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COMMENT LETTER

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ICI Submits Supplemental Comment Letter on SEC's Proposed Rules on Capital, Margin and Segregation (pdf)

December 5, 2013 Ms. Elizabeth M. Murphy Secretary Securities and Exchange Commission 100 F Street, N.E. Washington, D.C. 20549 Re: Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers (File No. S7-08- 12) – Supplemental Comments to Letter of February 4, 2013 and Meeting with Staff on September 19, 2013 Dear Ms. Murphy: The Investment Company Institute ("ICI")1 is pleased to provide additional information to supplement our letter of February 4, 2013 ("February Letter")2 and meeting of September 19, 2013 regarding changes that we recommend the Securities and Exchange Commission ("Commission" or "SEC") make to its proposed capital, margin, and segregation requirements for security-based swap dealers ("SBSDs") and major security-based swap participants ("MSBSPs").3 Specifically, we urge the Commission to include the following revisions in its final rules: • Require bilateral exchange of collateral by SBSDs/MSBSPs and their counterparties. 1 The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $16.1 trillion and serve over 90 million shareholders. 2 Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated February 4, 2013, available at http://www.ici.org/pdf/26967.pdf. 3 Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 FR 70214 (Nov. 23, 2012) ("Proposal"), available at http://www.gpo.gov/fdsys/pkg/FR-2012-11-23/pdf/2012-26164.pdf implementing regulations under Title VII of The Dodd Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"), Pub. L. 111-203, 124 Stat. 1376 (2010). Ms. Elizabeth M. Murphy December 5, 2013 Page 2 of 15 • Not impose capital charges on SBSDs/MSBSPs4 when their counterparties elect to have their collateral held at a third-party bank custodian. • Permit all counterparties to post collateral for both cleared and uncleared security-based ("SB") swaps through a third-party bank custodian. • Prohibit SBSDs from using funds in the customer reserve account held for one customer to benefit another customer. • Allow counterparties to SB swaps to withdraw excess collateral from the special custody account at a third-party bank custodian securing their obligations. • Permit the application of thresholds for initial margin. These changes would significantly strengthen

customer protections and incentivize SBSDs to act prudently when entering into SB swaps in recognition that they have a “stake in the game” (by virtue of the margin they must post). These revisions also would reduce operational risk by allowing parties to hold and transfer collateral through well-capitalized custodial banks, leveraging existing, industry-standard documentation and collateral management models that have worked efficiently in the over-the-counter swaps and repo (i.e., “tri-party repo”) contexts. We again strongly urge the Commission to require SBSDs to post initial and variation margin to their non-SBSD counterparties at the same level and in the same manner as required for a non-SBSD counterparty. Adopting this fundamental requirement would make the SEC’s margin rules consistent with the final policy framework issued by the Basel Committee on Banking Supervision (“BCBS”) and the International Organization of Securities Commissions (“IOSCO”) that establishes minimum standards for margin requirements for non-centrally cleared derivatives.5 We believe it is imperative that the SEC not diverge from these internationally agreed standards, which are critical to the protection of counterparties (such as registered funds), the reduction of a build-up of systemic risk at institutions that engage in a significant amount of swap transactions, and the prevention of regulatory arbitrage. In the BCBS/IOSCO Report, BCBS/IOSCO explained that the group had determined that a greater reliance on margin would provide a more effective risk mitigant than imposition of higher 4 Although most MSBSPs would not be subject to a capital charge under the Proposal, the Proposal provides that MSBSPs that are dually-registered as broker-dealers would be subject to a charge. Proposal, id. at 70256 n. 466. In our view, neither these MSBSPs nor SBSDs should be subject to such a charge. 5 Margin Requirements for Non-Centrally-Cleared Derivatives, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, September 2013, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD423.pdf (“BCBS/IOSCO Report”). Ms. Elizabeth M. Murphy December 5, 2013 Page 3 of 15 capital levels because: (i) margin is more targeted to a particular transaction and marketplace and is easy to adjust; (ii) capital is easily depleted whereas margin can be topped up, even intraday; (iii) margin allows for immediate liquidity; and (iv) requiring posting of collateral incentivizes more prudent behavior by market participants by forcing them to internalize the costs of risk taking.6 The remainder of this letter focuses on the SEC’s proposed capital charge on an SBSD when its counterparty exercises its right to elect an independent bank custodian to hold collateral (which was specifically discussed at our September meeting).7 We believe that an imposition of such a capital charge on an SBSD would result in adverse consequences and that such a result is unnecessary to satisfy the SEC’s regulatory objectives for the reasons discussed below. We provide more detailed information regarding the arrangements currently in place for holding collateral of funds