



February 11, 2013

Via Electronic Submission: rule-comments@sec.gov

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

Re: File No. S7-13-12: Order Granting Conditional Exemptions Under the Securities Exchange Act of 1934 in Connection With Portfolio Margining of Swaps and Security-Based Swaps

Dear Ms. Murphy:

Managed Funds Association¹ appreciates the opportunity to provide comments on the Securities and Exchange Commission's (the "**Commission**") December 19, 2012 order (the "**Order**")² granting conditional exemptive relief from compliance with certain provisions of the Securities Exchange Act of 1934, as amended (the "**Exchange Act**"),³ for registered clearing agencies and derivatives clearing organizations (collectively, "**CCPs**"), and registered broker-dealers and futures commission merchants, as clearing member firms (collectively, "**BD/FCMs**"), to offer a program to commingle and portfolio margin customer positions in cleared credit default swaps ("**CDS**"), which include both swaps and security-based swaps ("**SB swaps**"), in a segregated account established and maintained in accordance with Section 4d(f) of the Commodity Exchange Act, as amended ("**CEA**").

Executive Summary

MFA applauds the Commission's timing in issuing its Order given that broad-based index CDS are required to be cleared imminently under the clearing mandate of the Commodity Futures Trading Commission ("**CFTC**") by the first category of market participants under the

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 Commission "Order Granting Conditional Exemptions 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), available at <http://www.gpo.gov/fdsys/pkg/FR-2012-12-19/pdf/2012-30553.pdf>.

³ The Order notes that Section 713(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") provides explicit authority for such exemptive relief to facilitate portfolio margining programs. *Id.* at 75212, n. 6.

CFTC's clearing implementation phase-in schedule, including many MFA members that meet the CFTC's definition of "Active Fund".⁴ As the Commission is aware, a substantial number of buy-side market participants who will be required to clear their CDS indices hold offsetting single-name CDS in their portfolios. If they were required to clear their CDS indices but were unable to clear their single names, they would be subject to significant margining penalties. To avoid the disruption of a "big bang" transition from uncleared to cleared CDS, many Active Funds are establishing their clearing arrangements and have been voluntarily clearing CDS indices to ensure their clearing readiness for an orderly transition to mandatory clearing compliance.

We are very concerned, therefore, that although the Commission and the CFTC have issued their respective orders, customers are still unable to clear single-name CDS as the first CFTC clearing compliance date of March 11, 2013 quickly approaches. This customer clearing impediment is caused by the Commission's condition to require the Commission and the Financial Industry Regulatory Authority ("FINRA") to review and approve each BD/FCM's margin methodology (the "**Margin Method Approval Condition**") over and above the Commission's prior approval of the margin methodology of ICE Clear Credit, LLC (referred to herein as "**ICC**"). The Order provides for expedited, temporary approval of BD/FCM customer margining methodologies⁵, and we understand that a number of BD/FCMs are in the process of demonstrating to FINRA that they are prepared in all cases to require their customers to post, at a minimum, the amount calculated under the ICC margin methodology. In view of the pressing timetable for clearing CDS indices under the CFTC's clearing mandate, we respectfully urge the Commission and its staff to provide expedited, temporary approval under the Order to all BD/FCMs that meet the Commission's expedited submission requirements, and that are prepared to require margin from its customers that is equal to margin levels determined under ICC's approved margin methodology. We believe such expedited, temporary approval of all BD/FCMs' margin methodologies would be appropriate as a matter of course, given that all BD/FCMs, as clearing members of CCPs, must comply with regulator-approved CCP minimum margin levels.

