS will become destabilized and lose their economic viability, thereby compromising the ability of market participants to manage risk effectively. To allow for a transparent and efficient market for non-cleared SBS, the Commission should capture the best of existing industry practices, such as the two-way exchange of variation margin ("**VM**", also referred to in the Proposed Rules as margin collateral to address "**current exposure**") and robust netting, as well as impose appropriate additional, risk-mitigating safeguards.

In light of our overarching concerns, and more specifically as set out below, we respectfully urge the Commission to take into consideration our main margining positions in finalizing the Proposed Margin Rules:

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5 *See* Proposed Rule Release at 70215-17 (recognizing the international capital standard for banks as well as the existing and proposed regulations of the prudential regulators, the Financial Industry Regulatory Authority, Inc. and the Commodity Futures Trading Commission ("**CFTC**"), as well as the potential international implications of the Proposed Rules).

6 *See* Section 3(f) of the Securities Exchange Act of 1934 (the "**Exchange Act**").

- *<u>Uniformity of Regulation</u>*. MFA strongly believes that an internationally uniform set of margin requirements will facilitate orderly collateral management practices and minimize regulatory arbitrage in the non-cleared swaps and non-cleared SBS markets.

- *<u>Single Compliance Date</u>*. In the interest of simplicity and predictability, we respectfully suggest that the Commission should establish a single compliance date of one year from the publication date of its Final Margin Rules in the *Federal Register*.

- *<u>Bilateral VM Exchange</u>*. MFA strongly supports the bilateral exchange of VM, which would reinforce the current market "best practice" and limit both counterparty and systemic risk by preventing the accumulation of substantial unsecured exposures.

- *<u>Netting and Portfolio Margining</u>*. MFA greatly appreciates the Commission's support for the application of qualifying netting agreements and portfolio margining of SBS and other types of securities. To further enhance margin efficiencies by offsetting like risks, MFA urges the Commission to permit SBSDs' internal models to account for risk on a portfolio basis under cross-product master netting agreements.

- *<u>Transparency and Equitable Treatment under Internal Models</u>*. MFA recommends that the Commission condition its approval of SBSD internal models to determine IM amounts by requiring SBSDs to make the basic functionality of their IM models available to and replicable by their counterparties.

- *<u>Risk-Based Initial Margin</u>*. MFA supports requirements for initial margin ("**IM**", also referred to in the proposed rules as the "margin collateral" to address "**potential future exposure**") that appropriately reflect and address the risks to the financial system presented by the relevant non-cleared SBS transaction. To implement risk-based IM requirements, IM determinations by SBSDs using either a Commission-approved internal model method or a standardized, non-model approach should address the particular risks posed by the relevant non-cleared SBS product type or asset class.

With respect to the Proposed Capital Rules, we are particularly concerned that the Commission would impose a capital charge on SBSDs in the event that their non-commercial end-user counterparties elect to have their IM segregated in an account at an independent third-party custodian. Since we expect that such customers will ultimately incur the cost of this SBSD capital charge, it could make electing individual segregation prohibitively expensive for them. We respectfully request that this proposed capital charge should be eliminated in order for customers to have a meaningful statutory right. Eliminating the proposed capital charge would also enable the Commission to achieve regulatory consistency with the CFTC and the U.S. prudential regulators, neither of which has proposed a similar capital charge.

In support of MFA's request to eliminate this capital charge, we urge the Commission to leverage the derivative industry's progress in developing standard provisions for tri-party custody arrangements that provide enhanced customer protection of the IM that non-commercial end users are obligated to post, while also ensuring contractually that the secured party SBSD has sufficient control over, and access to, the posted IM in the event of enforcement of its rights against such collateral.

In addition, MFA appreciates that in developing Proposed Rules on segregation of collateral for cleared and non-cleared SBS, the Commission sought to protect customers and their collateral from the default of SBSDs by facilitating the prompt portability and return of customer property upon an SBSD's default.[7] With respect to the proposed segregation rules for cleared SBS ("**Proposed Cleared Segregation Rules**"), we strongly support the Commission's desire to facilitate portfolio margining of a customer's securities and cleared SBS positions.[8] Therefore, we understand the Commission's decision to propose omnibus segregation for cleared SBS collateral, but do not agree that omnibus segregation is necessary to facilitate such portfolio margining. We also believe that customers should have a default segregation option that safeguards their cleared SBS customer collateral not only from an SBSD's default but also from the default of another customer of an SBSD (*i.e.*, "fellow customer risk").[9] To allow customers to choose the level of asset protection that they feel is appropriate, while also ensuring that customers have a segregation option that will adequately protect their assets from both fellow customer risk and SBSD default risk, MFA strongly suggests that the Commission incorporate optionality into the segregation requirements for cleared SBS by:

(1) harmonizing its segregation rules with the CFTC's final segregation rules for cleared swaps ("**CFTC Final Cleared Segregation Rules**") by adopting legal segregation with operational commingling ("**LSOC**")[10] as the default segregation model;

(2) permitting a customer to waive LSOC protections and elect omnibus segregation for its cleared SBS; and

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7 *See* Proposed Rule Release at 70274.

8 *See id.* at 70326 (explaining that modeling the Proposed Cleared Segregation Rules on the requirements in Rule 15c3-3 ("**Rule 15c3-3**") under the Exchange Act will facilitate portfolio margining where an SBSD conducts business in securities and cleared SBS with the same counterparty).

9 "Fellow customer risk" is the risk that a clearing agency uses assets of an SBSD's non-defaulting customers to satisfy losses of that SBSD's defaulting customer in the event that those losses exceed the margin assets of the defaulting customer and the SBSD.

10 *See* CFTC final rule on "Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions", 77 Fed. Reg. 6336, (February 7, 2012), ("**CFTC Segregation Rule Release**"), available at: http://www.gpo.gov/fdsys/pkg/FR-2012-02-07/pdf/2012-1033.pdf. The LSOC model combines the operational and cost efficiencies of omnibus segregation with the legal protections of individual segregation by allowing swap dealers ("**SDs**") and major swap participants ("**MSPs**") to commingle operationally collateral posted by its cleared swaps customers while imposing books and records obligations intended legally to protect one cleared swaps customer from another cleared swaps customer's default.

(3) preserving the option to implement an optional individual segregation model for cleared SBS collateral in the future.

With respect to the proposed segregation rules for non-cleared SBS ("**Proposed Non-Cleared Segregation Rules**"), we applaud the Commission for giving customers options for the segregation of their collateral, including the right to elect that SBS Entities provide individual segregation of their IM with an independent third-party custodian. However, with respect to this individual segregation option, we respectfully recommend that the Commission augment the Proposed Non-Cleared Segregation Rules and mandate that:

(1) the customer have the right to elect that such segregation be pursuant to a tri-party agreement,

(2) an SBS Entity give its customers the right to choose a third-party custodian that is unaffiliated with the SBS Entity, and

(3) an SBS Entity disclose to its customer all costs that it will charge to the customer for individual segregation.[11]

We believe that inclusion of the foregoing requirements will enhance the customer protections of the individual segregation election for non-cleared SBS by ensuring that SBS Entities provide such segregation on commercially reasonable terms.

II. Proposed Margin Rules

In fulfilling its mandate to assure the safety and soundness of SBS Entities, the Commission should consider how the Proposed Margin Rules would affect buy-side firms, which comprise a significant portion of the SBS market and are customers of SBSDs.

The Proposed Margin Rules would establish minimum[12] margin requirements for non-cleared SBS, and would mandate the delivery of both IM and VM for non-cleared SBS from non-commercial end-users, such as hedge funds, to SBSDs.[13] Since hedge funds and other buy-side firms are often counterparties to SBSDs, this mandate will directly affect the cost to buy-side firms when entering into non-cleared SBS. Many of the costs associated with the Proposed Margin Rules will be incremental to buy-side firms, which regularly post both IM and VM to their counterparties, and collect VM for non-cleared SBS and swaps under current market

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11 Please note that this requested cost disclosure does not resolve our concerns with the Commission's proposed capital charge for customers electing individual IM segregation with an independent third-party custodian as discussed in Section III.A below.

12 Proposed Rule Release at 70260 (noting that SBS Entities could establish "house" margin requirements that are more conservative than those specified in the Proposed Margin Rules).

13 *See id*. at 70348-9, Proposed Margin Rule 18a-3(c)(1). The Proposed Margin Rules would require MSBSPs to collect VM from, and deliver VM to its counterparties, accounting for the fact that MSBSPs would be subject to "less stringent capital requirements than nonbank SBSDs". *Id*. at 70263 and 70349, Proposed Margin Rule 18a-3(c)(2).

practice; however, they may result in buy-side firms incurring costs beyond higher margin amounts and related operational expenses. For example, buy-side firms may incur increased trading costs in the form of adverse pricing, as SBSDs seek to pass along to their customers capital charges and expenses associated with new capital and margin requirements. In addition, if buy-side firms can no longer use robust netting arrangements, their overall funding costs for delivering margin will increase. In the aggregate, these incremental costs might be quite large. If the additional costs are excessive, they may effectively limit buy-side firms' access to the non-cleared SBS markets, which will likely adversely affect the SBS markets as they lose liquidity and depth. Thus, MFA urges the Commission to be mindful of increased costs that margin regulation may impose upon buy-side firms.

Specifically, we urge the Commission to issue final margin requirements that promote a fair and stable market for non-cleared SBS. For the reasons fully discussed below, we believe that sound regulation of margin delivered in connection with non-cleared SBS includes, at a minimum, the following attributes:

- consistency of margin requirements among regulators (discussed in Section II.A below);
- coordinated implementation of margin rules with a single compliance date (discussed in Section II.B below);
- parity among market participants in their obligations to deliver VM (discussed in Section II.C below);
- approved use of legally enforceable netting arrangements to both abate counterparty credit risk and to minimize the costs and capital inefficiencies resulting from over-collateralization of correlated positions (discussed in Section II.D below);
- transparent and equitable methods for determining margin amounts that both SBSDs and their counterparties can use independently (discussed in Section II.E below); and
- risk-based IM requirements that are appropriately tailored to address the risks posed by the relevant non-cleared SBS transaction (discussed in Section II.F below).

A. Uniformity of Regulation

MFA applauds the formation of the Working Group on Margining Requirements ("**WGMR**") of the Basel Committee of Banking Supervision and the International Organization of Securities Commissions ("**Basel-IOSCO**")[14] to develop a unified international framework for

[14] Basel-IOSCO Consultative Document on "Margin Requirements for Non-Centrally-Cleared Derivatives" dated July 2012 (the "**Basel-IOSCO Consultation Paper**"), available at: http://www.bis.org/publ/bcbs226.pdf. On February 15, 2013, the WGMR published its Second Consultative Document, available at: http://www.bis.org/publ/bcbs242.pdf, which contains the WGMR's nearly final proposals on margin requirements for non-centrally cleared derivatives.

margining non-cleared derivatives. Such international coordination is, in our view, essential for the efficient and effective functioning of the global swaps markets. More specifically, we strongly believe that an internationally uniform set of margin requirements will facilitate orderly collateral management practices and minimize regulatory arbitrage in the non-cleared swaps and non-cleared SBS markets. In the absence of such uniformity, market participants, including MFA members, will have to monitor and comply with multiple margin regimes, which would be administratively difficult, costly and burdensome, and may increase the likelihood for errors and instances of non-compliance. We reference our comment letter in response to the Basel-IOSCO Consultation Paper,[15] and we respectfully urge the Commission to consider our comments and recommendations to the WGMR in finalizing the Proposed Margin Rules.

