The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 24931

February 2, 2011

ICI Letter on Protection of Customer Collateral for Uncleared Swaps

[24931]

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 16-11
DERIVATIVES MARKETS ADVISORY COMMITTEE
ETF ADVISORY COMMITTEE No. 11-11
EQUITY MARKETS ADVISORY COMMITTEE No. 10-11
FIXED-INCOME ADVISORY COMMITTEE No. 15-11
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 9-11
SEC RULES COMMITTEE No. 10-11
SMALL FUNDS MEMBERS No. 16-11 RE: ICI LETTER ON PROTECTION OF CUSTOMER COLLATERAL FOR UNCLEARED SWAPS

The Institute has filed a comment letter on the Commodity Futures Trading Commission's ("Commission") proposal to: (i) impose requirements on swap dealers ("SDs") and major swap participants ("MSPs") with respect to the treatment of collateral posted by their counterparties for uncleared swaps and (ii) amend certain provisions of the Commission's Part 190 rules related to securities held in a portfolio margining account that is a futures account, for purposes of the Bankruptcy Code. [1] The letter supports some aspects of the proposal, but raises significant concerns relating to the parties' choice of custodian and the investment of segregated collateral. The letter is attached and summarized below.

I. Segregation of Margin for Swap Dealer and Major Swap Participant Counterparties

A. Definition of "Initial Margin"

The letter recommends that the proposed definition of "initial margin" (or the "Independent Amount"), which is margin posted at the outset of a swap transaction in a fixed amount agreed upon by the parties, be modified to reflect current market practices. Specifically, the letter states that the proposal should require segregation of the Independent Amount as agreed to by the parties under the related ISDA/CSA, rather than having any ambiguity as to whether the term "initial margin" means the same thing as "Independent Amount."

B. Notification of Right to Segregation

The letter explains that ICI agrees with many of the provisions related to the SD or the MSP notifying the counterparty with respect to an uncleared swap that the counterparty has the right to require that its initial margin be segregated in accordance with the proposal. [2] It states, however, that notification should not be required to be provided to a high-level decision-maker for the counterparty. Instead, notices should go to an authorized person to avoid the disruption that would be associated with a chief risk officer or other "high-level decision-maker" making an election to each SD or MSP.

The letter also states that the Commission does not need to mandate that the SD or MSP disclose the cost of custodial fees to the counterparty, because such information is normally provided by the custodian to the counterparties to the transaction or is available upon request from the SD. The letter recommends, however, that the Commission require an SD to disclose any embedded fees it will impose if a customer elects to establish a segregated account and thereby restrict the SD's rehypothecation rights.

C. Requirements for Segregated Margin

With respect to the proposal's "independent" custodian requirement, the letter recommends that, consistent with longstanding market practice, the choice of custodian be left to the agreement of the parties. [3] It agrees with the provision that the custody agreement should be in writing and must include the custodian as a party, but it opposes the proposed requirement that a written statement for turnover of control of initial margin from an SD, an MSP or the counterparty to the custodian be signed under oath or under penalty of perjury. In addition, the letter recommends that the Commission clarify that objective evidence must be provided to the custodian concerning the notice to confirm the accrual of the counterparties' rights as to the delivery of collateral from the custodian (both with respect to any control notice from the secured party and any final return notice from the pledgor, in each case following the other party's default).

D. Investment of Segregated Collateral

The letter does not support extending Rule 1.25's limitations to the investment of initial margin for uncleared swap transactions. It states that swap counterparties are best positioned to evaluate the proper categories of securities for investment of initial margin collateral for swap transactions and explains that extending the Rule 1.25 limitations as proposed could result in counterparties taking on additional exposure to their custodians. The letter therefore urges the Commission to allow the parties to a swap transaction to continue to enter into any commercial arrangement they agree upon regarding the investment of segregated initial margin and similar business issues.

E. Effective Date

Instead of six months, the letter recommends that the Commission provide at least one year to provide market participants adequate time to make the necessary contractual, systems and internal policy changes to comply with the proposal. The letter also recommends that the Commission ensure that counterparties are required to put forth a good faith effort in negotiating or renegotiating agreements.

II. Portfolio Margining Accounts

The letter supports the proposed amendments to ensure that securities held in a portfolio margining account carried as a futures account are customer property and the owners of those accounts are customers for the purposes of subchapter IV of chapter 7 of the

Bankruptcy Code.

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Associate Counsel

Attachment

endnotes

[1] Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy, 75 FR 75432 (December 3, 2010), available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2010-29831a.pdf.

[2] The letter also recommends that in a situation in which both parties are either an SD or an MSP, the parties would mutually agree on who has the requirement to post initial margin as part of the negotiation of the swap trade, and whichever party has to post margin has the right to have their initial margin segregated.

[3] The letter clarifies that this approach would mean that an affiliate of an SD or an MSP could serve as the custodian, if agreed upon, but counterparties should always have the ability to choose a custodian who is completely independent of the SD or MSP. Further, neither an SD nor an MSP should be permitted to say that it would agree only to a custodian that is an affiliate.