I. The Commission Should Issue Expedited, Temporary Approval of BD/FCM Margin Methodologies

We greatly appreciate that the Commission has imposed a number of conditions in the Order to ensure that customer protection concerns are appropriately addressed. However, with

⁴ As Category 1 Entities, Active Funds must begin clearing the designated classes of CDS indices and interest rate swaps subject to the CFTC's final clearing requirement determination on Monday, March 11, 2013. *See* CFTC Final Rule on "Clearing Requirement Determination Under Section 2(h) of the CEA", 77 Fed. Reg. 74284 (Dec. 13, 2012) at 74289, fn. 51. The CFTC defines the term "Active Fund" as "any private fund as defined in section 202(a) of the Investment Advisers Act of 1940, that is not a third-party subaccount and that executes 200 or more swaps per month based on a monthly average over the 12 months preceding the [CFTC] issuing a clearing requirement determination under section 2(h)(2) of the [CEA]". *See* CFTC Final Rule on "Swap Transaction Compliance and Implementation Schedule: Clearing Requirement Under Section 2(h) of the CEA", 77 Fed. Reg. 44441 (July 30, 2012) at 44456, §50.25(a).

⁵ Order at 75218, n. 56.

respect to the Margin Method Approval Condition, we have two primary concerns: unnecessary timing uncertainties for approvals and unintended market consequences.

Unnecessary Timing Uncertainties for Approvals. First, we are concerned with the uncertainty as to the amount of time that the Commission and FINRA will need to complete their reviews and approval processes for each individual clearing member firm, as we expect that there will be a flood of margin methodology submissions from clearing member firms prior to the CFTC's March 11, 2013 clearing compliance date for certain CDS indices. To avoid further delay in providing customers with the significant margin efficiencies and other benefits of portfolio margining, and to provide all CDS market participants with more timing certainty, we strongly urge the Commission to exercise its right to grant temporary, expedited approval of all BD/FCMs that demonstrate compliance with CCP minimum margin requirements.⁶ We believe the Commission would need only to confirm that the petitioning BD/FCMs are using the approved CCP methodologies in order to determine that all BD/FCMs' methodologies equate "to the amount determined using a margin methodology established and maintained by the BD/FCM that has been approved in writing by the Commission or the Commission staff."⁷ Such expedited approval of all BD/FCMs is necessary so that non-members of CCPs (*i.e.*, buy-side firms such as MFA members) can comply with the CFTC's mandatory clearing requirement for CDS indices in a capital-efficient manner and to ensure a fair and equitable system for clearance and settlement of securities transactions.⁸

Our main rationale for expedited approval hinges on the fact that both the Commission and the CFTC have previously approved CCP margin methodologies, which is regulatory endorsement of their soundness for risk management purposes. BD/FCMs, as clearing member firms of CCPs, are required to comply with regulator-approved CCP margin methodologies in basing their customer initial margin levels. In addition, the Commission has monitored and supervised other clearing agency procedures that enhance BD/FCM methodologies for cleared CDS. These procedures include clearing agency membership criteria, pricing methodologies, the margin methodology, the guaranty fund methodology, default waterfall procedures, and intra-day risk clearing member portfolio monitoring procedures. In the case of ICC, the Commission, the CCP and its clearing members now have extensive experience with the risk management systems and procedures needed for a sound portfolio margining program for cleared CDS portfolios in

⁶ Order at 75218, n. 56 (reserving the right of the Commission or the Commission staff to "provide temporary approval of a BD/FCM's margin methodology while the methodology is still being evaluated prior to granting final approval.").

⁷ Order at 75218.

⁸ As we pointed out in our June 13, 2012 letter to the Commission in support of ICC's portfolio margining petition, if clearing members are not approved to offer portfolio margining to CDS clearing customers, BD/FCMs are nonetheless allowed to benefit from portfolio margining of single-name CDS and CDS indices in their house accounts. This outcome perpetuates a fundamental and unwarranted competitive inequality in the CDS market, whereby only dealers will be able to maintain a cleared hedged CDS portfolio with substantially lower margin requirements. See MFA letter to the Commission on ICC's petition for an order permitting portfolio margining of single-name CDS 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>.