We appreciate that the Commission has largely modeled the Proposed Margin Rules for SBSDs on the broker-dealer margin rules in an effort to promote consistency with existing rules set by the relevant self-regulatory organizations.[16] However, to the maximum extent practicable, we respectfully suggest that the Commission should also be making efforts to more closely conform its final margin requirements to the WGMR's final margin requirements to promote the establishment of comparable margin levels across regulatory jurisdictions in the SBS market. Otherwise, we are very concerned that there may be inconsistent implementation of the margin requirements in different jurisdictions, or within jurisdictions by different regulatory authorities.[17] Such inconsistencies would fragment and unnecessarily destabilize the operation of the non-cleared SBS and swaps markets.

B. Coordinated Implementation of Margin Rules with a Single Compliance Date for all Market Participants

MFA recommends that the Commission's Final Margin Rules should apply: (1) to all market participants at the same time; (2) only after registered clearing agencies and other market participants have implemented a working central clearing infrastructure; and (3) only after the

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15 Filed with Basel-IOSCO on September 28, 2012 ("**MFA Basel-IOSCO Letter**"), available at: https://www.managedfunds.org/wp-content/uploads/2012/09/Basel-IOSCO-Margin-Proposals-MFA-Final-Letter.pdf.

16 Proposed Rule Release at 70259.

17 MFA has also submitted comment letters to the CFTC and the prudential regulators on their proposed margin requirements for non-cleared swaps and SBS. *See* MFA's comments on the prudential regulators' Notice of Proposed Rulemaking on "Margin and Capital Requirements for Covered Swap Entities", 76 Fed. 27564 (May 11, 2011), filed with the prudential regulators on July 11, 2011 (the "**MFA Prudential Regulator Letter**"), available at: http://www.managedfunds.org/wp-content/uploads/2011/09/Prudential-Regulator-Capital-Margin-Letter-Final-MFA-Letter.pdf; MFA comments on the CFTC's Notice of Proposed Rulemaking on "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants", 76 Fed. Reg. 23732 (Apr. 28, 2011) (the "**CFTC Margin Proposing Release**") and the CFTC's Notice of Proposed Rulemaking on "Capital Requirements of Swap Dealers and Major Swap Participants", 76 Fed. Reg. 27802 (May 12, 2011) filed with the CFTC on July 11, 2011 (the "**MFA CFTC Letter**"), available at: http://www.managedfunds.org/wp-content/uploads/2011/09/CFTC-Capital-and-Margin-Requirements-Letter-Final-MFA-Letter.pdf. On November 26, 2012, we also submitted a supplemental comment letter to the prudential regulators during their reopened comment period, available at: https://www.managedfunds.org/wp-content/uploads/2012/11/Prudential-Regulators-Capital-Margin-Supplemental-Letter-MFA-Final-Letter.pdf ("**MFA PR Supplemental Letter**").

Commission has adopted its regulatory framework needed to implement the Dodd-Frank Act's mandatory clearing requirements for SBS. In the interest of simplicity and predictability, we respectfully suggest that the Commission should establish a single compliance date of one year from the publication date of its Final Margin Rules in the *Federal Register*.[18] We believe that that this compliance period would reduce systemic risk by facilitating and motivating the entire industry's transition to SBS clearing. We also believe that this compliance period would give market participants sufficient time to adapt and adjust to increased collateral requirements in the non-cleared derivatives markets. Otherwise, we fear that there will be a sudden spike in demand for eligible collateral to secure non-cleared SBS.[19] In particular, SBS Entities need sufficient lead time to adapt existing IM models to the new model requirements to achieve the intended model benefits of netting and risk offsets on a portfolio basis, and to secure the requisite regulatory approvals for such models.

As a threshold matter, MFA strongly believes that the margin requirements for non-cleared SBS should not be phased-in by type of counterparty at staggered intervals, as proposed by the CFTC. We understand that there were logistical and operational factors supporting a phased implementation plan for the clearing mandate for different categories of market participants,[20] but we do not believe that those factors apply with respect to IM levels for non-

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18 *See* MFA PR Supplemental Letter at 4 (similarly recommending to the prudential regulators a single compliance date of one year from the publication date in the *Federal Register* of their final margin rules for non-cleared swaps and SBS).

In a prior comment letter to the Commission, MFA also proposed a single compliance date implementation approach. *See* MFA's comments on the Commission's "Statement of General Policy on the Sequencing of the Compliance Dates for Final Rules Applicable to Security-Based Swaps Adopted Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act", 77 Fed. Reg. 35625 (June 14, 2012), filed with the Commission on August 13, 2012, available at: http://www.sec.gov/comments/s7-05-12/s70512-12.pdf ("**MFA Sequencing Letter**"). In our prior letter, we recommended that there should be one compliance date for non-cleared SB swap margining requirements that would become effective only after the later of the compliance date for the clearing requirement that applies to all SB swap market participants and the latest effective date of the final SB swap trade documentation and margin requirements (*i.e*., 60 days after the last of such rules is published in the *Federal Register*). We further explained that this additional 60 days prior to triggering such compliance date would ensure that SB swap market participants have adequate lead time to evaluate the final SB swap trade documentation and margin requirements and to assess which adjustments need to be made to their trading documentation, business models and portfolios in an orderly manner before the compliance deadline.

In the interest of achieving greater harmonization among regulators and facilitating the industry objectives discussed in this letter, we propose that the final margin rules for non-cleared swaps and SBS adopted by the various regulators should have uniform compliance deadlines to the maximum extent practicable. Accordingly, this letter updates MFA's prior implementation recommendation to the Commission.

19 The WGMR anticipated increasing demand for liquid, high-quality collateral as a result of its margin proposals in the Basel-IOSCO Consultation Paper. The liquidity impact of such demand motivated the WGMR to conduct a quantitative impact study to assess both the amount of margin required on non-cleared derivatives and the amount of available collateral that could be used to satisfy increased margin requirements. *See* Basel-IOSCO Consultation Paper at 3.

20 *See* MFA's comments on the CFTC's Notice of Proposed Rulemakings on "Swap Transaction Compliance and Implementation Schedule: Clearing and Trade Execution Requirements under Section 2(h) of the CEA", 76 Fed. Reg. 58186 (Sept. 20, 2011) and on "Swap Transaction Compliance and Implementation Schedule: Trading Documentation and Margining Requirements Under Section 4s of the CEA", 76 Fed. Reg. 58176 (Sept. 20, 2011)

cleared SBS. We believe that the Commission would not achieve any public policy benefit by implementing the Final Margin Rules with respect to a certain type of SBS or asset class on one category of market participants before another category of market participants. Such an implementation approach would in fact distort pricing and competition across the marketplace, forcing certain counterparties to pay higher margin amounts before other counterparties with longer phase-in schedules. We see no justification from a cost-benefit perspective to impose disparate and prejudicial cost burdens on different categories of market participants.

Accordingly, our overarching implementation recommendation is that there should be one compliance date for all relevant market participants after a reasonable compliance period. We believe a compliance date of one year after the Commission's Final Margin Rules have been published in the *Federal Register* would provide a reasonably sufficient period of time for: (1) the Commission to finalize its SBS clearing rulemakings; (2) the clearinghouses to make clearing operationally available for SBS products in their clearing pipelines; (3) the SDs and SBSDs to adapt their existing IM models to account for the new model requirements, and to secure regulatory approvals for these models; and (4) the industry as a whole to better understand the scope of products that can and will be cleared, and the scope of products that will remain in the non-cleared markets. This better understanding will inform business and trading decisions by all market participants, and will give them the time they need to safely and soundly clear their sufficiently liquid and standardized swaps and SBS, and to prepare for the full impact of higher margin requirements for their non-cleared swaps and SBS. As indicated above, such an approach will also mitigate the risk of a market-wide collateral "crunch" that could result if participants did not have sufficient time to adapt to both new margin requirements associated with mandatory clearing and a rapid introduction of higher non-cleared swap and SBS margin requirements.

C. Mandatory Bilateral Exchange of VM

The Proposed Margin Rules require SBSDs to collect but not post (*i.e.*, pay) VM when they enter into SBS with counterparties that are non-commercial end-users.[21] MFA strongly encourages requirements for SBSDs to both collect and post VM with regard to SBS that they enter with non-commercial end-users, such as financial entity counterparties. We believe that such bilateral exchange of VM is crucial to the proper functioning of the SBS and swaps markets and abatement of counterparty and systemic risk therein. We note that the need for this requirement is even more compelling to achieve international uniformity with the WGMR's proposal for universal two-way exchange of VM.[22]

Lacking a regulatory requirement for two-way posting would create a presumption on the part of SBSDs that their VM posting is neither necessary nor important for prudent risk management. This presumption would be directly contrary to derivatives reform goals of

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filed with the CFTC on November 4, 2011, available at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=.

[21] *See* Proposed Rule Release at 70348-49, Proposed Margin Rule 18a-3(c)(1).

[22] Basel-IOSCO Consultation Paper at 14.

ensuring that the risks of derivatives are appropriately internalized by each derivatives market participant. The absence of a mandate for two-way posting would represent a step back from current market "best practice" of VM exchange by both parties, would potentially significantly increase systemic risk, and would lead to a loss of transparency for the Commission into an observable measure of an SBSD's safety and soundness by virtue of the daily discipline of two-way VM exchange.

1. Current Widespread Best Practice

A wide range of market participants currently exchange VM bilaterally for non-cleared swaps and SBS,[23] and buy-side firms largely have adopted this sound market practice as "best practice" for collateral management. Market participants, including many MFA members, have largely accepted the current market practice of asymmetrical IM exchange, whereby SBSDs uniformly require their buy-side counterparties to post IM, but typically SBSDs do not post IM to their customers. With respect to VM, the prevailing bilateral arrangements among buy-side firms and SBSDs reflect that buy-side firms trade with SBSDs most often as peers, with comparable expertise, technical proficiency and understanding of the risks inherent in trading swaps and SBS. Bilateral margin arrangements also reflect that both parties have counterparty credit risk when trading swaps and SBS. The collection of margin, together with netting, are effective means for any market participant to reduce counterparty credit risk. Bilateral margin exchange further ensures that both parties continuously reconcile their views on the price of their open positions, avoiding disputes particularly in dislocation periods. As fiduciaries, buy-side firms are responsible for protecting the interests of their investors, which include pension plans and university endowments. Thus, shielding assets invested with buy-side firms from financial contagion is important to the U.S. and global economy. Recognizing the immense protections that the collection of VM offers, swap and SBS market participants have historically delivered VM on a bilateral basis. To support this practice, market participants have efficient contractual arrangements and extensive operational infrastructure for bilateral VM exchange. Thus, the Commission would not be imposing a material incremental burden or a change from "best practice" for SBSDs if they require SBSDs to deliver VM to their counterparties.

2. Reduction of Systemic Risk

The bilateral exchange of VM prevents either party to an SBS or swap from accumulating substantial unsecured exposures, thus limiting both counterparty and systemic risk. The ability of market participants to accumulate an unlimited amount of unsecured obligations to counterparties was one of the primary causes of the recent financial crisis and, in part, was why entities such as AIG were "too interconnected to fail" and "too big to fail".[24] As a result, the failure to mitigate current counterparty credit exposures through the daily bilateral exchange of

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[23] MFA understands that one-sided VM arrangements are an exception to established market practices for collateral arrangements.

