

MEMO# 26777

December 19, 2012

SEC Issues Conditional Exemptions for Portfolio Margining of Swaps and Security-Based Swaps

[26777]

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 83-12
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 71-12
INVESTMENT ADVISER MEMBERS No. 51-12
SEC RULES MEMBERS No. 112-12 RE: SEC ISSUES CONDITIONAL EXEMPTIONS FOR
PORTFOLIO MARGINING OF SWAPS AND SECURITY-BASED SWAPS

The Securities and Exchange Commission (“SEC” or “Commission”) issued an order granting conditional exemptive relief from certain provisions of the Securities Exchange Act of 1934 (“Exchange Act”) in connection with a program to commingle and portfolio margin customer positions in cleared credit default swaps (“CDS”). [\[1\]](#) The program would commingle swaps and security-based (“SB”) swaps in a segregated account subject to Section 4d(f) of the Commodity Exchange Act (“CEA”) (“4d(f) Account”). Comments on the exemptive order are due on February 19, 2013.

The order was in response to a petition filed by ICE Clear Credit, LLC to allow portfolio margining of customer-related positions. Recognizing that a portfolio margining program has the potential to reduce clearing costs and reduce margin requirements, the SEC has granted the order subject to certain conditions. ICE Clear Credit, LLC also filed for relief with the Commodity Futures Trading Commission (“CFTC”), and the CFTC also would need to provide relief to allow SB swaps to be commingled with swaps in a 4d(f) Account.

The exemptions are provided both to the clearing agencies/derivatives clearing organizations (“DCOs”) and to the dually registered broker-dealers (“BDs”)/futures commission merchants (“FCMs”). The exemption for clearing agencies/ DCOs is subject to five conditions. The first two conditions are intended to provide for portfolio margining within a securities account as an alternative for customers that may want to conduct portfolio margining under a securities structure rather than in a swaps account. The third condition requires a clearing agency/DCO to have obtained any other relief needed to permit a BD/FCM that is a clearing member to maintain customer money, securities, and property received by the BD/FCM to margin, guarantee, or secure customer positions in cleared CDS in a 4d(f) Account. The fourth condition requires a clearing agency/DCO to

have appropriate rules and operational practices to permit a BD/FCM that is a clearing member to maintain customer money, securities, and property received by the BD/FCM to margin, guarantee, or secure customer positions in cleared CDS in a 4d(f) Account. The fifth condition requires a clearing agency/DCO to have rules mandating that each customer participating in the program must be an “eligible contract participant” as defined in Section 1a(18) of the CEA.

The exemption for the BDs/FCMs is subject to six conditions. The first condition contains two requirements that relate to the segregation of customer positions in CDS and applies to transactions involving customers that are not affiliates of the BD/FCM. The first requirement of the first condition is intended to help ensure that the exemption would apply only in circumstances where the customer funds are maintained in a 4d(f) Account.

Under the second requirement of the first condition, BDs/FCMs must enter into a non-conforming subordination agreement with each customer that contains a specific acknowledgment by the customer that its money, securities or property will not receive customer treatment under the Exchange Act or Securities Investor Protection Act of 1970 (“SIPA”) or be treated as customer property in a liquidation of the BD/FCM, and that such money, securities or property will be subject to any applicable protection under Subchapter IV of Chapter 7 of the Bankruptcy Code. The customer also must provide an affirmation that all of its claims with respect to such money, securities, or property against the BD/FCM will be subordinated to the claims of other securities customers and SB swap customers not operating under the portfolio margining program. The SEC states that the subordination agreement should help address the ICI’s concern regarding the need for clarity about how CDS commingled in a 4d(f) Account would be treated in the event of the bankruptcy of a BD/FCM. [\[2\]](#)

The second condition applies to transactions involving customers that are affiliates of the BD/FCM and consists of three requirements. The remaining four conditions apply to all BD/FCMs. These include requirements for:

- BDs/FCMs to set minimum margin levels at least equal to the amount determined using a margin methodology established and maintained by the BD/FCM that has been approved in writing by the SEC;
- BDs/FCMs to be in compliance with applicable laws and regulations relating to risk management, capital, and liquidity and to be in compliance with applicable clearing agency/DCO rules and CFTC requirements;
- Each customer of the BD/FCM participating in the program to be an “eligible contract participant;” and
- BDs/FCMs to furnish to their customers a disclosure document that indicates that the customer’s money, securities, and property will be held in a 4(d)(f) Account, the customer has elected to seek protections under Subchapter IV of Chapter 7 of the Bankruptcy Code, and the broker-dealer segregation requirements and any customer protections under SIPA and the stockbroker liquidation provisions will not apply.

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endnotes

[1] Order Granting Conditional Exemptions under the Securities Exchange Act of 1934 in Connection with Portfolio Margining of Swaps and Security-Based Swap, Release No. 34-68433, 77 FR 75211 (Dec. 19, 2012), available at <http://www.gpo.gov/fdsys/pkg/FR-2012-12-19/pdf/2012-30553.pdf>.

[2] For a summary of the ICI comment letter, see ICI Memorandum No. 26027 (Apr. 9, 2012), available at http://www.ici.org/my_ici/memorandum/memo26027.

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