December 27, 2013

The Hon. Mary Jo White
Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Request for Action by the Commission to Address CDS Portfolio Margining Concerns of Buy-Side Market Participants

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 Chair White:

We write to seek your assistance with a time-sensitive matter of critical importance to customers in the Credit Default Swap ("**CDS**") market. We respectfully request that the Securities and Exchange Commission (the "**SEC**" or the "**Commission**") take steps to make permanent the customer initial margin regime currently in place for cleared CDS portfolios. Managed Funds Association ("**MFA**"), the American Council of Life Insurers, and the Alternative Investment Management Association (collectively, "**we**" or the "**Associations**"[1]) represent investors that use derivatives, including single-name CDS and CDS indices, to invest and hedge their investment portfolios. We are highly supportive of central clearing of CDS, and request that the Commission facilitate voluntary clearing of single-name CDS by making permanent the current initial margin regime, as explained below. We believe that taking this step is critical to the overall success of transitioning the CDS markets to central clearing under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd Frank**").

The Associations applaud the Commission and the Staff for changing the prior temporary initial margin regime that set customer initial margin levels up to 200% of that charged to

[1] A description of the Associations is set forth in Annex 3 to this letter.

dealers. However, we understand that upon expiry of the temporary regime as of January 31, 2014, the Commission and the Staff will require a customer margin regime for the cleared CDS portfolio margin program (the "**CDS customer portfolio margin program**") that we believe will increase risk and impose undue costs on the buy-side. We are therefore very concerned by Staff actions that continue to proceed without any apparent regard for the adverse impact on, or views and comments of, investors that will be significantly affected. We hope to meet with you and your fellow Commissioners in the near future to discuss these concerns in greater detail.

Executive Summary

As noted, the Associations strongly support the move to clearing as mandated by Dodd Frank. In accordance with the Commission's order of December 19, 2012 (the "**Order**")[2], the Staff proposes to require each registered Broker-Dealer/Futures Commission Merchant ("**BD/FCM**") to adopt its own unique margin regime for the CDS customer portfolio margin program. As explained in our previous letters, we believe that such an approach is ill-advised. Although MFA supported certain aspects of the Order because it permitted commingling and portfolio margining of customers' positions in cleared single-name CDS and CDS indices in a Section 4d(f) account under the Commodity Exchange Act, we do not believe that requiring each BD/FCM to adopt individual margin models is either required under Dodd Frank or appropriate.

The Commission approved ICE Clear Credit's ("**ICC**") margin methodology for the CDS customer portfolio margin program two years ago.[3] ICC's methodology reflects robust margin analytics derived from a comprehensive data set, including both actual transaction data and market-wide data drawn from its clearing members and the CDS data repository. Individual BD/FCMs' margin methodologies are based on data sets that are much more limited, and accordingly are unlikely to be as robust and accurate as the methodology developed by ICC or any other clearing agency that may offer a CDS portfolio margin program. The ICC margin methodology sets a level playing field regardless of the variations in the robustness of margin analytics across individual BD/FCMs. Despite the Commission's approval of the ICC margin methodology, the Staff continues to require each BD/FCM to adopt individual margin models for the CDS customer portfolio margin program.

Rather than enabling customers to clear at the same or similar initial margin levels already established for dealers under the approved ICC margin methodology, and providing customers with certainty about, and transparency into, the margin models applicable to them, the Staff continues to require an untested approach that will lead to arbitrarily higher initial margin levels for investors. Such an approach will continue to undermine investors' ability to manage their cleared CDS portfolios, which is contrary to Dodd Frank's policy goals.

---

[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] *See* 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).

Over the last few years, we and other CDS market participants have sought to engage in constructive dialogue with the Commission and the Staff regarding portfolio margining of single-name CDS and CDS indices for buy-side market participants.[4] Although we welcomed the Commission's issuance of the Order for certain reasons, it also contained a number of substantive conditions that significantly and adversely affect the buy-side. Among other conditions, the Order requires that clearing BD/FCMs must each use a unique customer margin methodology to be established and maintained by each individual BD/FCM that has been approved in writing by the Commission or the Staff.[5] Since the issuance of the Order, the Staff has further issued a series of temporary approval letters (the "**Letters**") to ICC's clearing members that also set forth conditions and customer initial margin requirements that have a direct and significant impact on investors.[6] While the Order and the Letters directly affect buy-side investors, neither the Commission nor the Staff has solicited buy-side views prior to their issuance, or adequately responded to the substantive concerns we have raised after their issuance.[7] Meanwhile, the temporary conditional approval letter process precludes buy-side engagement, as the Staff issue letters to, and hold private discussions with, individual BD/FCMs to define customer initial margin model requirements without any buy-side participation or input.