registered under the Investment Company Act (“ICA”) that may be helpful to the SEC. Specifically, this letter describes: (1) how the current tri-party agreements should satisfy the requirements under Proposed Rules 18a-3 and 18a-4; (2) the significant protections provided by the tri-party arrangements; (3) the current use of these arrangements and industry efforts to expand their use with the implementation of the Dodd-Frank requirements; and (4) terms we believe should be required in tri-party collateral agreements to address any residual concerns that the SEC may have regarding appropriate control by SBSDs over collateral posted by counterparties. I. Background In October 2012, the Commission proposed capital, margin, and segregation rules for SBSDs and MSBSPs that are modeled on existing rules applicable to broker-dealers. According to the Proposal, the collateral collection obligation, in connection with which the counterparties transfer collateral to SBSDs or MSBSPs in the form of initial margin or variation margin, is intended to provide the SBSD or MSBSP with sufficient margin to cover the SBSD’s (or MSBSP’s) exposure to the counterparty on a cleared or bilateral SB swap in the event of counterparty default and liquidation of the position.8 Even though

Dodd-Frank expressly requires SBSDs and MSBSPs to allow counterparties to hold initial margin posted in respect to non-cleared SB swaps at an independent, third-party custodian, the Proposal discourages exercise of this right and treats SB swap positions for which collateral is held 6 Id. at 3. 7 See Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy, 78 FR 66621, 66623 (Nov. 6, 2013) ("CFTC Protection of Collateral Release") (CFTC recognized that "Congress' description as a 'right' of what would otherwise be a simple matter for commercial negotiation suggests that this decision is an important one, with a certain degree of favor given to an affirmative election"). 8 Proposal, supra note 3, at 70246. Ms. Elizabeth M. Murphy December 5, 2013 Page 4 of 15 through a third-party custodian the same way as an uncollateralized position by requiring the SBSD and certain MSBSPs to take a capital charge because the collateral is held away.9 The Commission explained that this proposed capital charge was necessary because collateral held through a custodian would be insufficient to protect the SBSD from losses if the counterparty defaults. The SEC reasoned that the collateral would not protect the SBSD because the SBSD would not have physical possession or control over the collateral or be able to liquidate the collateral promptly without intervention of another party.10 We respectfully disagree with the SEC's analysis for the reasons described below. We believe the SEC should seek to fulfill Congress' intent and encourage use of independent, third-party custodial arrangements to hold both initial and variation margin, subject to compliance with state uniform commercial code requirements and provision by custodians of the types of collateral transfer and reporting safeguards provided currently in the tri-party repo market.11 Moreover, as discussed in our February Letter, registered funds may be precluded from holding their collateral with an SBSD or MSBSP that is not a bank. Under the ICA, registered funds are required to custody their assets in accordance with Section 17 of the ICA. Nearly all registered funds use a U.S. bank custodian for domestic securities although the ICA permits other limited custodial arrangements.12 Rule 17f-1 permits registered funds to use a broker-dealer custodian, but the rule imposes conditions that are difficult in practice to satisfy. We do not believe that complying with the protective requirements under the ICA (and electing the right specifically provided by Dodd-Frank) should result in higher costs to registered funds, especially when third-party custodial arrangements would achieve the SEC's regulatory objectives. 9 See id. at 70246. 10 Id. at 70246 – 70247. 11 We also request that the Commission clarify in any rule it ultimately adopts that it would be permissible for counterparties to hold cleared SB swaps and related collateral through a custodial bank that is a member of a SB swap clearinghouse, regardless of whether the custodial bank is an SBSD. The rule also should clarify that the custodial bank would be authorized to hold all excess counterparty margin in a segregated account in the counterparty-customer's name and post with the clearinghouse the counterparty's required margin for the cleared SB swap. 12 In addition to Section 17, the ICA contains six separate custody rules for the different types of possible custody arrangements: Rule 17f-1 (broker-dealer custody); Rule 17f-2 (self custody); Rule 17f-4 (securities depositories); Rule 17f-5 (foreign banks); Rule 17f-6 (futures commission merchants); and Rule 17f-7 (foreign securities depositories). Foreign securities are required to be held in the custody of a foreign bank or securities depository. Ms. Elizabeth M. Murphy December 5, 2013 Page 5 of 15 II. Tri-Party Collateral Agreements Satisfy the Requirements of Proposed Rules 18a-3 and 18a-4 Collateral posted for non-cleared swaps must meet certain conditions under Proposed Rule 18a-3 for a nonbank SBSD to count the collateral as equity in the counterparty's collateral account. One of the six conditions requires that the collateral be subject to "the physical possession or control of the nonbank SBSD and capable of being liquidated promptly by the nonbank SBSD without intervention by any other party."13 Proposed Rule 18a-4(b) also expressly requires that "excess securities

