MANAGED FUNDS ASSOCIATION

Alternative Investment Management Association

September 18, 2013

Via Electronic Mail

Mr. John Ramsay
Acting Director of Division of Trading and Markets
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549–1090

Re: Discussion of Buy-Side Concerns with SEC Staff Requirements for Approving Individual BD/FCM Margin Methodologies for the CDS Customer Portfolio Margin Program; Request for Permanent Uniform Customer Margin Level

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; and CFTC Order, Treatment of Funds Held in Connection with Clearing by ICE Clear Credit of Credit Default Swaps

Dear Mr. Ramsay:

Managed Funds Association ("**MFA**") and the Alternative Investment Management Association ("**AIMA**") (the "**Associations**")[1] wish to raise with the Division of Trading and Markets (the "**Division**") our continuing concerns about portfolio margining of cleared credit default swaps ("**CDS**"). We respectfully submit that the Division's current approach of requiring each registered broker-dealer/futures commission merchant ("**BD/FCM**") to have an individually approved proprietary margin model undermines central clearing of CDS, which is a policy goal of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"). For the reasons discussed herein, we respectfully urge the Division to embrace on a permanent basis the methodology contemplated in the June 7, 2013 letters ("**Revised Letters**") to eight BD/FCMs that revised for six months the required client margin level (the "**Uniform Customer Margin Level**") for the CDS portfolio margin program.[2]

[1] The Associations represent an extensive range of hedge fund investors in the derivatives markets. A description of the Associations is set forth in the Annex to this letter.

[2] The Division's revised six-month client margin level requires the eight BD/FCMs to collect from clients "a minimum clearing agency required margin amount, any additional amounts pursuant to CFTC rules, and any additional margin as required by the [BD/FCM's independent risk management standards to assess the initial and ongoing credit risk of each individual counterparty.]" *See* Revised Letters.

As you know, the Revised Letters require that individual BD/FCMs implement a unique margin methodology within six months from the date that the Division issued the letters (*i.e.*, by December 7, 2013). The individual margin models must meet the requirements specified in Parts I and II of the Revised Letters (referred to herein as the "**BD/FCM Margin Model Condition**"). The Associations remain concerned about these requirements. We believe that the BD/FCM Margin Model Condition creates market uncertainty and complexities that are delaying uniform margin treatment as a necessary pre-condition for customer clearing of single-name CDS. The Associations appreciate that the Division may view this difficulty as an unfortunate but temporary interim dislocation. However, for the reasons outlined below, the Associations continue to believe that BD/FCM Margin Model Condition is unworkable and therefore the current lack of CDS clearing is not merely temporary.

I. Reasons for Lack of Buy-Side Adoption of Voluntary Clearing of Single-Name CDS

Our members are buy-side counterparties to security-based swap dealers[3] that use both swaps and security-based swaps to invest and to hedge their investment portfolios. The Associations have supported regulatory efforts to allow customer access to central clearing of eligible single-name CDS and CDS indices. The Associations have also advocated extensively for customer access to the cleared CDS portfolio margining program of ICE Clear Credit ("**ICC**") that, until recently, had been available only to ICC's self-clearing members for their proprietary CDS positions.[4] While we appreciate that the Revised Letters provide for buy-side access to ICC's portfolio margining program for the first time, the BD/FCM Margin Model Condition has created buy-side market uncertainty about what the required level of customer

[3] These terms have the meanings set forth in the SEC and Commodity Futures Trading Commission ("**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.

[4] *See* joint letter from MFA, the American Council of Life Insurers, and AIMA to SEC Chairman White and CFTC Chairman Gensler, dated May 10, 2013, with a request for action by both commissions to improve coordination and to facilitate portfolio margining for customers in the cleared CDS market, available at: https://www.managedfunds.org/wp-content/uploads/2013/05/CDS-Customer-Portfolio-Margining-Final-MFA-Coalition-Letter.pdf (the "**Buy-Side Coalition Letter**"); MFA letter in response to the SEC "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), filed with the SEC 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 SEC on ICE Clear Credit's petition for an order permitting portfolio margining of single-name credit default swaps and broad-based indices, filed with the SEC 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; MFA letter to the CFTC on ICE Clear Credit LLC's petition dated October 4, 2011 for an order permitting portfolio margining of swaps and security-based swaps, filed with the CFTC on December 21, 2011, available at: https://www.managedfunds.org/wp-content/uploads/2011/12/CFTC-Comment-Letter-in-Support-of-ICE-Portfolio-Margining-Petition-Final-MFA-Letter.pdf; 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 CFTC 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.

margin will be after the Uniform Customer Margin Level expires. It would be imprudent for a buy-side firm to enter into a cleared single-name CDS transaction that may have a 5-year or 10-year tenor knowing that the margin terms and treatment of that position may change dramatically six months into the transaction. This uncertainty has delayed voluntary customer clearing of single-name CDS and further inhibited customer access to the CDS portfolio margin program. This uncertainty has also inhibited any expansion of the cleared product set that could be achieved by the buy-side backloading their uncleared legacy CDS trades into central clearing.