[24] Oversight of the Federal Government's Intervention at American International Group, House Committee on Financial Services, 111th Cong. (Mar. 24, 2010) (statement of Hon. Ben S. Bernanke, Chairman, Federal Reserve Board of Governors)(addressing "why supporting AIG was a difficult but necessary step to protect our economy and stabilize our financial system").

VM could exacerbate system-wide losses in the event of an SBSD's default. Such losses could cause serious harm to the financial system. In addition, the failure of an SBSD to meet its daily VM obligations would also serve as an early warning system for detecting the deteriorating financial strength of an SBSD.

Given the systemic risk reducing benefits, the Commission should further its mission to ensure the safety and soundness of all market participants,[25] including SBSDs and MSBSPs, by requiring SBSDs to deliver VM to their customers. In the absence of SBSDs delivering VM, if an SBSD were to default, the uncollateralized SBS positions might result in other market participants suffering losses, which could potentially be significant for an individual market participant or in the aggregate across market participants. In turn, these market participants might become less stable and may experience difficulty fulfilling their obligations to other financial institutions for swaps and other financial products. Thus, by requiring SBSDs to deliver VM to all their customers for non-cleared SBS transactions, the Commission reduces the likelihood of an SBSD's financial contagion spreading among other market participants, not by direct firm-to-firm relationships among financial institutions, but through indirect transmission through the SBS markets.

As noted above, given the asymmetry that exists currently in SBS and swap markets with respect to the delivery of IM (*i.e.*, dealers collect IM from their customer counterparties but do not concomitantly post IM to them), and the higher degree of interconnectedness and systemic risk that such asymmetry engenders, it is even more imperative that the Commission codify the "best practice" of bilateral exchange of VM.

3. Increased Transparency

Bilateral exchange of VM will increase the transparency of the SBS and swaps markets, which is a key goal of the Dodd-Frank Act.[26] As a general matter, margin exchange is an observable measure of a SDSD's gains and losses with respect to its SBS transactions. An SBSD's ability to conceal losses associated with its SBS portfolio is difficult if that SBSD must deliver VM to its counterparties on a frequent basis. Such transparency could enhance reporting to regulators and the ability of regulators to gauge counterparty credit quality. Critically, such transparency would be advantageous to regulators evaluating and monitoring systemic risk.[27]

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[25] Section 764 of the Dodd-Frank Act (adding new Section 15F to the Exchange Act, which section instructs regulators, including the Commission, to set capital and margin requirements "[t]o offset the greater risk to the security-based swap dealer or major security-based swap participant *and the financial system* arising from the use of security-based swaps that are not cleared" (emphasis added)).

[26] S. Rep. No. 111-176 at 32 (2010), available at: http://www.gpo.gov/fdsys/pkg/CRPT-111srpt176/pdf/CRPT-111srpt176.pdf.

[27] *See* CFTC final rule §23.502(c) in "Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants", 77 Fed. Reg. 55904, 55963 (Sept. 11, 2012), available at: http://www.gpo.gov/fdsys/pkg/FR-2012-09-11/pdf/2012-21414.pdf, (where the CFTC has adopted final rules with respect to the documentation of swap transactions that would require SDs to "promptly notify the CFTC and any applicable prudential regulator, or with regard to swaps defined in section 1a(47)(A)(v) of the Act, the [CFTC, the Commission], and any applicable prudential regulator, of any swap valuation dispute in excess of $20,000,000 (or its equivalent in any other currency) if not resolved within:

We believe that requiring SBSDs to post VM would ensure that they engage in proper risk management and alert regulators to an impending failure, which would enable regulators in turn to intervene promptly and thus limit the degree to which a default by an SBSD could impact the U.S. financial system.

Daily VM exchange would enable the Commission to detect earlier an SBSD's financial troubles that would otherwise go undetected if an SBSD were not required to post VM, and acts as a limiting factor on the total amount of exposure an SBSD can take. Otherwise, an SBSD could mask its losses or hide the amount of its unsecured obligations to its swap counterparties if it had no requirement to post VM, and could potentially increase its exposures beyond the level its capital can support. We believe that this transparency to both the Commission and the counterparties to SBS Entities would better serve the Commission's public policy objectives of (1) enhancing the safety and soundness of SBS Entities, and (2) promoting financial system stability by imposing margin and capital requirements that are appropriate for the risk associated with non-cleared SBS.

4. Facilitation of Central Clearing

One of the key goals of the Dodd-Frank Act is to move the swaps and SBS markets toward greater central clearing.[28] When SBS Entities enter into cleared SBS transactions, the relevant registered clearing agency requires them to post VM on such SBS.[29] Requiring SBSDs to also post VM on non-cleared SBS would create symmetry between the cleared and non-cleared SBS markets. In addition, the bilateral exchange of VM would make the transition to central clearing less burdensome and operationally easier to integrate. If SBSDs are required to deliver VM on non-cleared SBS, then they will have to adapt their working capital and collateral management systems and policies to account for such obligations across their entire portfolio. Because these systems would then already be in place when the central clearing mandate becomes effective, they will reduce the financial and operational burden of progressively moving eligible portions of SBS portfolios to central clearing.

D. Netting and Portfolio Margining under the Proposed Margin Rules

1. Enhance the Application of Qualifying Netting Agreements

MFA appreciates that the Proposed Margin Rules clearly permit SBS Entities to apply any qualifying netting agreement in making their daily account equity calculations, subject to

(1) Three (3) business days, if the dispute is with a counterparty that is a [SD/MSP]; or (2) Five (5) business days, if the dispute is with a counterparty that is not a [SD/MSP]"). .

28 *Supra* note 26.

29 *See* Commission final rule on "Clearing Agency Standards", 77 Fed. Reg. 66220 (Nov. 2, 2012), at 66275 and 66285, §240.17Ad-22(b)(2), available at: http://www.gpo.gov/fdsys/pkg/FR-2012-11-02/pdf/2012-26407.pdf (finalizing clearing agency standards that require each clearing agency to "collect margin from its participants to limit exposures resulting from changes in prices or participant positions in current market conditions").

certain conditions.[30] Effective netting agreements lower systemic risk by reducing both the aggregate requirement to deliver margin and trading costs for market participants. Moreover, permitting netting across a wide variety of offsetting exposures, in addition to reducing aggregate counterparty credit risk and lowering trading costs, would: (1) allow entities to make efficient use of their capital; (2) provide market participants and regulators with better transparency as to the overall amount of counterparty risk between two parties, which is informative of risk in the derivatives markets; and (3) reduce complexity and settlement risk.

Many market participants currently have netting agreements that allow them to net both IM and VM amounts across many different exposures and assets.[31] Under the Proposed Margin Rules, however, the application of any qualifying netting agreement with respect to gross derivatives payables and receivables would be limited to daily equity calculations that will determine the required daily VM payments for the counterparty's account that holds non-cleared SBS. We respectfully urge the Commission to explicitly permit robust netting practices with respect to both IM and VM for cleared and non-cleared derivatives when crafting the final rules. Otherwise, we fear that such limitation would result in inadequate allowances for netting, which would in turn lead to over-collateralization of otherwise offsetting positions.

2. Facilitate Cross-Product Portfolio Margining

MFA strongly agrees with the Commission's support for portfolio margining of SBS and other types of securities as a principal rationale for modeling new Rule 18a-3 on the broker-dealer margin rules.[32] MFA believes that the Commission should permit a broader scope of portfolio margining. We applaud the Commission's recent issuance of its exemptive order to permit portfolio margining programs for cleared credit default swaps ("**CDS**") that include both swaps and SBS.[33] To further enhance margin efficiencies by offsetting like risks, we respectfully urge the Commission explicitly to permit SBSDs' internal models for calculating IM to account for risk on a portfolio basis, specifically accounting for risk offsets within all asset classes of

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30 Proposed Margin Rule 18a-3(c)(5) provides that SBS Entities may include the effect of a qualifying netting agreement that allows such entities to net gross receivables from and gross payables to a counterparty upon the counterparty's default if: "(i) The netting agreement is legally enforceable in each relevant jurisdiction, including in insolvency proceedings; (ii) The gross receivables and gross payables that are subject to the netting agreement with a counterparty can be determined at any time; and (iii) For internal risk management purposes, the [SBSD or MSBSP] monitors and controls its exposure to the counterparty on a net basis".

31 *See* MFA Prudential Regulator Letter at 8 and MFA CFTC Letter at 7-8 (providing examples of the kinds of netting that MFA might suggest, including netting of margin for: (1) OTC derivatives of the same or similar asset classes; (2) OTC derivatives with highly correlated assets or other financial products (*e.g.*, a credit default swap ("**CDS**") with referenced bond or an interest rate swap and Eurodollar futures); and (3) OTC derivatives exposures with margin for other financial product types (*e.g.*, physically-settling forwards, repurchase agreements, security lending agreements)).

32 Proposed Rule Release at 70259 ("The goal of modeling proposed new Rule 18a-3 on the broker-dealer margin rules is to promote consistency with existing rules <u>and to facilitate the portfolio margining of security-based swaps with other types of securities</u>" (emphasis added)).

33 Commission "Order Granting Conditional Exemption Under the Securities Exchange Act of 1934 in Connection With Portfolio Margining of Swaps and Security-Based Swaps", 77 Fed. Reg 75211 (Dec. 19, 2012) ("**Portfolio Margining Order**").

derivatives that are subject to a single, legally enforceable netting agreement. Accordingly, we urge the Commission explicitly to include in its final rules the principle of portfolio margining for calculating IM by confirming that internal value-at-risk ("**VaR**") models may take into account portfolio margining arrangements commonly referred to as "cross-product master netting agreements". Cross-product master netting agreements account for risk offsets among different types of correlated financial instruments, including cleared and non-cleared swaps and SBS. Portfolio margining under cross-product master netting agreements is permitted under existing regulatory regimes and is consistent with current market practice in the derivatives markets.[34] MFA wishes to emphasize that internal VaR models that permit cross-product master netting agreements would continue to be subject to the Commission's approval, ongoing review, and supervision.

MFA strongly believes that such portfolio margining arrangements would substantially mitigate the potential issue of a shortfall in eligible collateral in the wake of global regulatory reforms in the derivatives markets by allowing counterparties to recognize offsets for correlated financial instruments, including cleared and non-cleared derivatives. Such portfolio margining arrangements therefore free up excess collateral while adequately reflecting the risks of the portfolio.

Ensuring the continued viability of cross-product master netting agreements would also facilitate the transition to central clearing of derivatives by minimizing the need of market participants to post excessive collateral for portfolios that incorporate positions in both centrally cleared derivatives and non-cleared derivatives. During the transition to mandatory clearing, market participants will necessarily hold non-cleared derivative positions. Without the authority to margin correlated cleared and non-cleared positions on a portfolio basis, market participants would be unintentionally penalized during the transition to central clearing. Indeed, market participants will be forced to post redundant collateral for their cleared positions and their non-cleared positions. This unintended penalty during the transition to central clearing would act as a disincentive to market participants voluntarily moving more of their portfolios in non-cleared derivatives to be cleared by a central counterparty. The resulting bifurcation of derivatives portfolios between cleared and non-cleared derivatives is likely to have material and adverse liquidity implications in the cleared and non-cleared derivatives markets. Even after the transition of the liquid, standardized portion of the OTC derivatives markets to central clearing, portfolio margining should be available to encourage market participants to use cleared positions to offset the risk of their remaining non-cleared positions. Such cross-product portfolio margining would therefore reduce systemic risk by encouraging customers to maintain balanced and appropriately hedged portfolios as a result of the reduced aggregate margin requirements applicable when the aggregate portfolio is so hedged. Thus, counterparties would be effectively

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[34] Portfolio margining has been broadly accepted under various regulatory regimes, including under Exchange Act Rule 15c3-1. The Financial Industry Regulatory Authority permits portfolio margining for certain products pursuant to NASD Rule 2520(g) and NYSE Rule 431(g). Listed equity options (single-name and index), (broad-based) equity index futures and "margin equity securities" under the Federal Reserve Board's Regulation T are among the products already allowed to be cross-margined under these regimes. The Options Clearing Corporation, Chicago Mercantile Exchange, Inc., New York Portfolio Clearing, LLC and LCH.Clearnet, Ltd. also permit portfolio margining between certain products.

rewarded for maintaining a balanced or hedged portfolio of mutually offsetting transactions taking into account both cleared and non-cleared positions.