collateral" posted to any type of SBSD14 in respect to either a cleared or a non-cleared swap be in the "physical possession or control" of the SBSD. Excess securities collateral includes initial margin and all other collateral in excess of the SBSD's exposure to the counterparty. The requirement in the Proposal for "physical possession or control" allows collateral to be held either at the SBSD (i.e., in its "physical possession") or at a third party so long as the collateral is under the "control" of the SBSD. In the broker-dealer context, the Commission has interpreted "control" to require that securities be held in one of several locations specified in Rule 15c3-3 and that the securities be free of liens and other restrictions that could impede the ability of the broker-dealer to liquidate the securities.15 Permissible locations include banks.16 As discussed below, a careful analysis of properly-structured, tri-party collateral arrangements indicate that they satisfy the SEC's definition of "control." A. Tri-Party Collateral Arrangements Provide the Secured Party with "Control" over the Collateral. Although an SBSD would not have physical possession of securities collateral under a tri-party custodial arrangement, the SBSD would have legal "control" over the securities and cash pledged to it but held by the custodian so long as the arrangement were structured to comply with Articles 8 and 9 of the Uniform Commercial Code ("UCC"). Section 8-106(d)(2) of the UCC provides that a secured party has "control" of a "security entitlement" if: "the securities intermediary has agreed that it will comply with entitlement orders originated by the … [secured party] without further consent by the entitlement holder." In explaining the provision, the drafters noted that the provision allows a secured party that holds collateral through a "securities intermediary" to have control over the securities account and the assets held in the account, regardless of whether the intermediary is a custodian for the 13 See paragraph (c)(4)(i) of Proposed Rule 18a-3 under the Securities Exchange Act of 1934 ("Exchange Act"). 14 These include: bank SBSDs, stand-alone SBSDs and broker-dealer SBSDs. 15 Proposal, supra note 3, at 70276 – 70277 and n. 665 (citing 17 CFR 240.15c3-3(c)). 16 Id. at 70276-70277 Ms. Elizabeth M. Murphy December 5, 2013 Page 6 of 15 pledgor or for the secured party.17 Section 9-104 of Article 9 provides a similar right in respect to security entitlements over deposit accounts holding cash collateral. The term "security entitlement" is a property right that a person obtains in the contents of a securities account with a "securities intermediary."18 The concept of "security entitlement" provides a holder of the entitlement with a priority in the financial assets held in that account over the securities intermediary or the security intermediary's creditors.19 Article 8, which covers security interests in securities, was expressly adopted to provide more certainty to borrowers and lenders in light of changes in the manner in which securities are held. The determination of whether the secured party has a security interest in securities that have been posted as collateral depends upon whether the secured party has the present ability to have the securities sold or transferred without further action by the transferor. These rights are not required to be exclusive, and the secured party may (but is not required to) allow the debtor to retain rights of disposition over the account or securities, including through the right to substitute collateral. Moreover, the rights of the third party are not required to "spring" into being only upon a pledgor's default but can be in place throughout the term of the tri-party collateral arrangement.20 "Control" is based on the contractual agreement directing the custodian to follow instructions from the secured party with respect to the custody account without first obtaining consent from the entitlement holder. In practice, pledgors and secured parties memorialize the pledge of securities and the grant of "control" to the secured party through an "account control agreement" among a pledgor, secured party and securities intermediary. As required by condition (ii) of Proposed Rule 18a-3 applicable to nonbank SBSDs with respect to collateral collected for non-cleared SB swaps and the more general requirements of Proposed Rule 18a-4, the agreement allows collateral to be liquidated promptly by the secured party-SBSD without intervention by any other party.21 17 See UCC

Official Comments to Section 8-106, Comment 4 (“Subsection (d)(2) provides that a purchaser has control if the securities intermediary has agreed to act on entitlement orders originated by the purchaser if no further consent by the entitlement holder is required. Under subsection (d)(2), control may be achieved even though the transferor’s original entitlement holder remains listed as the entitlement holder”). 18 See UCC Section 8-102(a)(17) (“Security Entitlement means the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5”). 19 Uniform Law Commission, the National Conference of Commissioners on Uniform State Laws, UCC Article 8, Investment Securities (1994) Summary. See UCC Section 8-102(a)(14) (Security Intermediary means (i) a clearing corporation; or (ii) a person, including a bank or broker, that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity”). 20 UCC Official Comments to Section 8-106, Comment 7. 