INVESTMENT COMPANY INSTITUTE

MEMO# 26424

September 4, 2012

Draft ICI Comment Letter in Response to CFTC's Reopening of Comment Period on Proposed Margin Requirements for Uncleared Swaps; Member Comments Requested by September 10

[26424]

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TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 29-12
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 46-12
INTERNATIONAL COMMITTEE No. 33-12
SEC RULES COMMITTEE No. 53-12 RE: DRAFT ICI COMMENT LETTER IN RESPONSE TO CFTC'S REOPENING OF COMMENT PERIOD ON PROPOSED MARGIN REQUIREMENTS FOR UNCLEARED SWAPS; MEMBER COMMENTS REQUESTED BY SEPTEMBER 10

Recently, the Commodity Futures Trading Commission ("CFTC" or "Commission") re-opened for comment its proposed margin rules for uncleared swaps for swap dealers and major swap participants in response to a consultation paper published by the Basel Committee on Banking Supervision ("BCBS") and the International Organization of Securities Commissions ("IOSCO"). [1] The BCBS/IOSCO consultation paper represents the initial proposal by international regulators to establish international minimum standards for margin requirements for uncleared derivatives

ICI has prepared a draft comment letter, which is attached and briefly summarized below. **If you have comments on the draft letter, please provide them to Jennifer Choi at jennifer.choi@ici.org by Monday, September 10**.

The draft letter is intended to supplement our prior submission to the Commission in view of the BCBS/IOSCO Consultation Paper. [2] The letter states that the international regulators' proposed requirements in several key areas are instructive and consistent with ICI's previous suggestions to the Commission. The letter urges the Commission to work closely with BCBS and IOSCO as they finalize the global standards and to adapt its requirements to reflect the emerging global consensus on margin requirements for uncleared swaps to the extent possible.

I. Two-Way Margin

To better protect counterparties and the swaps markets more generally, the letter strongly urges the Commission, as ICI did in the July 2011 ICI Letter, to adopt final rules to require SDs and MSPs ("covered swap entities") to post margin to their non-swap entity counterparties at the same level and in the same manner as required for the counterparty. This fundamental requirement is consistent with the proposed global standard as proposed by IOSCO and BCBS under which entities that engage in non-centrally-cleared derivatives would be required to exchange, on a bilateral basis, initial and variation margin in mandatory minimum amounts. The letter recommends that the CFTC amend its proposal, which would not require covered swap entities to post margin to their counterparties in those instances when their counterparties were required to post margin.

II. Modify Definition of Financial End-User

The letter also reiterates that registered funds should be included as "low-risk financial end-users" under the CFTC margin rules and not be required to post margin under certain thresholds. The letter notes that IOSCO and BCBS stated that it may be desirable to apply different thresholds for initial margin (the amount under which a firm would have the option of not collecting initial margin) to different types of derivatives market participants. As highly regulated, financially sound swap counterparties and in recognition of the stringent securities regulation to which they are subject, the letter states that the CFTC should permit regulated funds to use an initial margin threshold below which they are not required to post collateral.

III. Calculation of Margin

The draft letter recommends (as in the July 2011 ICI Letter) that the CFTC adopt a system of calculating initial margin that would permit the counterparty to choose between a covered swap entity's proprietary model and a standardized table that specifies minimum initial margin as a percentage of the notional amount of a swap or security-based swap (with percentage ranges assigned to broad asset classes). The suggested approach is consistent with the proposal by the BCBS and IOSCO, which would permit the required amount of initial margin to be calculated by reference either to a quantitative portfolio margin model (subject to certain conditions) or a standardized margin schedule based on percentage of notional exposure by asset class. The letter argues that providing the counterparty with the option between a quantitative portfolio margin model or a standardized table or schedule would promote greater uniformity and transparency for market participants and be easier to administer operationally than the approach proposed by the Commission.

IV. Forms of Margin

Consistent with recommendations of the international regulators and the recommendations made in the July 2011 ICI Letter, the draft letter takes the view that the CFTC should expand the proposed list of eligible collateral to allow counterparties to a swap transaction the flexibility to agree upon the appropriate collateral that may be posted for a particular swap. The CFTC's proposal would limit the categories of eligible collateral to cash, U.S. Treasuries and, for initial margin only, certain government securities.

The Consultation Paper includes a non-exhaustive list of eligible collateral as examples: cash; high quality government and central bank securities; high quality corporate bonds; high quality covered bonds; equities included in major stock indices; and gold. In light of the BCBS/IOSCO proposal for a broader set of eligible collateral, the letter urges the CFTC to expand the list of eligible collateral. For registered funds, the letter states that restricting collateral to a narrow range of permitted assets may force funds to hold lower-yielding securities at an increased cost to fund shareholders and/or to hold assets that do not correspond to the fund’s investment objectives.

V. Daily Valuation of Margin

Finally, the CFTC requested comment on whether it should be more specific with regard to how frequently margin assets should be valued. The draft letter recommends that the Commission require at least daily valuation of margin as suggested by the IOSCO and BCBS. Daily valuation of margin will help ensure that accurate exposures are being covered. Without frequent valuation of margin, counterparties will not be able to calibrate the amount of margin to the value of the swap positions.

Jennifer S. Choi
Senior Associate Counsel – Securities Regulation

Attachment

endnotes

[1] *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, RIN 3038-AC97, 77 FR 41109 (July 12, 2012), *available* at http://www.gpo.gov/fdsys/pkg/FR-2012-07-12/pdf/2012-16983.pdf. *See Margin Requirements for Non-Centrally-Cleared Derivatives*, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, July 2012, *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD387.pdf (“Consultation Paper”).

[2] *See* Letter from Karrie McMillan, General Counsel, ICI, to David A. Stawick, Secretary, CFTC, dated July 11, 2011 (“July 2011 ICI Letter”).