We therefore respectfully request that the Commission include in the final rules the following statement, or a substantially similar statement: "Internal value-at-risk models that account for risk on a portfolio basis may also take into account all products that are approved for model use and that are subject to a single legally enforceable cross-product master netting agreement."

MFA urges the Commission to consider our accompanying portfolio margining letter that we recently submitted to the prudential regulators with the MFA PR Supplemental Letter.[35] That letter more fully discusses the benefits and legal analysis supporting the continued use of cross-product portfolio margining arrangements by market participants. As such accompanying letter demonstrates, such arrangements account adequately for risks of a portfolio, while avoiding the capital inefficiencies of over-collateralization.

E. Transparency and Equitable Treatment under Internal Models

MFA urges the Commission to adopt final 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 SBS transaction to determine independently the applicable margin amount. The ability of customers to replicate models enables them to anticipate how margin might change over the life of the SBS and how much they should hold in reserve. Enabling customer replicability does not require competitively sensitive disclosure of the proprietary aspects of an SBSD's internal model. Rather, the SBSD's provision of the model's basic functionality to its customer will enable the customer to predict, reconcile, and verify IM amounts. This level of transparency is fundamental to conducting capital planning and underlies a customer's ability or inability to devote its resources strategically to other investments or obligations. In MFA's view, customer replicability should be a condition to the Commission's approval of any internal model.

The Proposed Margin Rules contemplate the use of Commission-approved internal models (other than for equity SBS) or, if an SBSD is not approved by the Commission to use an internal model, the standardized percentage deductions for market risk or "haircuts" for either CDS or non-CDS for determining IM amounts.[36] MFA commends the Commission's provision for an SBSD to choose between a model or non-model approach for calculating IM.

Allowing SBSDs to use approved internal models to determine IM requirements introduces a potential impediment to transparency because the counterparties of SBSDs will not have insight into how an SBSD establishes the IM requirements. Transparency in the use of a

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35 *See supra* note 17, available at: https://www.managedfunds.org/wp-content/uploads/2012/11/MFA-Portfolio-Margining-Letter-MFA-Final-Letter.pdf.

36 *See* Proposed Rule Release at 70349, Proposed Margin Rules 18a-3(d)(1) (standardized approach) and (d)(2) (model approach). The Commission's bifurcation of the standardized haircuts between CDS and non-CDS is "designed to account for the unique attributes of [CDS] positions." *Id*. at 70232. MFA agrees with the Commission's general rationale for such bifurcation.

model to establish IM directly correlates to a buy-side firm's ability to replicate any determination of an amount of IM. The ability of a buy-side firm to replicate IM determinations is critical to that firm's capacity to anticipate and adjust to changes in its obligations. If SBS market participants do not have the information necessary to predict with reasonable certainty potential changes in IM requirements, there are two possible outcomes. Under the first possible outcome, SBS market participants would hold excess capital to account for an unanticipated IM change, which would necessarily limit SBS market participants' ability to invest capital elsewhere or meet other cash flow needs. Under the second possible outcome, SBS market participants would not hold additional capital in reserve and then an unanticipated change in an IM requirement could result in a series of defaults, which could have pro-cyclical effects if a class or multiple classes of participants have the same undisclosed margin models and are forced into closing or covering their positions all at the same time. Requiring transparency with respect to IM will allow an SBSD's counterparties to model for and anticipate margin changes and to avoid these two outcomes.

Generally, IM models should be objective (*i.e.*, a model should arrive at the same IM amount for identical SBS regardless of the counterparty's identity or creditworthiness). SBSDs might use a multiplier that is distinct from the base IM model to address any concerns about a counterparty's creditworthiness. We are concerned that, without legally required transparency: (1) SBSDs will potentially alter their models to produce a more favorable output when determining IM requirements for a particular counterparty or class of counterparties; and (2) counterparties to SBSDs will not have the information necessary to anticipate potential changes in IM requirements. Neither potential outcome is desirable. Therefore, MFA recommends that the Commission condition its approval of SBSD proprietary models to determine IM amounts by requiring SBSDs to make the basic functionality of their IM models available to and replicable by their counterparties.

In addition, we request that the Commission require SBSDs to apply the same base IM model for all counterparties, regardless of their creditworthiness. As mentioned above, SBSDs may use a multiplier that is distinct from the base IM model to address any concerns about a counterparty's creditworthiness. However, we object to an SBSD's varying the baseline for its IM model solely on account of the identity of its counterparties. For example, the Commission should prohibit an SBSD from using different base IM models for SBS with other SBS Entities and SBS with non-commercial end-users. We believe that such a prohibition on varying IM models by counterparty is necessary to provide proper transparency into IM calculations for market participants to ensure that IM amounts are not arbitrarily high, and to prevent discriminatory practices in the SBS markets that would regularly disadvantage counterparties with lower credit quality relative to counterparties with higher credit quality.

F. Margin Requirements Should be Risk-Based and Appropriately Tailored to the Relevant Non-Cleared SBS Transaction

Given the importance of certain non-cleared SBS as customized risk management tools, we respectfully urge the Commission to set non-cleared margin levels in such a way that they appropriately address the particular risks posed by the relevant non-cleared SBS transaction. To implement this recommendation, IM determinations by SBSDs using either a Commission-approved internal model method or a standardized, non-model approach should address the particular risks posed by the relevant non-cleared SBS product type or asset class. If final IM requirements are not sufficiently risk-based, it is likely that buy-side firms will bear the bulk of the cost increases attributable to higher margin requirements and related operational costs across the market. In particular, we are concerned that buy-side market participants will bear their sell-side counterparties' costs associated with negotiating, establishing and maintaining segregated custodian accounts for counterparties. Buy-side firms may also incur increased costs through adverse pricing as sell-side firms seek to pass on to their counterparties their increased margin and capital expenses. In the aggregate, such increased trading costs may be material and, if excessive, could limit access to the SBS market and therefore result in the non-cleared SBS market losing liquidity and depth.

1. Concerns with Ten-Day Market Risk Time Horizon for IM Determinations under Model Approach

Under the Proposed Rules, an SBSD with a Commission-approved internal VaR model for computing net capital may use its model to determine a counterparty's margin amount or IM. For both purposes, the SBSD's internal VaR model would need to use a 99%, one-tailed confidence level with price changes equivalent to a ten-business-day movement in rates and prices.[37] We understand that the Commission's rationale for proposing a ten-business-day requirement is "to ensure that the VaR model uses potential market moves that are large enough to capture multi-day moves in rates and prices".[38] Given this rationale, the Commission has requested comment on whether the VaR model should be required to use a longer period of time to establish a potentially greater margin collateral requirement for customers given that they may not be subject to capital and other prudential requirements.[39] For the reasons set out below, we do not believe that a longer time period would be warranted or justified for purposes of determining a counterparty's IM amounts for non-cleared SBS. We also believe, for the reasons explained below, that the Commission should provide for a more flexible, risk-specific approach to determine and adjust the appropriate liquidation time horizon by product type or asset class.

In our experience, current market practice with respect to many asset classes of non-cleared SBS and swaps results in a liquidation time horizon that is shorter than ten business days. A shorter liquidation period presents less market risk, thus warranting a lower margin collateral requirement to address that risk. It is market practice[40] to obtain one or more market quotations in order to terminate a non-cleared SBS or swap position, which position is then liquidated using that valuation. Under market standard bilateral contractual arrangements, where market quotations cannot be obtained, it is possible to use a mark obtained from an alternative pricing source, such as derived from a pre-agreed model. As such market practice allows for simple liquidation rather than requiring a replacement transaction, liquidating a position in a non-cleared

37 *See id*. at 70338, Proposed Margin Rule 18a-1(d)(9)(ii)(A).

38 *Id*. at 70262.

39 *Id.*

40 As set out in the the market standard ISDA documentation for non-cleared swaps.

SBS or swap based on the mark obtained may be completed relatively quickly, without material delay. Although the non-cleared SBS and swaps markets may be less liquid in certain cases, as liquidation is permitted on a payment basis without the need to ensure a replacement transaction, it does not necessarily follow that liquidation of a customer's position taken in a non-cleared SBS or swap will require more time than liquidating a position in a cleared SBS or swap.[41] Thus, the Commission's proposed ten-business-day market risk time horizon for VaR models may prove to be inaccurate or unjustified for purposes of calculating IM amounts for any counterparty. MFA therefore respectfully requests that the Commission reconsider the appropriateness of the ten-business-day market risk period for calculating a counterparty's margin amount in light of current market practice regarding the liquidation of non-cleared SBS and swaps. The Commission's final rules for margining non-cleared SBS should afford it flexibility in setting the appropriate time period for capturing market risk by product type or asset class using a more risk-specific approach, and provide for further adjustment of the baseline time period as the non-cleared SBS market evolves after the Dodd-Frank Act's clearing requirement is implemented.

2. Further Definition of Eligible Collateral

The Proposed Margin Rules would require counterparties to deliver cash, securities and/or money market instruments to meet the account equity requirements in Rule 18a-3. If the counterparty delivers securities or money market instruments, the SBSD would be required to take a prescribed haircut on such collateral equal to the deductions required under the Commission's Proposed Capital Rules. MFA agrees that cash collateral, whether denominated in U.S. dollars or in the currency in which payment obligations under the relevant non-cleared SBS are required to be settled, should retain 100% of its value. Beyond cash, securities and money market securities, the Commission has not specifically identified classes of assets that could be used as eligible collateral. The Commission is seeking comment on whether it should define the term "eligible collateral" by identifying specific asset classes, similar to the proposals of the CFTC and the prudential regulators. In the interest of achieving comparability on a key margin requirement, we believe the Commission should define the term "eligible collateral", preferably by adopting the CFTC's "forms of margin" approach.[42] In addition, with increasing collateral demands for securing non-cleared swaps and SBS, we prefer a wider and more flexible choice of sufficiently liquid, high-quality assets to serve as eligible collateral to meet the Commission's collateral requirements.

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[41] *See* CFTC Final Rule on "Derivatives Clearing Organization General Provisions and Core Principles", 76 Fed. Reg. 69334 (Nov. 8, 2011) at 69438, §39.13(g)(2)(ii), available at: http://www.gpo.gov/fdsys/pkg/FR-2011-11-08/pdf/2011-27536.pdf (for most cleared swaps, requiring a minimum five-day time horizon that the CFTC subsequently could choose to shorten).

[42] *See* CFTC Margin Proposing Release at 23738-39.