Discussion

- Current Customer Margin Regime

The Commission's Order authorizes single-name CDS to be commingled with CDS indices in one portfolio in a Section 4d(f) account governed by the Commodity Futures Trading Commission ("**CFTC**"). However, as we have pointed out in our prior letters, the Staff has imposed additional conditions and requirements beyond those of the CFTC in respect of the portfolio of cleared CDS in such account. Specifically, the Staff requires each clearing member of ICC to have its own individual customer margin methodology, with exposure calculated at a rate materially higher than that applied to dealers, rather than applying on a permanent basis the clearing agency margin plus any BD/FCM add-on to address individual counterparty credit risk. While the Staff has postponed implementation, first until December 7, 2013, and then again until January 31, 2014, there has been no indication that the Staff is willing to reconsider this approach.

---

[4] *See* Annex 2 for a summary of our engagement with the Commission to date.

[5] *See* Order at 75218.

[6] *See* Annex 1 for a summary of Commission Staff actions to date.

[7] *See also* Section 3(f) of the Exchange Act which requires that Commission rulemakings promote efficiency, competition and capital formation. In addition, Section 36 of the Exchange Act allows the Commission to "conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors." (emphasis added).

During this period of extended temporary relief, clearing BD/FCMs are permitted to collect from customers the minimum required margin amount calculated by the clearing agency (in parity with the treatment of self-clearing dealers), plus any amount required by CFTC rules, and any additional margin that a BD/FCM deems appropriate based on its assessment of the customer's counterparty credit risk. This approach is consistent with that used in a range of established cleared derivatives markets, and is the CFTC's approach with respect to portfolio margined single-name CDS and CDS indices. However, once this relief expires, each clearing BD/FCM will be required to impose its own margin model. In our prior letters, we have explained why this approach is unwarranted, and have set out the harms of this approach in detail, including (1) the fact that investors will have no transparency into these various margin models, (2) it will be impractical for customers therefore to assess them, and to manage capital under them, and (3) this approach favors the largest incumbent BD/FCMs over new entrants. In our November 4, 2013 meeting with the Staff, we also explained that this approach will create wrong-way risk for the buy-side. More specifically, this wrong-way risk is created by the Staff's required use of a BD/FCM's capital level as a factor in determining when additional margin amounts from its customers is required. In a scenario where the BD/FCM's capital level is falling significantly, the potential for customers to post higher margin amounts also increases, despite any action by the BD/FCM's customers. In other words, if a BD/FCM begins to have financial difficulties for reasons unrelated to its customers' CDS activities, it could force the CDS customers to post greater margin, exposing customers to greater loss. We are aware of no counter to the concerns we have raised.

We have previously asked the Staff to make permanent the temporary customer margin regime provided under the relief. Doing so would remove a critical barrier to the voluntary clearing of single-name CDS by buy-side market participants and ensure fair and equal treatment of buy-side market participants. Dealers, by contrast, have been able to clear CDS with a sensible, risk-based approach to portfolio margining for two years. A mere extension of the relief, as the Staff has recently provided to BD/FCMs in letters that have not been publicly posted to date, is regrettably not sufficient. Under any extension, buy-side participants will continue to be deterred from clearing due to the fear that at the end of such further temporary relief, margin levels on their cleared positions could increase to levels which would make maintaining their CDS positions no longer viable. Few firms will decide to clear their single-name CDS when the economic terms of such a decision are subject to uncertain and significant change.[8] Under the current regime, a single security-based CDS position in a customer's cleared CDS portfolio will expose the entire portfolio to an unknown margin regime. Accordingly, buy-side firms simply cannot accept such unknowable risk.

As we noted in our prior letters, the purpose of initial margin is to provide a buffer to protect against losses caused by the volatility of the particular product type rather than counterparty type, as the Joint BCBS-IOSCO Working Group on Margining Requirements validated in its final global margin framework: "Initial margin protects the transacting parties

[8] Based on recent ICC statistics, we note that there has only been a total of $264 million notional of buy-side corporate single-name CDS clearing, as compared to $3.73 trillion notional of CDS index clearing. *See* https://www.theice.com/clear_credit.jhtml.