21 Proposed Rule 18a-3(c)(4)(iii). Ms. Elizabeth M. Murphy December 5, 2013 Page 7 of 15 Under a typical control agreement, the secured party will have an unconditional right to dispose of the assets upon any triggering event, such as the pledgor’s default or the pledgor’s failure to maintain sufficient equity in the collateral account. The secured party also will have the right to exclusive control over the account simply by delivering a notice of exclusive control to the custodian, which the custodian has no right to question. To provide protection to the pledgor against overreaching by the secured party, the secured party will typically covenant to the pledgor that it will not submit a notice of exclusive control or seek to exercise remedies in respect to the pledged securities account and securities in the account unless the pledgor has defaulted or there has been a similar triggering event, such as a termination event or “specified condition” under the Master Agreement published by the International Swaps and Derivatives Association, Inc. (“ISDA”).22 This approach provides certainty to the parties because it ensures that the securities intermediary will follow the instructions of the secured party.23 Courts have recognized the legitimacy of collateral control arrangements and enforced them in accordance with their terms,24 noting that, to view the arrangements in any other light would be to ignore commercial reality.25 This recognition of tri-party collateral arrangements by the courts ensures that condition (c)(4)(iv) of Proposed Rule 18a-3 would be met by relying on a properly drafted control agreement.26 22 The concept of a “Specified Condition” is included in the ISDA Credit Support Annex as a trigger for exercise of default remedies by the secured party under the ISDA Credit Support Annex. The triggering events are subject to definition by the parties through designation in Paragraph 13 of the ISDA Credit Support Annex. 23 See UCC Official Comments to Section 8-106, Comment 7 (“In many situations, it will be better practice for both the securities intermediary and the purchaser to insist that any conditions relating in any way to the entitlement holder be effective only as between the purchaser and the entitlement holder. That practice would avoid the risk that the securities intermediary could be caught between conflicting assertions of the entitlement holder and the purchaser as to whether the conditions in fact have been met. Nonetheless, the existence of unfulfilled conditions effective against the intermediary would not preclude the purchaser from having control”). 24 See Scher Law Firm v. DB Partners I LLC, 27 Misc.3d 1230(A), 911 N.Y.S.2d 696 (Kings County 2010) (finding that a broker-dealer’s security interest in collateral was perfected by the control agreement, and the broker-dealer obtained control over the collateral pursuant to the control agreement in accordance with the requirements of UCC 8-106(d)); see also SIPC v. Lehman Brothers Inc., 433 B.R. 127 (Bankr. S.D.N.Y. 2010) (rejecting an argument by a pledgor of collateral to a bankrupt broker-dealer under a control agreement that the pledged collateral should be excluded from the definition of “customer property” under the Securities Investor Protection Act (“SIPA”) because the assets were not in the “possession” of the debtor and, thus, never “held” by the debtor. The Court found that the assets held under the tri-party agreement

“were under the dominion and control of [the debtor]”). 25 SIPC v. Lehman Brothers Inc, supra note 24 (noting as well that failure to enforce the control provided to a secured party over collateral held through a properly-documented, tri-party custody arrangement “disregards the commercial reality of the agreements among the parties”). 26 Proposed Rule 18a-3(c)(4)(iv). Ms. Elizabeth M. Murphy December 5, 2013 Page 8 of 15 B. Tri-Party Collateral Arrangements Satisfy the Requirements that the Assets be Held Free of Liens and Held at an Appropriate Location According to the SEC, the term “possession or control,” as used in Rule 15c3-3, means that a broker-dealer may not lend, rehypothecate or use the referenced assets in its business.27 Collateral posted through a third-party custodian and held in a special custody account would be held free of liens, other than the lien imposed by the agreement in favor of the secured party.28 Under the tri-party arrangement, similar to the requirement for broker-dealers under Rule 15c3-3, the secured party could not lend, rehypothecate or use these assets in its business. Allowing SB swap counterparties to post securities and other collateral through a special custody account at third-party bank custodian would be consistent with the requirement under Proposed Rule 18a-3 that the instruments be held in one of five specified ways – one of which is to be “in the custody or control of a bank as defined in section 3(a)(6) of the [Exchange] Act.”29 III. Tri-Party Collateral Arrangements Incorporate Significant Protections for Secured Party and Pledgor A. Tri-Party Collateral Arrangements Provide Protections Against Operational Risk By centralizing margin operations at a custodial bank, counterparties can more easily standardize transfer times, minimize transfer errors, facilitate cross-product netting of collateral posted and received and provide for transparency through online custodial systems and confirmations. As the custodial banks have proven in the tri-party repo market, they are well positioned to process multiple transactions simultaneously on their books and offer streamlined and automated collateral allocation and substitution capabilities.30 Custodial banks also can offer economies of scale to counterparties and efficiencies based on the fact that they have existing systems to handle margining and appropriate staffing levels and expertise. Because the custodian is independent, custodial employees also may not have an incentive to expropriate customer margin if the SBSD experiences liquidity issues (e.g., as was the case with MF Global). By leveraging custodial infrastructures to handle margin transfers, investment of cash, and recordkeeping, counterparties can ensure that collateral is posted and returned (when no longer 27 Proposal, supra note 3, at 70278. 