III. Proposed Capital Rules

A. Eliminate Capital Charge for Customer Electing Individual IM Segregation with Independent Third-Party Custodian

As more fully discussed in Section V below, under the Proposed Non-Cleared Segregation Rules, customers have the option to elect individual segregation for non-cleared SBS.[43] However, the Proposed Capital Rules also provide that SBSDs will incur a capital charge in the event that their non-commercial end-user counterparties elect to have their IM segregated in an account at an independent third-party custodian under Section 3E(f) of the Exchange Act ("**Section 3E(f)**").[44] Since we expect that such customers will ultimately incur the cost of this SBSD capital charge, it could make electing individual segregation prohibitively expensive for them. This result directly undermines the objective of Section 3E(f), which the Dodd-Frank Act added to the Exchange Act in the wake of the Lehman Brothers bankruptcy. The goal of the provision is to allow customers to request an enhanced level of protection for the IM they post to secure their non-cleared SBS, as individual segregation would "keep these assets separate from the bankruptcy estate of the SBSD or MSBSP if it fails financially and becomes subject to a liquidation proceeding".[45] Although customers would have a protective statutory right intended for their benefit, the imposition of a capital charge that SBSDs would likely pass on to them would act as an economic disincentive to ever exercising this right. We respectfully request that this proposed capital charge should be eliminated in order for customers to have a meaningful statutory right. Eliminating the proposed capital charge would also enable the Commission to achieve regulatory consistency with its fellow regulators. We note that neither the CFTC nor the prudential regulators have proposed a similar capital charge with respect to segregation of IM for non-cleared swaps or SBS.

In the Proposed Rule Release, the Commission explains its reasons for taking such a strikingly inconsistent proposal by highlighting two primary concerns: first, that the segregated IM would be in the physical possession or control of an independent third-party custodian rather than the SBSD; and second, that the segregated IM could not be liquidated by the SBSD without the intervention of the independent third-party custodian.[46] The Commission thus views the segregated IM held at an independent third-party custodian as not meeting the collateral requirements in its proposed new Rule 18a-3 for calculating the amount of equity in the account of a counterparty.

We strongly believe that standard provisions in tri-party custody or tri-party control arrangements, which some MFA members have negotiated, would address both of the Commission's concerns, thus justifying elimination of this proposed capital charge in the Commission's final rules. Such tri-party arrangements are used in the U.S. secured financing

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43 *See* Proposed Rule Release at 70352, Proposed Rule 18a-4(d)(1).

44 *See id.* at 70330, Proposed Rule 15c3-1(c)(2)(xiv)(B)(2) and 70336, Proposed Rule 18a-1(c)(1)(viii)(B)(2).

45 *See id.* at 70275.

46 *See id.* at 70246-47 (with respect to Proposed Rule 15c3-1(c)(2)(xiv)(B)(2)) and 70268-69 (with respect to Proposed Rule 18a-3).

market and the non-cleared OTC derivatives market to achieve the enhanced protection afforded by individual IM segregation at an independent third-party custodian. We respectfully urge the Commission to eliminate the proposed capital charge and instead, leverage the derivative industry's progress in developing standard provisions for tri-party custody arrangements that provide enhanced customer protection of the IM that non-commercial end users are obligated to post, while also ensuring contractually that the secured party SBSD has sufficient control over, and access to, the posted IM in the event of enforcement of its rights against such collateral.

1. UCC Control of Collateral by Dealer Secured Party

In a tri-party custody arrangement, an unaffiliated custody bank or other institutional custodian assumes responsibilities for safeguarding, investing, transferring and releasing posted collateral under a three-way contract among the custodian, the pledgor (which would be the customer under the Proposed Margin Rules) and the secured party (which would be the SBSD under the Proposed Margin Rules.)[47] The posted collateral is indirectly controlled by the secured party via the collateral safeguarding covenants by the custodian to the secured party, with a control agreement in favor of the secured party. The secured party must obtain and perfect its valid security interest in the posted collateral by having "control" over the collateral assets under Article 8 (perfection by control over a certificated security, an uncertificated security, or a security entitlement is provided in §8-106) and Article 9 (perfection by control over deposit accounts is provided in §§9-104, 9-314 and 9-327) of the Uniform Commercial Code ("**UCC**"). UCC Articles 8 and 9 have been widely adopted in the U.S. Subject to the UCC and the respective rights of the parties under the tri-party custody agreement, the secured party typically establishes the requisite degree of control under the UCC by virtue of its contractual ability to direct the custodian to follow its instructions (except when it is the defaulting party under the relevant agreements). The SBSD secured party may also gain exclusive control over the pledgor's posted collateral by virtue of the "entitlement order" instructions that it issues to the custodian in the event of the pledgor's default or other specified condition, particularly via a "Notice of Exclusive Control" under such circumstances to eliminate any right of a defaulting counterparty to attempt to instruct the custodian to move its collateral.[48] The custodian would

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47 *See* Memorandum, "Independent Amount Segregation: Summary of ISDA's Sample Tri-Party IA Provisions", published in 2011 by the International Swaps and Derivatives Association, Inc. ("**ISDA**"), available at https://www.managedfunds.org/wp-content/uploads/2013/02/ISDA-SampleTri-Party-IA-Provisions-Memorandum.pdf. ISDA has published documents to facilitate negotiations of contractual provisions in tri-party custody agreements for segregation of "Independent Amounts" or "IA" (as such term is defined in the standard ISDA credit support annex for non-cleared OTC derivatives transactions; the term is synonymous with IM).

See also Letter, dated February 4, 2013, from the Investment Company Institute ("**ICI**") to the Commission in response to the Proposed Rules, available at: http://www.sec.gov/comments/s7-08-12/s70812-20.pdf (the "**ICI Letter**"). ICI, a buy-side trade association representing U.S. investment companies, also noted the significant protections of segregated IM for customers provided by tri-party arrangements. The ICI Letter also discussed the control and access provisions for SBSDs in tri-party agreements that should address the Commission's concerns, thus rendering unnecessary the Commission's imposition of the proposed capital charge for individual IM segregation at an independent third-party custodian.

48 *See* "Independent Amounts", Release 2.0, dated March 1, 2010, a white paper (the "**IA White Paper**") produced jointly by ISDA, MFA and the Securities Industry and Financial Markets Association ("**SIFMA**") at p. 10 (describing tri-party collateral IM holding arrangements and control provisions for the secured party to achieve a

then be contractually required to turn over possession of the collateral to the SBSD, thus facilitating the timely liquidation of the collateral assets.[49]

2. Prompt Collateral Access for Liquidation by Dealer Secured Party

As noted above,[50] tri-party custody arrangements may contain certain provisions that would permit the pledgee of collateral (the secured party/dealer) to gain exclusive control over the posted collateral by issuing "entitlement order" instructions. Inclusion of such provisions in a tri-party agreement would enable the SBSD secured party to gain exclusive control and timely access to such collateral in the event of the pledgor's default or other specified events. Such access would allow the SBSD secured party to liquidate the pledgor's non-cash collateral to cover its exposures. In the event of a counterparty's bankruptcy, the SBSD dealer's contractual rights to liquidate, terminate, or accelerate a securities contract or swap agreement would be unimpaired, as such contractual rights are not subject to the automatic stay.[51]

In response to the Commission's request for comment in Question 9 of the Proposed Rule Release,[52] MFA strongly believes that it is neither appropriate nor necessary to apply this proposed capital charge in lieu of margin for counterparties who elect segregation of their posted IM at an independent third-party custodian pursuant to Section 3E(f) for all of the reasons set forth above.

B. Capital Requirements Limiting Available Pool of SBSDs

As noted above, the Commission's Proposed Capital Rules will affect the price at which SBSDs will enter into non-cleared SBS with customers, because SBSDs will likely pass through the capital costs and charges associated with non-cleared SBS.[53] As customers of SBSDs,

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perfected security interest in the collateral), available at: https://www.managedfunds.org/wp-content/uploads/2013/02/Independent-Amount-WhitePaper-Final.pdf. The IA White Paper was delivered to the Federal Reserve Bank of New York and other banking supervisors pursuant to a derivative industry letter dated June 9, 2009 in the wake of the Lehman Brothers bankruptcy.

49 *See id.* at 40, endnote 38.

50 *See also* ICI Letter at 7.

51 11 U.S.C. sections 555 (securities contract) and 560 (swap agreement).

52 *See* Proposed Rule Release, Question 9 at 70247.

53 MFA is particularly concerned with the aggregate cost impact on customers of such capital costs and charges imposed on their SBSD counterparties. In addition to the proposed capital charge in lieu of margin for counterparties who elect segregation of their posted IM at an independent third-party custodian pursuant to Section 3E(f), the Commission is also proposing to impose a capital charge on SBSDs for cleared swaps in undermargined customer accounts. This capital charge already exists for securities in Rule 15c3-1 of the Exchange Act but it applies only when a securities account is undermargined for five business days. With respect to non-cleared SBS, the Commission is proposing to reduce the time period before which an SBSD would incur this capital charge for non-cleared SBS from five business days to one business day or less, thereby increasing the likelihood of triggering the imposition of this capital charge on SBSDs. *See* Proposed Rule Release at 70336, Proposed Rule 18a-1(c)(1)(ix). The ICI Letter also noted the likely cost impact on customers from the Commission's proposed capital charge for cleared swaps if the SBSD collects margin collateral from its counterparty in an amount less than an amount determined using the Commission's proposed standardized deductions, which may well be higher than a

MFA's members are interested in the Commission's Proposed Capital Rules, particularly due to their interplay with the Commission's Proposed Margin Rules for calculating a counterparty's IM. Otherwise, the direct application of such capital requirements to MFA's members is uncertain. In particular, capital requirements are of significance because they will determine the composition and breadth of the SBSD community by either becoming a "barrier to entry" for certain dealers or causing existing dealers to exit the market.[54] For buy-side firms, a limited number or concentration of firms acting as SBSDs may impair competitive pricing and terms for tailored products. Moreover, a limited number of SBSDs will likely result in less negotiating power for customers as there will be fewer counterparties offering viable alternatives in both pricing and products. Thus, the Commission should ensure that the final capital rules would enable sufficiently capitalized firms to be SBSDs, but they should not be overly burdensome such that only the largest financial firms can or are willing to be SBSDs.[55]

C. Reporting of Capital Requirements

Increasing transparency in the SBS and swap markets is a key goal of Title VII of the Dodd-Frank Act.[56] The Commission, under the Proposed Capital Rules, would require an ANC broker-dealer to provide early warning notification to the Commission if its tentative net capital fell below $6 billion.[57] We appreciate the Commission's explanation that such increase is modeled on the requirement for OTC derivatives dealers to provide notice when the firm's tentative net capital falls below an amount that is 120% of the firm's minimum tentative net capital amount.[58] MFA supports this proposed "early warning" notice requirement as we believe it would improve the Commission's monitoring of these key market participants.[59]

clearing agency's deductions. ICI Letter at 8, n. 13. *See* Proposed Rule Release at 70330, Proposed Rule 15c3-1(c)(2)(xiv)(A) and 70335, Proposed Rule 18a-1(c)(1)(viii)(A).

54 *See e.g.,* statement of Mr. Eric Chern, Chicago Trading Company at the Joint CFTC-Commission Staff Roundtable Discussion on Proposed Dealer and Major Participant Definitions Under the Dodd-Frank Act at 110, available at: http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission2_061611-trans.pdf.