the BD/FCMs' house accounts. In view of all of these factors, provided the CCP-prescribed margin methodology is applied, we strongly believe that no further review of BD/FCM margin methodologies should be necessary, particularly when the Commission has performed extensive review and regular monitoring of the margin and guaranty fund methodologies of registered clearing agencies. Accordingly, BD/FCMs using a regulator-approved CCP margin methodology from which to base their customer initial margin levels should be given expedited approval for purpose of satisfying the Margin Method Approval Condition. This expedited approval would create a level playing field among BD/FCMs that submit applications under the Order prior to the CFTC's March 11, 2013 compliance deadline for the first category of market participants. It would also give market participants more certainty about when BD/FCMs are approved to offer portfolio margining programs to customers. This timing sensitivity for customers is particularly urgent given the CFTC's fast-approaching compliance date of March 11, 2013 for mandatory clearing of CDS indices and the need to accelerate clearing readiness now.

In addition, the expedited approval of each BD/FCM margin methodology that we are recommending further hinges on the BD/FCM's demonstration that it bases customer margin levels on CCP initial margin levels, which the CCP must collect on a gross basis for its clearing members' customer accounts.⁹ We strongly believe that such an expedited submission requirement would be consistent with the process efficiencies that the Commission and FINRA have gained through their years of experience approving CCP margin methodologies.

With respect to ICC, for example, the Commission has reviewed and approved ICC's portfolio margining methodology and has concluded that the methodology is "consistent with Section 17A(b)(3)(F) of the [Exchange] Act, including ICC's obligation to ensure that its rules be designed to assure the safeguarding of securities and funds in the custody or control of the clearing agency or for which it is responsible."¹⁰ In the ICC Margin Order, the Commission determined that ICC's portfolio margining methodology is adequately designed to ensure prompt and accurate clearance and settlement of CDS, including indices that must be cleared under CFTC rules and provisions of Title VII of the Dodd-Frank Act. Specifically, the Commission has already satisfied the requirement under Section 17A(b)(3)(F) of the Exchange Act that the rules of a clearing agency be "designed to remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions and to assure the safeguarding of securities and funds in the custody or control of the clearing agency or for which it is responsible."¹¹ In a customer-clearing context and under a mandatory clearing regime, many clearing agency rules regarding margin apply with equal force to customers of clearing members. In approving ICC's portfolio margining methodology for self-clearing members, the Commission acknowledged that these benefits should also be conferred

⁹ CFTC Final Rule on "Derivatives Clearing Organization General Provisions and Core Principles", 76 Fed. Reg. 69334 (Nov. 8, 2011) at 69439, §39.13(g)(8)(i).

¹⁰ Commission "Order Approving Proposed Rule Change to Adopt ICC's Enhanced Margin Methodology", Release No. 34-66001; File No. SR-ICC-2011-03 (Dec. 16, 2011) at p. 5 (hereinafter "**ICC Margin Order**").

¹¹ ICC Margin Order at p. 4.

for customer-clearing BD/FCMs whose securities and funds will be in the custody and control of registered clearing agencies or for which they will be responsible.

Since the issuance of the ICC Margin Order, the Commission and FINRA have had more than a year to observe the soundness of ICC's portfolio margining methodology from a risk management perspective with respect to ICC clearing participants' proprietary positions in index CDS contracts and offsetting single-name CDS contracts. ICC intends to use the same methodology for its customer portfolio margining program. The Commission has also reviewed and approved enhancements to ICC's methodology which have been in effect for over a year, including the use of a jump-to-default requirement, mean absolute deviation as a measure of spread volatility, implementing an auto-regressive process to obtain multi-horizon risk measures, enhanced spread response scenarios, liquidity margin requirements, and base concentration charges. These same factors would also apply to customers of BD/FCMs that rely on ICC's margin methodology.