The Associations believe that the buy-side's uncertainty is compounded by the fact that, if the BD/FCM Margin Model Condition were implemented, our members would have to assess independently, and then compare, each of the different individual BD/FCM margin methodologies that the SEC (and FINRA) eventually would approve. Depending on the extent to which each BD/FCM is willing to disclose its margin methodologies, a buy-side firm's BD/FCM-to-BD/FCM analysis of margin methodologies may not be possible. At a minimum, this BD/FCM-to-BD/FCM analysis of margin methodologies would impose considerable burdens on the buy-side as they seek to make informed business decisions that facilitate productive use of capital and prudent risk management in the CDS markets.

II. Adverse Effects of the BD/FCM Margin Model Condition

In the Revised Letters, the Division requires that each BD/FCM must individually implement a margin methodology for transactions in the CDS customer portfolio margin program that meets the Division's requirements. This condition has a number of serious adverse consequences:

- Unnecessary Customer Margin Inequalities. The implication that the buy-side needs to post more margin than self-clearing members would appear to stem from a misplaced emphasis on counterparty type rather than product risk.[5] If a given level of initial margin is sufficient to support a self-clearing dealer's proprietary CDS portfolio, then it should be more than sufficient to support a smaller buy-side firm's cleared CDS portfolio.

- Divergent Margin Models. The BD/FCM Margin Model Condition contemplates that BD/FCMs could use models that diverge from both the ICC's model and from each other BD/FCM's model for use in the CDS portfolio margin program. Divergent margin models lead to both a lack of uniformity and a lack of certainty for the buy-side.

- Lack of Transparency. The buy-side depends on transparency in margin methodologies to manage its capital and investment and risk management strategies. ICC has provided the requisite transparency, including tools for the buy-side to use to estimate margin changes with each new trade and the ability to verify margin calls. However, it is unclear that each individual BD/FCM will be able to provide the buy-side with such transparency or

[5] We note that the recently published final framework of the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions made no distinction between clients and dealers for setting uniform initial margin requirements for non-cleared derivatives. *See* "Margin Requirements for non-centrally cleared derivatives," issued on Sept. 2, 2013, available at: http://www.bis.org/publ/bcbs261.pdf.

margin management tools, or that such provision will be made in a uniform and consistent manner.

- Anti-Competitive Consequences. In approving or rejecting individual BD/FCM margin methodologies, the Division would effectively be picking "winners and losers" among BD/FCMs for the following reasons:

  - First, due to the statistical confidence parameters inherent in margin calculations, the BD/FCMs that will be able to offer the lowest margin are the largest dealer banks that have the largest dealing data sets and proprietary analytics capabilities.

  - Second, the Division would be creating a significant barrier to entry for any BD/FCM that has not had an active or sizable CDS trading desk. Irrespective of the quality of clearing services that such a BD/FCM may be able to provide, if they do not have the historical CDS data set or comparable level of resources to create a new margin methodology (as opposed to administering the ICC methodology), they are effectively barred from entry into the market for CDS clearing services.

- Less Robust Margin Analytics. Individual BD/FCMs may not have comparably robust margin analytics to match the robustness of ICC's margin analytics. They may also lack the ability to access the same breadth of historical data as ICC. ICC, by comparison, has a comprehensive data set, including both actual transaction data and market-wide data drawn from its clearing members and the CDS data repository. Therefore, individual BD/FCMs' margin methodologies may not be as robust and accurate as the methodology developed by ICC or any other clearing agency that may offer a CDS portfolio margin program.

- Additional Oversight Burdens. Finally, we believe the Division would be taking on a substantial burden in supervising the individual margin methodologies of potentially up to 20 BD/FCMs that may participate in the portfolio margin program. We respectfully believe that the Division could more effectively concentrate its efforts on ensuring one sound and strong margin methodology at the clearing agency for all classes of market participants.

We strongly believe that the lack of uniformity among margin methodologies and the attendant uncertainty is unwarranted, given the tested ICC margin methodology for CDS products and the ample BD/FCM protections and safeguards in the clearing environment.[6] We encourage the Division to consider further the lengthy list of protections that the BD/FCMs have to control the risks posed by their clearing customers, as set forth in the Buy-Side Coalition Letter.[7] As explained in more detail in the Buy-Side Coalition Letter, the Associations perceive no benefit or risk reduction value in imposing additional requirements for BD/FCM proprietary

[6] For a discussion of such BD/FCM protections and safeguards, *see* Buy-Side Coalition Letter at pp. 13-14.

[7] *See id*.

margin models in setting customer margin levels.[8]

III. Recommendations to Achieve Market Certainty and Facilitate Buy-Side Clearing of Single-Name CDS

As the Buy-Side Coalition Letter and prior MFA letters have more fully explained, ICC's proven margin model justifies its use as the ongoing minimum margin amount for CDS customers.[9] With the ICC margin model, customers can benefit from a margin methodology for CDS indices and single-name CDS that has been approved and tested by the SEC, FINRA, and the CFTC.[10] BD/FCMs are required to comply with ICC's approved margin model in basing their initial margin levels for CDS customer positions. We also understand that all BD/FCMs that are seeking to clear single-name CDS for customers have represented to the SEC and FINRA that they have in place their own standards and models to assess the individual counterparty credit risk of their customers, in addition to collecting the ICC minimum margin amount. Our members embrace the Division's six-month Uniform Customer Margin Level as formulated in the Revised Letters, because it integrates these risk-based amounts, while also achieving consistency with the CFTC by including any additional margin amount that may be required by the CFTC's rules for speculative CDS positions.

The Associations therefore respectfully recommend that the Division should make the Uniform Customer Margin Level the ongoing level after the initial six-month period expires on December 7, 2013. Not only would the permanent adoption of this approach be more efficient for the SEC and FINRA staffs to administer, it would also facilitate the Dodd-Frank Act's clearing reforms by removing the unintended impediments to single-name CDS clearing and customer access to the CDS portfolio margin program. The ongoing customer margin level would remain subject to regulatory oversight by virtue of the Division's ongoing supervision of the clearing agencies' margin methodologies, and the Division's access to the BD/FCMs' internal risk reports and other relevant data and aggregate statistics.

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[8] Further, our members have serious concerns with the unclear calculation of the customer margin measurement above 1% of a BD/FCM's tentative net capital in the BD/FCM Margin Model Condition, as among other points, certain BD/FCMs have indicated that they may not disclose their "tentative net capital". Our members believe its potential impact on their portfolios of cleared CDS indices could be significant, leading to excess margin requirements for the buy-side. This lack of clarity could force some buy-side firms to split their portfolios of cleared CDS indices and cleared single-name CDS into two different accounts with two BD/FCMs to insulate their cleared CDS indices from the potential adverse effects of the BD/FCM Margin Model Condition uncertainties. Such portfolio splitting would result in a loss of risk-based margin offsets between correlated CDS positions in a single account. This result is counterintuitive as the BD/FCMs as well as the regulators should facilitate more risk-balanced portfolios through portfolio margining. As explained in the Buy-side Coalition Letter, we believe this CDS portfolio fragmentation leads to market inefficiencies that are not risk-reducing. *See* Buy-Side Coalition Letter at p. 10.

[9] *See* supra, n. 4.

[10] *See* Buy-Side Coalition Letter at p. 6, n. 17.

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The Associations appreciate the opportunity to explain buy-side concerns with the uncertainties and unintended consequences of the Division's requirements for approving individual BD/FCM margin methodologies in the CDS portfolio margin program. We would welcome the opportunity to discuss our concerns and recommendations in greater detail.

Please do not hesitate to contact the undersigned or Laura Harper, MFA Assistant General Counsel, at (202) 730-2600 with any questions the SEC, the Division or their staffs might have on this letter.

Respectfully submitted,

/s/ Stuart J. Kaswell

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

/s/ Jiří Król

Jiří Król
Deputy CEO
Head of Government and Regulatory Affairs
Alternative Investment Management
Association

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

Michael A. Macchiaroli, Associate Director, Division of Trading and Markets
Thomas K. McGowan, Deputy Associate Director, Division of Trading and Markets
Randall W. Roy, Assistant Director, Division of Trading and Markets

The Hon. Mary John Miller, Under Secretary for Domestic Finance, United States Department of the Treasury

Annex

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

The Alternative Investment Management Association (AIMA) is the trade body for the hedge fund industry globally; AIMA's membership represents all constituencies within the sector – including hedge fund managers, fund of hedge fund managers, prime brokers, fund administrators, accountants and lawyers. AIMA's membership comprises over 1,300 corporate bodies in over 40 countries.