55 *See* Proposed Rule Release at 70228 (stating that there are currently only six broker-dealers authorized by the Commission to use internal VaR models to compute net capital ("**ANC broker-dealers**"). The Commission's rationale for its proposals to increase the net capital requirements for such ANC broker-dealers is two-fold: first, to bolster their capital reserves to account for market, credit, operational and other risks in response to the 2008 financial crisis, and second, to account for their anticipated increased SBS activities as registered SBSDs).

56 S. Rep. No. 111-176 at 32.

57 *See* proposed amendments to Proposed Capital Rule 15c3-1(a)(7)(iii).

58 Proposed Rule Release at 70228 (citing to 17 CFR 240.17a-11(c)(3)).

59 The Commission has supported early warning requirements for many years. *Cf.* Commission, *Study of Unsafe and Unsound Practices of Brokers and Dealers, Report and Recommendations of the SEC, pursuant to Section 11(h) of the Securities and Investor Protection Act of 1970,* H. Doc. 92-231 (1971) at 31.

D. Capital Relief for Robust Netting on a Portfolio Basis

We support the Proposed Capital Rules allowing both netting arrangements and the delivery of collateral to reduce an SBSD's overall capital requirement. Netting and the delivery of collateral are important tools for the reduction of counterparty risk, and we appreciate the Commission recognizing these benefits as part of the capital requirements set forth in the Proposed Capital Rules.

In addition, we encourage the Commission to provide greater recognition of the benefit of netting by modifying the Proposed Capital Rules to allow SBSDs to reduce their capital requirement by netting cleared and non-cleared derivatives positions across several counterparties on a portfolio basis as well as across products. For example, if an SBSD had exposure to counterparties through certain non-cleared SBS, but also had offsetting liabilities to such counterparties under repurchase agreements, the SBSD should not have to hold capital for the non-cleared SBS positions if its true counterparty exposure is fully offset. If SBSDs receive full credit for robust netting arrangements, it will benefit their customers because SBSDs will be less inclined to pass through capital-based charges (or at least small charges) to their customers.

E. Capital Relief for Cleared SBS

We note that the Proposed Capital Rules would require an SBSD to determine its minimum net capital by calculating 8% of its "risk margin amount"[60] ("**8% margin factor**").[61] As proposed, the 8% margin factor would be determined by using the greater of required margin or standardized haircuts with respect to cleared SBS *plus* the margin amount (or IM) for non-cleared SBS. The Commission's stated goal of this provision is to "require the stand-alone SBSD to increase its net capital in tandem with an increase in the risk of its security-based swap transactions".[62] MFA respectfully submits that central clearing reduces counterparty credit risk associated with SBS because, with regard to SBSDs, it is likely that their clearing agency counterparty will be more creditworthy than their current counterparties.[63] We believe that the Commission should reflect the lower risk associated with central clearing by ensuring that the

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60 *See id*. at 70336, Proposed Capital Rule 18a-1(c)(6). The proposed definition of "risk margin amount" means "the sum of: (i) The greater of the total margin required to be delivered by the [SBSD] with respect to [SBS] transactions cleared for [SBS] customers at a clearing agency or the amount of the deductions that would apply to cleared [SBS] positions of the [SBS] customers pursuant to paragraph (c)(1)(vi) of this section; and (ii) The total margin amount calculated by the [SBS] dealer with respect to non-cleared [SBS] pursuant to § 240.18a-3(c)(1)(i)(B)." The Commission's proposed definition is specifically designed to link the stand-alone SBSD's minimum net capital requirement to its cleared and non-cleared SBS activity. *Id*. at 70223.

61 *Id.* at 70221 (presenting a summary table of proposed capital requirements for stand-alone SBSDs not using internal models under Proposed Capital Rule 18a-1, and for broker-dealer SBSDs, with or without approved internal models, under proposed amendments to Rule 15c3-1, all of which would require the 8% margin factor calculation to determine the applicable minimum net capital requirement).

62 *Id.* at 70224.

63 *See* Darrell Duffie et al. *Policy Perspectives on OTC Derivatives Market Infrastructure*, Federal Reserve Bank of New York Staff Reports No. 424 (January 2010) at 4-5, available at: https://gsbapps.stanford.edu/researchpapers/library/RP2046.pdf.

capital charge for an SBSD's cleared SBS exposures is lower than any capital charge for equivalent non-cleared SBS exposures. A lower capital charge would appropriately lower the cost of central clearing for SBSDs and, ultimately, their customers. We believe that creating such incentives to clear SBS will reduce systemic risk in SBS markets.

IV. Proposed Cleared Segregation Rules

A. Recommendation for Customer Segregation Optionality

In developing the Proposed Cleared Segregation Rules, the Commission's intent was to accelerate "the prompt return of customer property to customers either before or during liquidation proceedings if the [SBSD] fails",[64] and to facilitate portfolio margining by promoting "consistent treatment of collateral in circumstances where a broker-dealer SBSD conducts business in securities and security-based swaps with the same counterparty".[65] As a result, in proposed Rule 18a-4, the Commission proposes to adopt omnibus segregation for cleared SBS thereby harmonizing the protections for cleared SBS with the protections for securities under Rule 15c3-3.[66] In addition, the Commission requests comment on the question "[i]s it appropriate to model the segregation provisions for security-based swap customers on the provisions of Rule 15c3–3? If not, explain why and identify another segregation model."[67]

MFA fully supports the goals of facilitating the prompt portability and return of customer collateral and positions and encouraging portfolio margining.[68] Moreover, we believe that an appropriate default segregation model must not only protect cleared SBS customer collateral from an SBSD's default but also from the default of another customer of that SBSD (*i.e.*, fellow customer risk). We do not believe that the omnibus segregation model in proposed Rule 18a-4 or Rule 15c3-3 accomplishes the latter goal,[69] but we appreciate that more protective segregation

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64 Proposed Rule Release at 70325.

65 *See id*. at 70326.

66 *See id*. at 70278 (explaining that the Commission designed new Proposed Cleared Segregation Rule 18a–4 to accommodate the operational aspects of an SBSD collecting collateral from SBS customers to margin cleared SBS and delivering collateral to registered clearing agencies to meet margin requirements of the clearing agencies with respect to the customers' transactions).

67 *Id*., Question 3.

68 *See* MFA's various comment letters in support of portfolio margining. In particular, MFA letter to the Commission on the Portfolio Margining Order, filed with the Commission on February 11, 2013, available at: https://www.managedfunds.org/wp-content/uploads/2013/02/SEC-Portfolio-Margining-Exemptive-Order-MFA-Final-Letter.pdf; MFA letter to the Commission on ICE Credit's petition for an order permitting portfolio margining of single-name credit default swaps and broad-based indices, filed with the Commission on June 13, 2012, available at: https://www.managedfunds.org/wp-content/uploads/2012/06/SEC-Comment-Letter-in-Support-of-ICE-Portfolio-Margining-Petition-Final-MFA-Letter.pdf; and MFA Sequencing Letter *supra* note 18. *See also*, MFA PR Supplemental Letter *supra* note 17; and MFA letter to the CFTC on ICE Clear Europe Limited's petition dated May 31, 2012 for an order permitting commingling of customer funds and portfolio margining for swaps and security-based swaps, filed with the Commission on December 14, 2012, available at: https://www.managedfunds.org/wp-content/uploads/2012/12/CFTC-Comment-Letter-in-Support-of-ICE-Clear-Europe-Petition-Final-MFA-Letter.pdf.

69 *See* Section IV.B below for our discussion of the protections of LSOC as compared to omnibus segregation.

models also result in increased costs to customers due to enhanced operational and accounting requirements.[70] Therefore, to balance customer protection needs with cost concerns, we respectfully request that the Commission should use the same approach that it is proposing for non-cleared SBS by building optionality into customers' segregation protections for their cleared SBS collateral.

Specifically, as customers to SBS Entities and fiduciaries to our investors, we would strongly recommend that the Commission incorporate optionality into the segregation requirements for cleared SBS by:

(1) harmonizing its segregation rules with the CFTC Final Cleared Segregation Rules by adopting LSOC as the default segregation model;

(2) permitting a customer to waive LSOC protections and elect omnibus segregation for its cleared SBS; and

(3) preserving the possibility of implementing an optional individual segregation model for cleared SBS customers in the future.

In making this recommendation, MFA is also mindful of the fact that the CFTC has adopted LSOC for protection of cleared swaps customer collateral. We do not believe that customers should have less protection, transparency and accounting for their cleared SBS collateral than for their cleared swap collateral, unless they opt into such lesser protections. Furthermore, many SBSDs and clearing agencies regulated by the Commission will also be SDs and derivatives clearing organizations regulated by the CFTC. In such dual-regulated capacities, these entities will be conducting business with customers with respect to their futures, securities, cleared SBS, swap and mixed swap transactions. We believe that there may be efficiencies for the customer to have one type of segregation or another as well as the ability to change the level of protection between omnibus segregation and LSOC as needed.

B. Adopt LSOC as Default Model for Cleared SBS

1. LSOC More Protective than Omnibus Segregation

MFA urges the Commission to adopt LSOC as the default segregation model for cleared SBS, rather than the proposed omnibus segregation model, because LSOC provides stronger customer protections than omnibus segregation. We believe that LSOC provides the proper default level of protection for collateral of cleared SBS customers should another SBS customer of an SBSD default. In addition, we believe the individual accounting mandated by LSOC will ensure more efficient portability of customer positions and related collateral than omnibus segregation in the event of a default by an SBSD or one of its customers.

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[70] *See* Proposed Rule Release at 70325-6 (explaining the costs and benefits of the segregation proposals, in particular, individual segregation).

As a general matter, LSOC would require an SBSD to keep books and records that identify each customer's cleared SBS and the related collateral but would still allow an SBSD to maintain that collateral operationally in a commingled customer account separate from any assets of the SBS entity or the relevant clearing agency.[71] The Commission's proposed omnibus segregation model does not include such individualized accounting,[72] and thus, upon a default by an SBSD or its customer, the model would not protect non-defaulting customers against fellow customer risk and would hamper portability.

LSOC would eliminate fellow customer risk with regard to cleared SBS by restricting a clearing agency from accessing the collateral belonging to non-defaulting customers of an SBSD to satisfy any losses associated with a default by another customer of that SBSD.[73] Elimination of such risk is critical because an important benefit of central clearing is the reduction of credit risk to parties when entering into SBS. In addition, an SBSD's customers do not have the necessary information to determine and mitigate any fellow customer risk to which they are exposed because customers do not and should not know the identity of their fellow customers or the nature of those customers' trading activity and positions. Without this confidential information, no customer can assess the creditworthiness of its fellow customers. Accordingly, adopting LSOC would protect customers by eliminating the need for them to accept a risk that they cannot properly assess.

LSOC also would enhance the portability of customers' positions to a greater extent than omnibus segregation. Portability is crucial in the cleared SBS market because it permits customers to transfer cleared SBS positions and collateral without incurring incremental transaction costs or encountering the various operational, accounting, tax and legal issues that would arise if the customer had to terminate and recreate those positions with another SBSD. The prompt transfer of customer positions also facilitates the orderly resolution of a failing SBSD, thus minimizing any disruption or dislocation in the cleared SBS market and limiting other problems that may result from interconnectedness with the insolvent SBSD.[74]

In addition, the individualized accounting required by LSOC would allow customers to identify and access collateral in the ordinary course of business, and thus, would facilitate non-defaulting customers' porting of cleared SBS trades and collateral if an SBSD fails or appears to

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71 CFTC Segregation Rule Release at 6339, where the CFTC summarizes these key features as part of its adopted LSOC model.