from the potential future exposure that could arise from future changes in the mark-to-market value of the contract during the time it takes to close out and replace the position in the event that one or more counterparties default. The amount of initial margin reflects the size of the potential future exposure. It depends on a variety of factors, including how often the contract is revalued and variation margin exchanged, the volatility of the underlying instrument, and the expected duration of the contract closeout and replacement period, and can change over time, particularly where it is calculated on a portfolio basis and transactions are added to or removed from the portfolio on a continuous basis".[9] We are not aware of any substantive rationale by the Staff that supports their requirement for customers to post a higher level of initial margin for the same CDS products as dealers, or that supports requiring a multiplicity of different models in the marketplace, each based, by definition, on a lesser data set than that used by the clearing agency for its model. We strongly believe that the Staff's prescribed approach deters efficiency, capital formation and particularly, competition. From our perspective, the Staff's approach places investors at a permanent competitive disadvantage to dealers, and also favors the largest BD/FCMs that have historically had the largest dealing desks and thus have more comprehensive data sets relative to smaller BD/FCMs and new entrants into the market for clearing services.

As we articulated in our previous letters, we understand there to be no empirical basis for the Staff's requirement that each individual clearing BD/FCM have its own internal margin methodology. We understand such an approach to be riskier in many respects, and contrary to the interests of investors. Further, as IOSCO recently stated, one of the "operational benefits of central clearing" is the "[e]limination of model risk since all counterparties use the CCP's risk model instead of brokers applying their own bespoke models to determine margin requirements."[10] The Staff's proposed approach negates this benefit by requiring the bespoke models that IOSCO rejects.

We request that the Commission make the current initial margin regime permanent. As clarified in our previous letters, we support the Staff's requirement in the current margin regime for a BD/FCM to assess the initial and ongoing credit risk of its individual counterparty based on the BD/FCM's own risk management standards. However, for the reasons stated in this letter and in our previous letters, we submit that requiring a unique margin model beyond the BD/FCM's own credit risk assessment of the customer is unwarranted. In granting our request, the Commission could direct the Staff to continue to research their alternative methodology by asking BD/FCMs to calculate initial margin according to internal models in parallel, and providing the data to the Commission. This "pilot program" approach would allow the Commission to assess whether improvements could be made to the clearing agency's margin methodology on the basis of the data derived from the study. It would also provide data to inform further consideration and public discussion of the utility, if any, of requiring individual clearing BD/FCM margin methodologies.

---

[9] *See* "Margin requirements for non-centrally cleared derivatives," issued on Sept. 2, 2013, by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions", par. 3(d) at p. 11.

[10] *See* IOSCO's *Securities Markets Risk Outlook 2013-2014* at page 55, available at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD426.pdf.

We are highly supportive of central clearing of CDS, and hope the Commission will facilitate voluntary clearing of single-name CDS by making permanent the initial margin regime currently in place, as described above.

****

Please do not hesitate to contact Laura Harper, Assistant General Counsel of MFA, at (202) 730-2600, or the undersigned with any questions that you might have regarding this letter. We welcome the opportunity to discuss our views and concerns with you in person.

Respectfully submitted,

/s/ Stuart J. Kaswell

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

/s/ Carl B. Wilkerson

Carl B. Wilkerson
Vice President & Chief Counsel, Securities & Litigation, American Council of Life Insurers

/s/ Jiří Krol

Jiří Krol
Director of Government and Regulatory Affairs
Alternative Investment Management Association

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

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

Peter J. Curley, Associate Director for Clearance and Settlement

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

Annex 1: History of Commission Staff Action on CDS Portfolio Margining

Date	**Action**
November 7, 2011	Commission Notice of Filing of Proposed Rule Change to Adopt ICE Clear Credit LLC's (ICC) Enhanced Margin Methodology (the "Decomp Model")[11]
December 16, 2011	Commission Order Approving Proposed Rule Change to Adopt ICC's Enhanced Margin Methodology[12]
January 30, 2012	ICC launched CDS portfolio margining program for clearing participants' proprietary positions.[13]
December 19, 2012	Staff set out the CDS customer portfolio margin regime through temporary conditional approvals in the form of letters to BD/FCMs under the Commission's December 19, 2012 order (the "Order").[14] The Order grants conditional exemptive relief from compliance with certain provisions of the Securities Exchange Act of 1934, as amended, for registered clearing agencies and derivatives clearing organizations and BD/FCMs, to offer a program to commingle and portfolio margin customer positions in cleared CDS, which include both swaps and security-based swaps, in a segregated account established and maintained in accordance with Section 4d(f) of the Commodity Exchange Act, as amended.
January 15, 2013	ICC announces launch of the CDS customer portfolio margining program for buy-side clearing of CDS.[15]
March 8, 2013	Staff issues its first series of temporary conditional approval letters under the Order, requiring that customers post 150-200% of the ICC minimum margin level on a temporary basis, until the Commission and FINRA complete their review of each individual BD/FCM's customer margin methodology.
June 7, 2013	Staff issues its second series of temporary conditional approval letters under the Order, revising the temporary customer margin level to 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 risk

