

MEMO# 25388

August 8, 2011

ICI Letter on Protection of Cleared Swaps Customer Contracts and Collateral

[25388]

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 65-11
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 31-11
ETF ADVISORY COMMITTEE No. 55-11
EQUITY MARKETS ADVISORY COMMITTEE No. 50-11
FIXED-INCOME ADVISORY COMMITTEE No. 60-11
SEC RULES MEMBERS No. 98-11
SMALL FUNDS MEMBERS No. 55-11 RE: ICI LETTER ON PROTECTION OF CLEARED SWAPS
CUSTOMER CONTRACTS AND COLLATERAL

ICI has filed a letter with the Commodity Futures Trading Commission (“Commission” or “CFTC”) commenting on its Notice of Proposed Rulemaking on the appropriate model for protecting the margin collateral posted by customers for cleared swap transactions. [\[1\]](#) Based upon a desire to minimize potential market disruption as standardized swaps migrate from the over-the-counter (“OTC”) market to the framework of centralized clearing and exchange trading, as contemplated by the Dodd-Frank Act, and mindful of the cost this migration will entail, ICI’s letter supports the model referred to as Legal Segregation With Commingling (“LSOC”) at this time as the most appropriate model for protecting margin posted by customers clearing swap transactions. ICI’s letter is attached and summarized below.

Background

Notwithstanding the preference for LSOC, ICI’s letter states that the Full Physical Segregation model would potentially provide the maximum protection for customer collateral and is the model most consistent with the current OTC market practice where funds post initial margin for OTC swap transactions in individual, segregated accounts at third-party custodians. It explains, however, that the Full Physical Segregation model might impose costs and operational burdens on all market participants, including customers, and the derivatives industry as a whole that do not currently exist in the OTC market. ICI’s letter concludes that, although funds may be willing to bear these additional costs and, in fact,

funds currently incur costs for the use of individual, segregated accounts at tri-party custodians to post their initial margin for their uncleared OTC swap transactions, the majority of ICI members believe that the cost-benefit analysis, driven by the best interests of their shareholders, weighs in favor of LSOC for cleared swap transactions.

LSOC

ICI's letter recommends that the Commission adopt LSOC and that it do so in a timely manner to provide the marketplace with sufficient time to begin implementing the operational and systems infrastructure necessary to facilitate a smooth transition to clearing, particularly with respect to the protection of cleared swaps customer collateral.

Investment Risk

The letter recognizes that LSOC generally would mitigate Fellow-Customer Risk [\[2\]](#), but it would not eliminate the risk that each cleared swaps customer would share pro rata in any decline in value of FCM or DCO investments made with collateral posted by customers in connection with cleared swaps, also referred to as "Investment Risk." [\[3\]](#) It therefore recommends that the Commission, as well as the relevant self-regulatory organizations, undertake to monitor closely FCMs' and DCOs' investment of cleared swaps customers' collateral as part of a comprehensive regulatory framework for the protection of cleared swaps customer collateral.

The letter further recommends that the Commission reopen the comment period on its proposal to amend Rule 1.25 – i.e., the rule setting forth the category of eligible collateral for rehypothecation purposes. It explains that some ICI members have concerns regarding the scope of permissible investments under CFTC Rule 1.25, such as the credit, currency and duration risk of such instruments, even as proposed to be amended, in the context of investment and rehypothecation of cleared swaps customer collateral. Reopening the comment period would provide these cleared swaps customers with an opportunity to fully address these concerns in light of the Commission's current proposal to protect cleared swaps customer contracts and collateral.

One Day Risk

ICI's letter states that LSOC would mitigate Fellow-Customer Risk in most cases, but it would not entirely eliminate this risk. For example, in the event of a default by a member FCM, a DCO would allocate collateral of the defaulting FCM between the FCM's defaulting and non-defaulting cleared swap customers based upon the data provided by the FCM to the DCO the day prior to default. This "one-day lag" could be significant, especially during periods of market volatility. For this reason, the letter recommends that the Commission consider additional means of mitigating this risk, if possible.

Reporting and Recordkeeping

The letter explains that, given the level of detailed information that will be required to ensure legal separation within a commingled account, accurate and timely reporting of position level data with respect to each underlying cleared swaps customer will be particularly important to the successful implementation of LSOC. It recommends that the Commission mandate reporting and recordkeeping requirements for this purpose; require DCOs to adopt rules which require their member FCMs to comply with the reporting and recordkeeping requirements; require DCOs to monitor their member FCMs for compliance with such rules, including periodic audits; and conduct strident oversight of DCOs' compliance with their self-regulatory obligations in this area.

Other Issues

ICI's letter explains that, pursuant to prior precedent, a DCO is permitted to access the collateral of non-defaulting futures customers to cure a default in certain circumstances. [4] The letter therefore requests that the Commission make clear in final rules implementing LSOC that the position set forth in Interpretative Statement No. 85-3 is not applicable to cleared swaps transactions or the collateral of cleared swaps customers of a defaulting member FCM of a DCO.

Optional Model

The letter opposes the Optional model. It states that, due to the legal, regulatory, operational, and other issues which would be presented, it would not be appropriate to implement individual customer collateral protection on an optional basis. It explains, for example, that optionality could result in a situation where the riskiest customers would opt into models providing for Fellow Customer Risk and the more conservative customers would opt out of such models, thereby concentrating risk in the system.

Heather L. Traeger
Associate Counsel

[Attachment](#)

endnotes

[1] CFTC Notice of Proposed Rulemaking: Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 76 Fed. Reg. 33818 (June 9, 2011).

[2] Fellow-Customer Risk is the risk that a derivative clearing organization ("DCO") would access the collateral of a non-defaulting cleared swap customer to cure a future commission merchant's ("FCM") default.

[3] Section 4d(f) of the CEA permits FCMs and DCOs to invest cleared swaps customers' collateral in limited enumerated investments and the Commission is proposing that such instruments include those referenced in CFTC Rule 1.25. The Commission has proposed to amend Rule 1.25. See Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions, 75 Fed. Reg. 67642 (November 3, 2010).

[4] See CFTC Interpretative Statement No. 85-3, Regarding the Use of Segregated Funds by Clearing Organizations Upon Default by Member Firms (Aug. 12, 1985) ("Interpretative Statement No. 85-3").