72 Proposed Rule Release at 70276 (explaining that new Proposed Cleared Segregation Rule 18a–4 would prescribe detailed requirements for how SBSDs must segregate cleared SBS collateral of a customer when an SBSD commingles those assets with the cash and securities of other customers).

73 *See* CFTC Segregation Rule Release, *supra* note 10, at 6339.

74 Portability helps to contain financial contagion by quickly defusing the number of customers, cleared SBS and collateral maintained with a failing SBSD. *First*, customers who port quickly do not incur losses should their swaps be "out-of-the-money" at the time the customer ports its cleared SBS positions. *Second*, once a customer has ported cleared SBS and collateral to a solvent SBSD, it is no longer exposed to risks associated with the failing SBSD, including operational issues such as the ability to receive the proceeds of a terminated swap in an expedient manner. *Finally*, porting allows the estate of a failed SBSD to liquidate quickly, thus, lowering the related costs.

be failing.[75] In contrast, under the proposed omnibus segregation model, in the event of an SBSD's insolvency, a clearing agency would have recourse to cleared SBS collateral of non-defaulting customers. In such circumstance, the clearing agency is unlikely to release the cleared SBS collateral of such non-defaulting customers until the process of liquidating the portfolio of the defaulting SBSD and its customers. Thus, the operational and legal commingling of cleared SBS customer collateral would effectively prohibit non-defaulting customers' from promptly porting their cleared SBS collateral and positions to a solvent SBSD.

From a risk reduction, portability and customer protection perspective, MFA believes that LSOC is a more appropriate default segregation model for cleared SBS than omnibus segregation and we ask the Commission to reconsider mandating LSOC as the default level of protection for cleared SBS.

2. Recent Events Demonstrate Problems with Omnibus Segregation

MFA believes that the recent events related to MF Global, Inc. ("**MF Global**") and Peregrine Financial Group, Inc. ("**Peregrine**") demonstrate the weaknesses of omnibus segregation from a customer protection standpoint. As the Commission is aware, MF Global had an approximately $700 million shortfall in customer funds[76] and Peregrine falsely represented that it held in excess of $220 million of customer funds when in fact it held approximately $5.1 million.[77] Because our members are customers to SBS Entities, these events and the subsequent insolvencies by MF Global and Peregrine caused our members to experience delays in the return of their segregated customer assets or to incur material losses of their funds. In those situations, MF Global and Peregrine held the customer funds in omnibus customer accounts, which resulted in mutualization among their customers of those losses. Therefore, we strongly believe that the Commission should provide a default segregation option that strengthens the segregation protections available to customers for their cleared SBS collateral.

MFA recognizes that the omnibus model that Rule 15c3-3 provides (and that proposed Rule 18a-4 contemplates) has provided substantial investor protection for many years. We also understand that LSOC would not protect against fraud or investment risk. Nonetheless, we believe that substantial advances in technology and computer capability create opportunities for greater investor protection than was feasible at the time the Commission adopted Rule 15c3-3 in 1972. In addition, LSOC's robust accounting and related customer disclosure would provide customers with enhanced transparency related to their collateral, and thus, give them greater certainty that their counterparty is not misusing or misappropriating their collateral.

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75 *See* CFTC Segregation Rule Release, *supra* note 10, at 6339.

76 *See Report of the Trustee's Investigation and Recommendations, In re MF Global Inc.*, No. 11– 2790 (MG) SIPA (Bankr. S.D.N.Y. Jun. 4, 2012), available at: http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/mfglobaliinvestreport060412.pdf.

77 *See* Complaint, U.S. Commodity Futures Trading Commission v. Peregrine Financial Group, Inc., and Russell R. Wasendorf, Sr., No. 12–cv–5383 (N.D. Ill. July 10, 2012), available at: http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfpfgcomplaint071012.pdf.

MFA recognizes that the accounting required under LSOC would create additional operational costs that customers would bear. However, our members have fiduciary obligations to the investors in their funds, and consequently, must act in the best interests of those investors. Given the losses in assets and investor confidence that our members suffered due to MF Global and Peregrine, the additional costs attributable to LSOC as compared to omnibus segregation seem negligible to many of our members and are costs that they are willing to bear. For those customers that determine that they do not want to incur these costs to receive the additional protections, they could still waive into omnibus segregation, but only upon the customers' affirmative choice to forego these protections.

3. CFTC Analysis of LSOC Compared to Omnibus Segregation

As the Commission knows, in determining which segregation model to mandate for cleared swaps customer collateral, the CFTC considered, among other options,[78] both omnibus segregation and LSOC. The Commodity Exchange Act ("**CEA**") and CFTC regulations require omnibus segregation for futures customer collateral,[79] like Section 15 of the Exchange Act and Rule 15c3-3 require for securities customer collateral. However, the comments that the CFTC received in response to its proposed segregation rules for cleared swaps revealed that commenters "generally viewed the [LSOC] Model as the minimum level of protection necessary for Cleared Swaps Customer Collateral".[80] As a result, for cleared swaps, the CFTC determined that omnibus segregation was insufficient, and adopted LSOC because of its consistency with the Dodd-Frank Act and the more individualized protection it provides for collateral as compared to omnibus segregation.[81] LSOC would similarly be consistent with the Dodd-Frank Act requirements applicable to the Commission, since (as required by Section 3E(c)(1) of the Exchange Act) LSOC would also allow "money, securities, and property of cleared security-based swap customers of a broker, dealer, or SBSD [to], for convenience, be commingled and deposited in the same one or more accounts".[82] Therefore, MFA agrees with the CFTC's analysis of LSOC as compared to omnibus segregation as well as its permissibility under the Dodd-Frank Act, and we respectfully request that the Commission similarly implement LSOC as the default segregation model for cleared SBS.

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[78] *See* CFTC advanced notice of proposed rulemaking; request for comment on "Protection of Cleared Swap Customers Before and After Commodity Broker Bankruptcies", 75 Fed. Reg. 75162 (Dec. 2, 2010), available at: http://www.gpo.gov/fdsys/pkg/FR-2010-12-02/pdf/2010-29836.pdf; and CFTC Notice of Proposed Rulemaking on "Protection of Cleared Swap Customer Contracts and Collateral; conforming Amendments to the Commodity Broker Bankruptcy Provisions", 76 Fed. Reg. 33818 (Jun. 9, 2011), available at: http://www.gpo.gov/fdsys/pkg/FR-2011-06-09/pdf/2011-10737.pdf (where the CFTC considers the physical segregation model and the legal segregation with recourse model).

[79] *See* Sections 4d(a) and (b) of the CEA and CFTC Regulations 1.20 to 1.30.

[80] CFTC Segregation Rule Release at 6342. *See also id*. at 6344 (stating that out of 25 comment letters the CFTC received, 20 supported LSOC, full physical segregation or some combination thereof).

[81] *See id*.

[82] Proposed Rule Release at 70275 (citing Section 3E(c)(1) of the Exchange Act (15 U.S.C. 78c–5(c)(1))).

C. Optional Customer Election of Omnibus Segregation

MFA understands that the Commission mirrored the Proposed Cleared Segregation Rules on Rule 15c3-3 generally to promote portfolio margining by ensuring consistent treatment of customer collateral where a broker-dealer SBSD conducts business in both securities and security-based swaps with that customer.[83] We strongly support the benefits of portfolio margining, and we have submitted various letters to the Commission and other regulators in support of portfolio margining generally as well as in response to industry petitions seeking orders to permit portfolio margining.[84]

On the one hand, MFA does not agree that SBS Entities must hold cleared SBS collateral in omnibus segregation arrangements as a prerequisite to permitting cross-margining of a customer's cleared SBS and securities positions. On the other hand, we recognize that there will be some increased cost to customers of having LSOC as a default segregation model and we believe customers should have the option to forego those costs. Therefore, while we support LSOC as the default segregation model for cleared SBS, we also recommend that the Commission provide customers the option of electing omnibus segregation. We believe such optionality will preserve maximum customer choice, while also ensuring that the default model provides more robust customer protections.

D. Preserve Possibility of Optional Individual Segregation for Cleared SBS

In addition to adopting LSOC as the default level of segregation for cleared SBS and providing customers the right to elect omnibus segregation for portfolio margining purposes, MFA also recommends that the Commission continue to consider adopting an optional individual segregation model for cleared SBS in the future.

1. General Benefits of Individual Segregation

As a general matter, individual segregation would provide greater protection for customer assets posted to collateralize cleared SBS. As the Commission knows, the key difference between individual segregation and LSOC is that individual segregation would require SBSDs to hold a customer's collateral in an account separate from other customers' collateral. Such an individual account would provide a customer with greater legal certainty that its cleared SBS collateral is completely insulated from fellow customer risk and that it would be able to port promptly its cleared SBS positions and collateral in the event of an SBSD's default (due to either the default of another customer or the SBSD's independent issues).

In addition, individual segregation would establish protections for customers' cleared SBS collateral that are equal to those available to customers with regard to the IM they post for non-cleared SBS.[85] As discussed herein, some of our members have negotiated individual

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83 *See id*. at 70326.

84 *See* supra note 68.

85 Proposed Rule Release at 70352, Proposed Non-Cleared Segregation Rule 18a–4(d)(1) (setting forth the rules that provide for individual segregation for non-cleared SBS collateral).

segregation arrangements in the OTC derivatives market, and MFA believes these protections should be available in the cleared SBS market for all customers.

2. Responses to Commission Questions on Individual Segregation

In the Proposed Rule Release, the Commission mentions that it considered individual segregation for cleared SBS but opted "to provide SBSDs and their counterparties a less expensive segregation alternative to individual account segregation".[86] The Commission's cost concern resulted from a comment letter submitted to the CFTC where the commenter asserted that the additional costs of individual segregation would be $141.8 million per covered swap entity.[87] In addition, because of the lack of trading data for cleared SBS, the Commission refers to the available statistics in the current OTC derivatives market and cites the *ISDA Margin Survey 2012*, which asserts that only 4.8% of IM received in the OTC derivatives market is currently segregated with a third party custodian.[88] As a result, to obtain additional information about current segregation arrangements, in the Proposed Rule Release, the Commission solicits feedback on various questions related to individual segregation, including customers' current use of such model, the related costs and the ability to resolve a defaulting SBSD.[89]

Since our members are customers and have not had access to central clearing, there is no current market standard for segregation of their cleared SBS collateral. Below MFA will provide the Commission information about our members' typical segregation arrangements in the non-cleared SBS market. However, we recognize that, because the regulatory requirements and markets for cleared SBS differ from that of non-cleared SBS, the related costs and customer protection benefits of electing one segregation model as compared to another may differ for cleared SBS and non-cleared SBS as well.

For non-cleared SBS, in the current OTC derivatives market, some of MFA's members have individual segregation arrangements in place for protection of their collateral. Typically, these are tri-party arrangements among the customer, its counterparty and a third-party custodian, and involve individually negotiated arrangements where the terms and costs vary from customer to customer. We have found that it is difficult and time-consuming to establish these tri-party arrangements since the negotiations of the necessary documentation can take several months. As a result, some of our members that might otherwise want to establish such arrangements in the OTC derivatives market have found it prohibitive to do so, thus explaining why the use of individual segregation arrangements may not be more prevalent, even though the

86 *Id*. at 70326.

87 *See id*. at 70326.

88 *See id*. at 70325.