In our view, the failure to leverage the extensive experience of FINRA and the Commission in reviewing and approving ICC's portfolio margining methodology and other CCP margin methodologies would result in substantial delays to the detriment of customers, which is the investor constituency the Commission is charged with protecting. If the Commission chooses to implement the Margin Method Approval Condition by directing FINRA to undertake extensive reviews of BD/FCM margin methodologies and their related risk management systems and procedures on a firm-by-firm basis, we fear that customers will be unfairly and unjustifiably adversely affected by unnecessary process delays. One such adverse effect would be entirely contrary to the key clearing reforms of Title VII of the Dodd-Frank Act by creating customer impediments to clearing access. The other adverse effects are the undue burdens imposed on customers by: (1) continuing their delays in realizing the benefits from ICC's portfolio margining program and the resulting capital efficiencies for their businesses, and (2) prolonging their unjustified competitive disadvantage to dealers who have already been benefiting from ICC's portfolio margining program for their proprietary positions in cleared single-name CDS and CDS indices.

Unintended Market Consequences. Second, we believe there are other unintended market consequences in implementing the Margin Method Approval Condition that would result from the potentially lengthy process of the Commission's serially approving or rejecting BD/FCM margin methodologies. More specifically, many customers, including MFA members, have been working with dealers to ready themselves for clearing OTC derivatives and have been clearing CDS indices voluntarily to ensure an orderly transition to mandatory clearing compliance. Establishing these working relationships and clearing arrangements takes substantial investments of time by both customers and their BD/FCMs. If the dealer with whom a customer has been working fails to obtain approval of its margin methodology prior to the compliance date for the CFTC's first clearing mandate, including simply because such dealer needs to wait for other BD/FCMs earlier in line, we fear there will be a stampede by customers to those dealers whose methodologies were approved first. This result would be commercially disruptive of longstanding working relationships between customers and their BD/FCMs, and would undermine the goal of distributing clearing responsibility across a range of clearing

members. Thus, customers would bear the operational risk of their original dealer's margin methodology being rejected or not being approved on a timely basis. For clearing member firms that are the first to receive their approvals, while they would have significant competitive advantages over other dealers, they would also have the burdens of additional time and cost to negotiate new clearing agreements and to build connectivity to their new customers. Customers would also bear the higher costs of trading CDS, as there would be a reduced number of SBS dealers with whom customers can transact. None of these consequences represents a reasonable solution for market participants.

To avoid these unintended market consequences, we urge the Commission to grant expedited approval to all clearing member firms that can prove they meet the CCP minimum margin requirements. There is ample cause for expedited approval where further delay will prevent customers from clearing through their existing clearing member counterparties and require customers to potentially make clearing arrangements within a compressed time period, potentially at a premium, and under terms that are costly to them given the lack of choice among potential clearing member counterparties.

Promotion of Efficiency, Competition and Capital Formation. We respectfully suggest that the Commission consider the economic effects and financial burden to BD/FCM customers of the Commission's rules in determining whether they will promote efficiency, competition and capital formation.¹² Customers are significantly affected by the Commission's discretion in mandating the Margin Method Approval Condition in the Order. CDS clearing for customer accounts should be no less capital-efficient or burdensome for customers of clearing members than for clearing members. Any delay in customer access to CDS single-name clearing, as well as any disparate treatment of margin between dealers and customers, and among individual BD/FCMs, would all have a potentially destabilizing effect.

Further, the attendant process inefficiencies caused by extensive "first-look" reviews conducted by FINRA and the Commission of all BD/FCM margin methodologies and their related risk management systems and procedures would be unduly burdensome to customers, resulting in continued delays in portfolio margining programs for their businesses and unfair competitive disadvantage to dealers.

For the reasons set forth above, MFA respectfully requests that the Commission facilitate the implementation of the Margin Method Approval Condition prior to mandatory clearing of CDS indices by providing expedited approval of all BD/FCM margin methodology submissions that demonstrate compliance with regulator-approved CCP minimum margin levels.

¹² See Exchange Act Section 3(f).

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MFA thanks the Commission for the opportunity to provide comments regarding the Order and its implementation. Please do not hesitate to contact Laura Harper, Assistant General Counsel, or the undersigned 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

John Ramsay, Acting Director, Division of Trading and Markets, SEC