[11] http://www.sec.gov/rules/sro/icc/2011/34-65699.pdf

[12] http://www.sec.gov/rules/sro/icc/2011/34-66001.pdf

[13] *See* ICC's press release, available at: http://ir.theice.com/investors-and-media/press/press-releases/press-release-details/2012/ICE-Clear-Credit-Launches-Portfolio-Margining-Benefits-for-Clearing-Participants/default.aspx.

[14] 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.

[15] *See* ICC's press release, available at: http://ir.theice.com/investors-and-media/press/press-releases/press-release-details/2013/IntercontinentalExchange-Receives-Regulatory-Approval-for-Customer-Portfolio-Margining-Expands-Capital-Efficiencies-for-Buy-Side-Clearing/default.aspx.

	management standards to assess the initial and ongoing credit risk of each individual counterparty; and requiring individual BD/FCMs to implement an approved margin methodology by December 7, 2013.
December 6, 2013	Staff issues its third series of temporary conditional approval letters under the Order, extending the June 7 temporary margin relief from December 7, 2013 until January 31, 2014.

Annex 2: History of Our Engagement with the Commission on CDS Portfolio Margining

As active participants in the CDS markets, MFA and the other Associations have been seeking to engage constructively with the Commission in meetings and letters to adopt the ICC CDS customer portfolio margin program. In addition to the Associations' activity summarized below, we are aware that our members and other industry participants have had numerous discussions of their own with the Commission on this topic over the last two years.

Date	**Action**
December 21, 2011	MFA submitted letter to the CFTC in support of ICC's petition dated October 4, 2011 for an order permitting portfolio margining of swaps and security-based swaps. MFA sent courtesy copies to SEC Commissioners.[16]
June 13, 2012	MFA submitted letter to the Commission in support of ICC's petition for an order permitting portfolio margining of single-name CDS and CDS indices.[17]
February 11, 2013	MFA submitted a comment letter in response to the Order.[18]
April 8, 2013	MFA, ACLI, the Asset Management Group of SIFMA, and the Futures Industry Association met with representatives from both the Commission and the CFTC to discuss our concerns.
May 10, 2013	MFA and the Associations submitted a request letter to Chairmen White and Gensler requesting the two commissions to improve coordination and to facilitate portfolio margining for customers in the cleared CDS market.[19]
September 18, 2013	MFA and AIMA submitted a joint follow-up letter to Mr. John Ramsay, Acting Director of the Commission's Division of Trading and Markets ("Division") explaining buy-side concerns with the Division's requirements for approving individual BD/FCM margin methodologies for the cleared CDS customer portfolio margin program).[20]
November 4, 2013	To follow-up on our September 18 letter, MFA and ACLI met with Commissioner staff and Division staff to further discuss our concerns.

[16] https://www.managedfunds.org/wp-content/uploads/2011/12/CFTC-Comment-Letter-in-Support-of-ICE-Portfolio-Margining-Petition-Final-MFA-Letter.pdf

[17] https://www.managedfunds.org/wp-content/uploads/2012/06/SEC-Comment-Letter-in-Support-of-ICE-Portfolio-Margining-Petition-Final-MFA-Letter.pdf

[18] http://www.sec.gov/comments/s7-13-12/s71312-1.pdf

[19] https://www.managedfunds.org/wp-content/uploads/2013/05/CDS-Customer-Portfolio-Margining-Final-MFA-Coalition-Letter.pdf

[20] https://www.managedfunds.org/wp-content/uploads/2013/09/SEC-CDS-Portfolio-Margining-Requirements-for-BD-FCM-Margin-Models-Final-MFA-AIMA-Letter.pdf

Annex 3: Description of the Associations

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 **American Council of Life Insurers** (ACLI) is a Washington, D.C.-based trade association with more than 300 legal reserve life insurer and fraternal benefit society member companies operating in the United States. ACLI advocates in federal, state and international forums. Its members represent more than 90 percent of the assets and premiums of the U.S. life insurance and annuity industry. In addition to life insurance, annuities and other workplace and individual retirement plans, ACLI members offer long-term care and disability income insurance, and reinsurance.

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.