89 *See id*. at 70327 (where the Commission requests comment on the following questions: (1) To what extent do counterparties presently require that their assets associated with security-based swaps be independently segregated?; (2) What would be the overall market impact of a right by customers to demand individual segregation? How would costs to end users be impacted? Would those costs differ depending on the type of end user or size of its positions with the SBSD?; (3) How would the existence of omnibus versus independent accounts factor into the ability easily to resolve a defaulting SBSD?; and (4) Would the proposed segregation requirements prove to be difficult to implement for existing contracts?).

risk reduction and portability benefits of individual segregation are so important to MFA's members.

In the context of cleared SBS, MFA appreciates the Commission's cost concerns related to individual segregation for cleared SBS. However, MFA is not aware of any empirical evidence offered that definitively establishes that costs of individual segregation for cleared SBS are prohibitively more than for non-cleared SBS. To the contrary, in the OTC derivatives market, it has been the experience of our members that fully segregated, individual account arrangements resulted in manageable and reasonable increased administrative burdens and related costs for their counterparty. In the Proposed Rule Release, as part of the cost-benefit analysis, the Commission mentions higher custodian fees and operational costs as the source of the increased expense on individual segregation, but cites only one estimate that quantifies what those increased costs might be.[90] We are aware that customers that elect individual segregation for cleared SBS will incur higher costs. However, MFA believes that if the Commission made individual segregation an available option for cleared SBS, many customers would desire to have these additional benefits if the costs would not be prohibitively expensive.

3. Harmonization with Global Cleared Derivatives Segregation Protections

In the Proposed Rule Release, the Commission acknowledges the potential substantial impact of its final segregation rules on international commerce and on the competitive position of entities operating across jurisdictions.[91] Because of the potential unintended consequences of inconsistent international regulation, MFA emphasizes the importance of the Commission harmonizing the Proposed Cleared Segregation Rules with segregation requirements for cleared derivatives implemented by other U.S. and international regulators.

In particular, other U.S. and international regulators are implementing or considering implementing individual segregation for cleared derivatives in their jurisdictions. As a result, MFA believes it is important for the Commission to continue to consider the viability of individual segregation for cleared SBS. For example, in Europe, the European Commission has finalized regulations[92] mandating that central counterparties must allow customers to choose between omnibus segregation and individual segregation for their cleared derivatives assets and positions.[93] In addition, when the CFTC adopted LSOC for cleared swaps, it also stated that it was "actively considering seeking notice and comment on a proposal to allow individual protection of client assets".[94] Although MFA understands that the adoption of individual segregation for cleared SBS raises legal, operational and cost issues that the Commission would need to address, given other regulators' efforts to consider and resolve these issues and the need

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[90] *See id*. at 70326.

[91] *See id*. at 70217.

[92] The final Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivative transactions, central counterparties and trade repositories, available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF.

[93] *See id*. at 201/36, Article 39(2) and (3).

[94] CFTC Segregation Rule Release at 6349.

for international regulatory harmonization, we believe it important for the Commission to continue its consideration of individual segregation for cleared SBS.

V. Proposed Non-Cleared Segregation Rules

MFA strongly supports the Proposed Non-Cleared Segregation Rules providing the option for customers to elect individual segregation with an independent third-party custodian for the IM posted on their non-cleared SBS. Such individual segregation protects a customer's IM in the event of its SBS Entity counterparty's or a fellow customer's default, and thus, ensures the stability and integrity of the SBS market. In addition, we appreciate the optionality of the individual segregation election.[95] Although MFA is supportive of individual segregation, we recognize that, for cost or other reasons, certain customers may prefer omnibus segregation or to waive affirmatively segregation altogether. Thus, we strongly support the Commission allowing the customer to choose the appropriate level of segregation for their IM, and provide recommendations below on the Proposed Non-Cleared Segregation Rules that represent our thoughts from a customer perspective as to what constitutes appropriate and meaningful individual segregation for IM posted on non-cleared SBS.

A. Customer's Option to Elect Tri-Party Custody Agreement

In Question 2 related to the Proposed Non-Cleared Segregation Rules for non-cleared SBS, the Commission asks for commenters to "[d]escribe the current practices and arrangements for individual segregation. For example, are these arrangements based on tri-party agreements between the SBSD, counterparty, and independent third-party custodian?"[96] Some of MFA's members have negotiated, tri-party agreements in place with SBS Entities and independent third-party custodians with respect to the collateral they post on their bilateral trades, and we believe all customers should have the right to elect these protections.

As discussed in Section III.A above, tri-party individual segregation arrangements are important from a customer protection standpoint because, if customers are not parties to the custodial agreement (*i.e.*, are not in contractual privity with the third-party custodian), then the SBS Entity essentially maintains exclusive control over the customers' IM. This control is what allows potential misuse and misappropriation of customer IM and restricts customers' ability to protect their rights to their IM. As a result, MFA believes that the Commission should mandate that customers have the option to elect that their individual segregation arrangement for non-cleared SBS be pursuant to tri-party agreements.[97]

In addition, we believe that providing customers that choose individual segregation the option of electing a tri-party arrangement will harmonize the Proposed Non-Cleared Segregation

[95] *See* Proposed Rule Release at 70352, Proposed Rule 18a–4(d)(1).

[96] *Id*. at 70288.

[97] As discussed in Section III.A, *supra*, MFA believes that the Commission must eliminate the capital charge imposed on tri-party arrangements so as to prevent this option from being cost-prohibitive.

Rules with the CFTC's proposed rules for uncleared swaps.[98] Section 23.602(b) of the CFTC's Proposed Rules require that "any agreement for the segregation of Margin pursuant to this Section shall be in writing, [and] shall include the custodian as a party". This language and statements of the CFTC and its staff during the discussions preceding the vote on issuance of the CFTC Proposed Rules[99] imply that SDs and MSPs must offer individual segregation of IM to their customers in the form of a tri-party agreement among the SD or MSP, the customer and the custodian. We do not believe that the Commission should mandate that all arrangements be pursuant to tri-party arrangements because, as discussed earlier in this letter, those arrangements can be difficult and time-consuming to put in place. However, MFA believes that it necessary for customers to have the option of having tri-party arrangements for the collateral they post on their uncleared swaps and non-cleared SBS positions, and we encourage the Commission to mandate that customers have the right to elect that such individual segregation be pursuant to a tri-party agreement.

B. Individual Segregation Offered on Commercially Reasonable Terms

MFA appreciates that customers have the right to elect individual segregation of the IM they post on non-cleared SBS. However, to ensure that this option is not subject to excessive restrictions, costs or terms to make it an unfeasible election for customers, we urge the Commission to ensure that SBS Entities offer individual segregation of IM posted in connection with non-cleared SBS on commercially reasonable terms. The Commission can assure such availability by:

(1) clarifying that customers' right to segregation with an independent third-party qualified custodian includes the choice of a custodian that is unaffiliated with their SBS Entity counterparty; and

(2) requiring an SBS Entity to disclose to its customers all costs that the SBS Entity will charge to the customer for electing individual segregation.

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98 *See* §23.602(b) of the CFTC 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", 75 Fed. Reg. 75432 (December 3, 2010), available at: http://www.gpo.gov/fdsys/pkg/FR-2010-12-03/pdf/2010-29831.pdf ("**CFTC Proposed Uncleared Segregation Rules**").

99 *See* CFTC Webcast Archive, November 19, 2010 Open Meeting on Fifth Series of Proposed Rules under the Dodd-Frank Act, available at: http://www.capitolconnection.net/capcon/cftc/111910/wmarchive.htm (in attempting to ensure that the CFTC Proposed Uncleared Segregation Rules permitted the use of tri-party agreements, CFTC Commissioner Bart Chilton asked CFTC staff whether the CFTC Proposed Uncleared Segregation Rules forestalled the use of such agreements. In responding to Commissioner Chilton's question, Robert B. Wasserman, then CFTC Associate Director, Division of Clearing and Intermediary Oversight, stated that, with respect to IM, the CFTC Proposed Uncleared Segregation Rules provide customers the right to elect to require segregation of their IM posted as collateral for uncleared swaps. Continuing, he asserted that, if a customer elects such segregation, the CFTC Proposed Uncleared Segregation Rules requires a tri-party agreement with the SD, the customer and the custodian).

1. Designation of an Independent Third-Party Custodian

As required by the Dodd-Frank Act, the Commission is seeking to implement rules that facilitate the segregation of IM with an "independent third-party custodian".[100] Unfortunately, the Proposed Non-Cleared Segregation Rules do not specify what constitutes "independence" as it relates to selection of a third-party custodian. MFA understands that, under certain circumstances, there are benefits and efficiencies to using a custodian affiliated with a customer's SBS Entity counterparty,[101] and thus, we do not object to the use of an affiliated custodian in all cases. However, we also want to ensure that the selection of the custodian is fair, reasonable and subject to mutual agreement by the parties. Therefore, we recommend that the Commission clarify that the SBS Entity does not have the right to dictate the designation of the independent third-party custodian.

Moreover, to balance the parties' interests, MFA respectfully suggests that the Commission impose the following additional requirements on the selection process:

First, the Commission should permit SBS Entities to propose an affiliated custodian to the customer. However, in such situation, the affiliate must be one of at least three custodial options, with the other two options being unaffiliated, independent banks or trust companies. This practice will prevent SBS Entities from effectively dictating the use of specific or affiliated custodians.

Second, the Commission should prohibit an SBS Entity from unreasonably refusing a custodian chosen by the customer (that is different from the SBS Entity's proposed options) so long as the independent third-party custodian meets certain criteria, discussed below. This approach assures that any custodian chosen is acceptable to both parties to the non-cleared SBS.

Third, the Commission should require each selected custodian to be regulated by a federal or state bank regulator and authorized under federal or state laws to exercise corporate trust powers. This requirement ensures that each custodian offered by an SBS Entity meets certain uniform criteria in order to promote common standards across different custodial options.

2. Disclosure of Individual Segregation Costs

MFA respectfully recommends that the Commission require SBS Entities to provide customers with robust disclosure of all costs that the SBS Entity will charge to the customer if it elects individual segregation of its IM.[102] Specifically, with respect to such disclosure, the Commission should require SBS Entities to:

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[100] *See* Section 763(d) of the Dodd-Frank Act (adding Section 3E of the Exchange Act).

[101] Customers, for example, may find it more efficient to use a single custodian for all of their IM covering multiple SBS Entities.

[102] Please note that this requested cost disclosure does not resolve our concerns with the Commission's proposed capital charge for customers electing individual IM segregation with an independent third-party custodian as discussed in Section III.A above.

(1) present costs on an itemized basis and include fees and expenses of each proposed custodian option; and

(2) itemize any incentives, benefits or income that the SBS Entity will receive should a customer select a particular custodian.

Our members with tri-party segregation arrangements currently in place for their bilateral trades typically do not pay any additional amounts to their counterparties, but rather pay only reasonable custodial fees directly to their custodian. Thus, we are concerned that if the Commission should decline to adopt our recommendations, SBS Entities might choose to provide segregation at such an unreasonable price that it would effectively preclude customers from choosing individual segregation.

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We thank the Commission for the opportunity to provide comments on the Proposed Rules. We would welcome the opportunity to discuss our views in greater detail. Please do not hesitate to contact the undersigned, Laura Harper or Carlotta King at (202) 730-2600 with any questions the Commission or its staff might have regarding this letter.

Respectfully submitted,

/s/ Stuart J. Kaswell

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

cc: The Hon. Elisse B. Walter, Chairman
The Hon. Luis A. Aguilar, Commissioner
The Hon. Troy A. Paredes, Commissioner
The Hon. Daniel M. Gallagher, Commissioner