28 In some cases a collateral control agreement will include a lien in favor of the custodian sufficient to cover advances made by the custodian or the custodian’s fees. Where this is included in the agreement, the secured party will typically require that the custodian subordinate its lien to that of the secured party. 29 Proposal, supra note 3, at 70351. 30 Task Force on Tri-Party Repo Infrastructure, Payments Risk Committee, Final Report, February 15, 2012. Ms. Elizabeth M. Murphy December 5, 2013 Page 9 of 15 needed) quickly and efficiently, and collateral posting can be minimized through netting collateral postings across positions and establishing a net equity (in a similar manner as contemplated by Regulation T and Rule 4210 of the Financial Industry Regulatory Authority (“FINRA”) in respect to broker-dealer margin accounts).31 In addition, from an operational perspective, custodians significantly improve the margining process by facilitating efficient management of collateral (whether posted by a counterparty or an SBSD or MSBSP), transparency into collateral positions and robust operational infrastructures. Therefore, contrary to the Proposal’s suggestion that custodial arrangements increase systemic risk and, in particular, solvency risk in respect to SBSDs, the use of custodial arrangements reduces systemic risk, enhances the audit trail and ensures that security interests are properly perfected and available for a secured party to act on as a result of the “control” of collateral provided to the SBSD or MSBSP by the tri-party arrangement. B. Collateral Held by a Custodian Allows the Pledgor (including an SBSD

or MSBSP Posting to a Counterparty) to Manage Its Portfolio Section 4(d) of the 1994 (New York Law version) ISDA Credit Support Annex, which is the collateral agreement customarily used by SBSDs, MSBSPs, and SB swap counterparties in the United States, provides for substitution of collateral upon notice to, but without consent from, the secured party. Although this provision may be modified by parties in Paragraph 13 of the Annex, the default provision allows for free rights of substitution of collateral. In practice, this provision allows the pledgor flexibility to reinvest collateral while maintaining collateral in the required amount at the custodian. This flexibility ensures that a pledgor – whether an SBSD, MSBSP or counterparty – can efficiently and effectively manage its portfolio and use its assets, even when those assets are subject to a lien. These arrangements mitigate the risk that posting of collateral, particularly by an SBSD or MSBSP, will cause a "liquidity drain."32 All of the major bank custodians have built on-line systems that provide real-time transparency into the substitution process, which benefits both the secured party and pledgor. 31 For a rule authorizing consolidation and netting across accounts, see FINRA Rule 4210(f)(5)("When two or more accounts are carried for a customer, the margin to be maintained may be determined on the net position of said accounts, provided the customer has consented that the money and securities in each of such accounts may be used to carry or pay any deficit in all such accounts"). 32 See Proposal, supra note 3, at 70267 (noting that commenters to margin proposals published by the Commodity Futures Trading Commission ("CFTC") and the bank regulators indicated that requiring segregation of initial collateral, in particular, would cause "a massive liquidity drain" and would harm the marketplace by limiting the availability of swap collateral). Ms. Elizabeth M. Murphy December 5, 2013 Page 10 of 15 C. Use of Tri-Party Collateral Arrangements Makes Customer Assets Readily Identifiable in Bankruptcy Congress added an express segregation right for counterparties to SBSDs and MSBSPs for their non-cleared swaps initial margin to provide greater protections to counterparties upon the bankruptcy of an SBSD or MSBSP.33 The SEC described the intent of segregation as generally facilitating identification of customer assets upon a broker-dealer's bankruptcy and increasing the possibility that the assets will be physically available at the bankrupt broker-dealer to be returned to the customer or transferred to a solvent institution.34 Bankruptcy treatment of SB swaps is subject to some uncertainty. SBSDs are subject to the stockbroker liquidation provisions of the U.S. Bankruptcy Code ("Bankruptcy Code"),35 and Dodd- Frank suggests – although it has not yet been decided by a bankruptcy court – that both cleared and uncleared SB swaps and the related collateral should be deemed "securities accounts" as defined in the stockbroker liquidation provisions.36 It is also not clear whether the SB swap positions and related collateral would be considered to be customer property for purposes of SIPA, which SBSDs may opt into by voluntarily becoming a member of the Securities Investor Protection Corporation ("SIPC"). The Proposal addressed the uncertainty in treatment under the Bankruptcy Code and under SIPA by requiring counterparties of SBSDs who have elected to segregate initial margin to agree to subordinate their claims against the SBSD to the claims of all SB swap counterparties of the SBSD to the extent that the segregated assets are not treated as customer property in a liquidation of the SBSD.37 33 Proposal, supra note 3, at 70275 ("The objective of individual segregation is for the funds and other property of the counterparty to be carried in a manner that will keep these assets separate from the bankruptcy estate of the SBSD or MSBSP if it fails financially and becomes subject to a liquidation proceeding. Having these assets carried in a bankruptcy- remote manner protects the counterparty from the costs of retrieving assets through a bankruptcy proceeding caused, for example, because another counterparty of the SBSD or MSBSP defaults on its obligations to the SBSD or MSBSP"). 34 Proposal, supra note 3, at 70276 ("Rule 15c3-3 requires a broker-dealer that maintains custody of customer securities and cash (a 'carrying broker-dealer') to take two primary steps to safeguard these assets. The

steps are designed to protect customers by segregating their securities and cash from the broker-dealer's proprietary business activities. If the broker- dealer fails financially, the securities and cash should be readily available to be returned to the customers. In addition, if the failed broker-dealer is liquidated in a formal proceeding under SIPA, the securities and cash should be isolated and readily identifiable as 'customer property' and, consequently, available to be distributed to customers ahead of other creditors"). 35 Proposal, supra note 3, at 70274. 36 Id. The term "securities account" is used in Section 741 of the Bankruptcy Code in defining the terms "customer" and "customer property." 37 The logic of requiring subordination is that the counterparty should not need the benefit of priority status with respect to posted collateral upon the bankruptcy of an SBSD because the segregated assets should be treated as bankruptcy remote as a result of the tri-party arrangement. In light of the uncertainty regarding treatment in bankruptcy, the SEC added this conditional waiver and provided that, if the segregation is not effective in treating the counterparty assets as being outside of the bankruptcy estate, then the counterparty will be treated as having a pro rata priority claim to customer property. See Proposed Rule 18a-4 and Proposal, supra note 3, at 70287-70288. Ms. Elizabeth M. Murphy December 5, 2013 Page 11 of 15 In light of the clear intention of Congress to provide greater protection to counterparties to non-cleared SB swaps in bankruptcy of an SBSD or MSBSP by the grant of a segregation right for initial margin, the Commission should encourage the use of the existing right of segregation under section 3E(f) of the Exchange Act by not imposing capital charges. The Commission should provide for expanded use of tri-party arrangements, in respect to both initial and variation margin. The broader availability of tri-party arrangements would protect all types of counterparties to SB swaps (including SBSDs and MSBSPs) upon the bankruptcy of the counterparty to which their collateral has been pledged. The fact that the bankruptcy treatment of counterparty assets upon the bankruptcy of an SBSD is subject to some uncertainty is not a reason to reject this approach. The Commission has addressed the uncertainty through its proposed subordination requirement. Moreover, it is clear that counterparties as well as the market generally would benefit as result of the stronger and more equitable bankruptcy process that would be possible when counterparty property is readily identifiable, not commingled with assets of the debtor and not available for misuse by the debtor as it is heading towards insolvency. IV. Use of Tri-Party Collateral Arrangements is Well Understood by Market Participants and Will Likely be Expanded with Implementation of Dodd-Frank Rules Control agreements are widely used with respect to non-cleared derivatives transactions. As noted above, registered funds are required to use these arrangements to comply with Section 17(f) of the ICA.38 Pension funds and other institutional investors often rely on the arrangements as well. Control agreements typically include standard, contractual terms that make clear that collateral is pledged for the benefit of the secured party and ensure that both the pledgor and secured party have the benefits of the arrangement but are protected against misuse of the collateral by the other party. ISDA recently published a standard form of control agreement as a result of a three-and-a-half- year long project involving dealers, buy-side counterparties and custodians.39 The ISDA model form is designed to be supplemented by an annex that is agreed between the parties so that the agreement may be customized.40 The model form is clear, easy to negotiate (since the Annex includes selection menus) and fully compliant with UCC requirements to ensure that the secured party has a perfected priority security interest in the collateral. Tri-party arrangements are tailored to work with the ISDA master agreement and other standard documentation to provide predictability regarding default and early termination triggers and 38 See supra note 12 and accompanying text. 39 Although the ISDA form of control agreement was designed for use in connection with posting of initial margin by the counterparty, the form could be adopted for other situations, including for posting of

variation margin by the counterparty and for posting of both initial and variation margin by the dealer. 40 See ISDA Publishes ISDA 2013 Account Control Agreement (ACA) at press@ISDA.org. Ms. Elizabeth M. Murphy December 5, 2013 Page 12 of 15 remedies. The documentation allows a secured party to act quickly in liquidating collateral so as to mitigate market risk. Under the 2002 ISDA Master Agreement, bankruptcy defaults take effect without notice although other defaults, as well as termination events, require written notice by the non- defaulting party to the defaulting party. Payments are due with respect to defaults on the date specified by the non-defaulting party (which may be the date of the bankruptcy or notice) or two business days later, with respect to a termination event. Standard control agreements, including the ISDA model template, provide for immediate enforcement of a notice of exclusive control by the custodian so that a defaulting party may not withdraw assets. There is little or no practical difference in timing between exercise of default remedies when collateral is held under a custodial arrangement and when collateral is held directly by a secured party. V. Recommended Terms to Include in Tri-Party Collateral Arrangements For the reasons discussed above, we believe that the Commission should confirm that tri-party agreements satisfy the requirements in Proposed Rules 18a-3 and 18a-4. If the Commission believes certain mandatory terms are necessary in such agreements,41 we recommend the following provisions for the protection of both counterparties:42 • Account Plating. A control agreement would provide that the account be appropriately labeled by the custodian to reflect the pledge relationship, the name of the secured party and the name of the pledgor (i.e., "[Name of Pledgor] for the benefit of [Name of Secured Party], as pledgee"). Labeling in this manner: (i) clarifies that the pledgor has pledged and not sold the assets; (ii) avoids confusion from a tax perspective regarding beneficial ownership; and (iii) identifies the lien and nature of secured party's interest in the account. • Compliance with Entitlement Orders. The control agreement would prohibit the custodian from accepting instructions with respect to the account from persons other than the secured party and the pledgor. Until the occurrence of an event of a default, termination event or "specified condition" under the ISDA Master Agreement43 between the secured 41 We recommend that the Commission require that segregation be subject to a written agreement that includes the custodian as a party. See CFTC Protection of Collateral Release, supra note 7, at 66627 (CFTC recently adopted rules to require written agreements that include the custodian as a party in respect to tri-party arrangements for initial collateral for swaps). 42 The ISDA model form includes all of the protective provisions described below (other than collateral substitution, which is addressed in the ISDA Credit Support Annex rather than in the model control agreement). 43 "Termination events" are defined in Section 5(b) of the ISDA Master Agreement and include events such as illegality, force majeure and events that the parties define, such as a debt ratings downgrade or a drop in a party's net asset value. The term "specified condition" is defined in the Credit Support Annex to the ISDA Master Agreement to mean an event that excuses obligations of parties to post or return collateral and triggers a right to terminate the affected transactions. Specified conditions are selected by parties to the Master Agreement, and include events such as illegality, a change in tax laws, and a credit deterioration as a result of a merger. Ms. Elizabeth M. Murphy December 5, 2013 Page 13 of 15 party and the pledgor (a "Notice of Exclusive Control" or "NEC Event"), the custodian would be allowed to accept instructions from both the secured party and the pledgor. The secured party would covenant not to issue such instructions unless and until the occurrence of an NEC Event, but the custodian would be obligated to follow instructions even if the secured party breached its covenant. In the absence of an NEC Event, the pledgor would agree with the secured party to provide only limited instructions allowing it to substitute collateral of equal value in accordance with procedures agreed with the secured party. The control agreement would clearly prohibit the custodian from accepting any further instructions from the

pledgor upon the occurrence of an NEC Event.44 • Specified Withdrawal Rights. A control agreement would include a restriction on the ability of the pledgor to withdraw collateral except in the event that the pledgor simultaneously substitutes for the withdrawn collateral eligible collateral of equal value. • Notice of Exclusive Control. A control agreement would include a provision allowing the secured party to obtain exclusive control over the pledgor's posted collateral through an NEC. The terms would specify that custodian has no right to question the right of the secured party to submit the NEC, and the custodian would be obligated, upon receipt from the secured party to do so, immediately to turn over possession of the collateral to the secured party and take any other steps requested to liquidate the collateral and use such proceeds to pay to the secured party all amounts owed by pledgor. The agreement would include a covenant by the secured party not to submit an NEC unless an NEC Event has occurred and is continuing. • Custodian Covenants. A custodian would be required to covenant not to hold a lien over the account or its assets or if the parties agree that custodian may have a limited lien (e.g., to cover custodial fees and overdraft lines), the custodian would expressly subordinate its right and lien to that held by secured party.45 With respect to other "margin" accounts, the broker-dealer community has at times been reluctant to allow customers to post margin and collateral through a tri-party custody arrangement for 44 This language typically reads as follows: "The Custodian hereby acknowledges the security interest granted to Secured Party by Pledgor in the Posted Collateral. The Custodian will comply with the "entitlement orders" (as defined in Section 8-102(a)(8) of the Uniform Commercial Code of the State of New York) concerning the Account originated by Secured Party without further consent by Pledgor until this Agreement is terminated as provided herein. Except for substitution of collateral, as provided in section ____, the Custodian agrees not to act on entitlement orders or other instructions originated by any other person with respect to the Account unless it has received the prior written consent of the Secured Party." 45 Other provisions that counterparties and dealers often require in connection with tri-party collateral arrangements are: (i) a representation that the custodian is not an affiliate of either of the other parties; (ii) a representation that the custodian is a bank, as defined in the Exchange Act; and (ii) a covenant by the custodian to hold the collateral in the United States. Ms. Elizabeth M. Murphy December 5, 2013 Page 14 of 15 securities margin accounts because these arrangements restrict the ability of the broker-dealers to freely use customer collateral to finance their own operations. Because of these concerns, broker-dealers have recommended that the tri-party arrangements that are required to be used with respect to collateral posted by registered funds be subject to a number of unnecessary requirements that are inconsistent with the requirements on registered funds and do not reflect the realities of commercial law. For example, broker-dealers have proposed that (1) customers not be allowed to withdraw assets from the account even though the assets are in excess of the applicable margin requirements,46 (2) collateral substitutions and investments of customer cash in money market instruments be prohibited unless the broker-dealer provides an instruction allowing for such withdrawals,47 and (3) broker-dealers be able to freely use and invest the collateral for their own benefit (i.e., rehypothecate the posted collateral).48 We recommend that the SEC not adopt these or impose any other restrictions on tri-party arrangements beyond those we have suggested above. We believe concerns about broker-dealer financing should not be addressed by imposing unnecessary requirements on tri-party arrangements and such unnecessary terms should not be carried over to tri-party collateral arrangements for SB swap transactions. VI. Conclusion We strongly urge the Commission to recognize and encourage the use of tri-party collateral arrangements for both initial and variation margin in connection with both cleared and non-cleared SB swaps. In addition, the Commission should not impose a capital charge on an SBSD or MSBSP for transactions for which its counterparty elects to have its collateral held

at an independent custodian. A capital charge is unnecessary given the legal recognition that a secured party under a tri-party control agreement has the same right to control the collateral as if the secured party held physical possession of the collateral or held the collateral in an account in the secured party's name at its own custodian.49 Imposing a capital charge also is inconsistent with the intent of Congress in granting an explicit right, under the Dodd-Frank Act, for counterparties to hold initial margin at an independent, third-party custodian. * * * 46 This limitation is stricter than the rules regarding customer withdrawals from margin accounts under Regulation T and FINRA Rule 4210, which allow for withdrawals without consent. See, e.g., FINRA Rule 4210(b). 47 As discussed above, the flexibility to provide for substitution of collateral and investment of cash in money market instruments is important to fiduciaries in managing registered funds or other types of funds and customer assets to manage the portfolio and provide for reasonable returns on the posted collateral. 48 Compare this term to Rule 17f-6 under the ICA, which provides that margin delivered to a futures commission merchant ("FCM") by a registered fund may be invested by the FCM only in accordance with strict limitations provided under rules of the CFTC. 49 UCC Official Comments to Section 8-106, Comment 7. Ms. Elizabeth M. Murphy December 5, 2013 Page 15 of 15 We appreciate the opportunity to provide supplemental comments on the Proposal. If you have any questions on our comment letter, please feel free to contact me at (202) 326-5815, Sarah Bessin at (202) 326-5835, or Jennifer Choi at (202) 326-5876. Sincerely, /s/ Karrie McMillan General Counsel cc: The Honorable Mary Jo White The Honorable Luis A. Aguilar The Honorable Daniel M. Gallagher The Honorable Kara M. Stein The Honorable Michael S. Piwowar John Ramsay, Acting Director, Division of Trading and Markets, SEC Michael A. Macchiaroli, Associate Director, