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July 21, 2011

ICI Letters on CFTC's and Banking Regulators' Margin Proposals for Uncleared Swaps

[25344]

July 20, 2011

TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 53-11
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 28-11
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 31-11
ETF ADVISORY COMMITTEE No. 48-11
EQUITY MARKETS ADVISORY COMMITTEE No. 45-11
SEC RULES MEMBERS No. 86-11
SMALL FUNDS MEMBERS No. 50-11 RE: ICI LETTERS ON CFTC'S AND BANKING
REGULATORS' MARGIN PROPOSALS FOR UNCLEARED SWAPS

As we previously informed you, the Commodity Futures Trading Commission ("CFTC") and the banking regulators [\[1\]](#) have proposed margin requirements for uncleared swaps for registered swap dealers and major swap participants (together, "swap entities"). [\[2\]](#) The proposed rules set forth requirements for the amount, type and frequency of margin required to be collected based primarily on the type of swap counterparty. On July 11, 2011, ICI submitted comment letters to the CFTC and the banking regulators raising numerous concerns with the proposed margin rules. [\[3\]](#) In particular, ICI's letters recommended that the proposed rules be modified to require swap entities to post margin at the same levels and in the same amounts as would be required under the proposed rules for the particular type of counterparty. The letters are attached and briefly summarized below.

I. Market Participants

The proposals would categorize swap counterparties into four groups each with their own margin requirements: swap entities; high-risk financial end users; low-risk financial end users; and nonfinancial end users (or commercial end users). The banking regulators and the CFTC have proposed to use the definition of financial end user in Title VII of the Dodd-Frank Act. [\[4\]](#) The ICI's CFTC letter requested clarification regarding the classification of funds within the definition of financial end user and both ICI letters recommended that funds should be categorized as low-risk financial entities. [\[5\]](#) The letters explained that

funds are highly regulated, financially sound counterparties and the rules should reflect the fact of their stringent oversight. Further, funds should be permitted to use an initial margin threshold below which they are not required to post collateral. The letters also requested clarification that the proposed rules would apply to funds on a portfolio-by-portfolio basis.

II. Margin Requirements

The proposed rules would set forth margin obligations, permissible methods for calculating initial and variation margin, and types of eligible collateral. ICI's letters strongly recommended that the CFTC and the banking regulators revise the proposed rules to require corresponding two-way margin requirements between swap entities and non-swap entity counterparties. The letters also recommended that the CFTC and banking regulators modify the proposed margin models to provide greater certainty to counterparties and expand the categories of eligible collateral to accommodate market practices and realities.

A. Two-Way Margin

The proposed margin rules only would include requirements regarding the amount of margin that a swap entity must collect from its counterparties. To better protect counterparties to swap transactions and the swaps markets, ICI's letters recommended that the CFTC and the banking regulators require 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. The letters explained that two-way margin requirements would aid safety and soundness by helping a swap entity and its counterparty to offset their exposures and prevent them from building up exposures that they cannot fulfill. Two-way variation margin also would minimize the liquidity risk of uncleared swaps by removing current exposures prior to any efforts by a swap entity to mitigate losses from a default by a counterparty. The letters concluded that the CFTC and banking regulators have the authority under the Dodd-Frank Act to require swap entities to post margin in transactions with financial end user counterparties.

ICI's letters also commented on the potential custody of swap entities' collateral. For transactions between swap entities, the proposed margin rules would require that any collateral that was required to be collected by a swap entity be held by an independent, third-party custodian. In addition, it would allow such treatment for collateral collected by swap entities in transactions with non-swap entity counterparties. [\[6\]](#) ICI's letters recommended a similar approach for treatment of swap entities' collateral in transactions with non-swap entity counterparties: the swap entity's collateral, in particular initial margin, should be held by independent, third-party custodians (i.e., tri-party arrangements) with restrictions on rehypothecation and reinvestment unless the parties determine otherwise.

B. Calculation of Margin

ICI's letters offered several recommendations regarding the alternatives for the calculation of margin set forth in the CFTC' and banking regulators' proposed margin rules.

i. Banking Regulators' Margin Models

The banking regulators' proposed margin rules present two alternatives that a swap entity may use to calculate its initial margin requirements. A swap entity would be permitted to calculate its initial margin requirements using the 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. Alternatively, a swap entity would be permitted to calculate its minimum initial margin requirements using a proprietary model that meets certain criteria and has been approved by the relevant banking regulator.

ICI's banking regulator letter generally supported the proposed approach for calculating initial margin for uncleared swaps. [7] The letter recommended that the banking regulators adopt a system of calculating initial margin that would permit the counterparty to choose between the amount generated by a swap entity's model and the standardized minimum initial requirements set forth in Appendix A of the proposal. It explained that such a framework for calculation of initial margin would promote greater uniformity and transparency for market participants, and be easier to administer operationally. ICI's banking regulator letter also raised concerns with one of the proposed modeling standards for swap entities' proprietary initial margin models. The letter stated that the standard for initial margin requirements requiring a 10-day liquidation period is too long, and recommended a 5-day liquidation period instead.

The banking regulators proposed to provide that the margin requirements not become effective until 180 days following publication of final rules in the Federal Register. ICI's banking regulator letter recommended that, if the banking regulators adopt the proposed rules to require that swap entities file their models with the appropriate banking regulator and that such regulator approve such models, a mechanism be established so that the margin regulations would not become effective until the banking regulators have reviewed all submissions made by a certain cut-off date. The letter explained that such a procedure should serve to assure that some swap entities do not gain a competitive advantage over others by being able to enter into uncleared swaps using initial margin calculated under a proprietary model when others cannot lawfully do so because they are waiting for the banking regulators to process their margin model applications.

ii. CFTC Margin Model

The CFTC's proposed margin rules would permit swap entities to calculate margin using the following types of models that meet other specified standards: (1) a model currently in use for margining cleared swaps by a DCO; (2) a model currently in use for margining uncleared swaps by an entity subject to regular assessment by a banking regulator; or (3) a model available for licensing to any market participant by a vendor. [8] If no model meeting the standards of the rule were available, the swap entity would be required to calculate margin in accordance with an alternative approach that would base the margin requirements on the margin requirements for related cleared products.

ICI's CFTC letter recommended that the CFTC adopt a system of calculating initial margin that would permit the counterparty to choose between a swap entity's model and the standardized minimum initial requirements set forth in Appendix A of the banking regulators' proposal. It explained that such a framework for calculating initial margin would promote greater uniformity and transparency for market participants, and be easier to administer operationally. Specifically, it stated that such a recommendation would permit, but not require, swap entities to develop initial margin calculations using their own models in the first instance, but would provide that a counterparty could always choose the standardized minimum initial requirements.

ICI's CFTC letter also stated that the standards for models being proposed by the CFTC, including that a model be validated by an independent third party prior to use and annually

thereafter, and that the model's methodology be stated with sufficient specificity to permit the counterparty and the CFTC to calculate the initial margin requirement independently, provide sufficient safeguards to permit the use of swap entity proprietary models. The letter recommended, however, that the proposed standard requiring a 10-day liquidation period for initial margin requirements be shortened to 5 days.

With respect to the proposed alternative for calculating margin, ICI's CFTC letter stated that it would be too difficult and cumbersome to use a DCO model for margining cleared swaps as a basis to calculate initial margin for uncleared swaps. Further, trying to find a cleared swap or futures contract that is economically equivalent to an uncleared swap, which would be the basis for the alternative method of calculating initial margin, would also be burdensome to administer. ICI's CFTC letter concluded that it would be preferable to permit a counterparty to choose the banking regulators' standardized minimum initial requirements as the alternative initial margin calculation method.

Finally, ICI's CFTC letter recommended that, similar to the banking regulators, if the CFTC adopts the proposals to require that swap entities file their models with the CFTC and that the CFTC approve such models, a mechanism be established so that the margin regulations would not become effective until the CFTC has reviewed all submissions made by a certain cut-off date.

C. Forms of Margin

The proposed margin rules would limit the categories of eligible collateral to cash, U.S. Treasuries and, for initial margin only, certain government securities. Consistent with current swaps market practice, ICI's letters recommended that the CFTC and the banking regulators expand the proposed lists of eligible collateral to allow counterparties to a swap transaction the flexibility to agree upon the appropriate collateral arrangements for a particular swap. The letters explained that the absence of a range of acceptable collateral may result in a drag in performance as well as a divergence from the benchmark of a portfolio. The letters further suggested that, if the CFTC or banking regulators are unwilling to provide the recommended degree of flexibility, they permit the use of fixed-income securities issued by a well-known seasoned issuer that has a high credit standing, are unsubordinated, historically display low volatility, are traded in highly liquid markets, and have valuations that are readily calculable. Such securities would include, for example, sovereign debt securities and pre-refunded municipal securities.

III. Coordinate Effective Date of Cleared and Uncleared Margin Rulemaking

ICI's CFTC letter recommended that the CFTC align the proposed margin rules for uncleared swaps with the effective dates for margin rules mandated for cleared swaps. The letter stated that the proposed rules would unjustly hamstring swap investors with respect to moving initial margin and would result in disproportionately high margin rates for swaps lacking a cleared alternative. Significantly, the likely consequences of applying the proposals at different times would be detrimental to the swaps markets and swap market participants. ICI's CFTC letter explained, for example, that in some cases, swap market participants would be forced to clear for commercial reasons that, due to standardization, may not fully reflect the risks of the individual swap or allow market participants to appropriately hedge their individualized risks. Alternatively, market participants may seek to use other methods for mitigating or hedging their investment risks, resulting in less liquidity in the swaps markets.

IV. Regulatory Coordination

ICI's letters urged the CFTC and the banking regulators to pursue consistent and harmonized regulation domestically and internationally with respect to their proposed margin rules in recognition that the swaps markets are a global marketplace. Where harmonization is not possible, the letters recommended that regulators work to coordinate their proposals to the greatest extent possible. The letters explained that meaningful inconsistencies and differences between proposals may result in several unintended consequences including fragmentation of markets and regulatory arbitrage. Further, overlapping and potentially conflicting rules for swap market participants could result in uncertainty and could reduce the confidence of market participants seeking to hedge their risks in the swaps markets.

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[Attachment \(in .pdf format\)](#)

endnotes

[1] Banking regulators include the Federal Reserve, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Farm Credit Administration and Federal Housing Finance Authority.

[2] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 FR 23732 (April 28, 2011), available at <http://www.cftc.gov/LawRegulation/FederalRegister/ProposedRules/2011-9598.html> and Margin and Capital Requirements for Covered Swap Entities, 76 FR 27563 (May 11, 2011), available at <http://www.gpo.gov/fdsys/pkg/FR-2011-05-11/html/2011-10432.htm>.

[3] For purposes of this memorandum, the letters will be identified as "ICI's CFTC letter," "ICI's banking regulator letter" and, when jointly, as "ICI's letters."

[4] A financial end user would include: commodity pools; private funds; ERISA employee benefit plans; persons predominately engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act; persons that would be commodity pools or private funds if organized under the laws of the United States or any State; foreign governments or political subdivisions; and any other person that the relevant agency may designate.

[5] A low-risk financial end user would be an end user that does not have "significant swap exposure," predominately uses swaps to hedge or mitigate the risks of its business activities, including balance sheet, interest rate or other risk arising from its business, and is subject to capital requirements established by a banking regulator or state insurance regulator. This categorization, therefore, would not capture mutual funds. A high-risk financial end user would be one that does not fall within the scope of the term low-risk end user.

[6] ICI's letters strongly supported the proposed requirement that swap counterparties be given the opportunity to select a custodian that is not affiliated with the swap entity, but is

not required to do so. The letters noted that this flexibility allows a fund to determine which custodian best satisfies its needs to safeguard customer collateral posted as margin.

[7] ICI's banking regulator letter also generally supported the proposal to permit a swap entity to calculate variation margin requirements on an aggregate basis across all swap transactions with a counterparty that are executed under the same qualifying master netting agreement.

[8] The proposed rules would not provide for swap entities to use proprietary models because, according to the CFTC, it does not have the resources to review numerous models individually given current budget constraints.

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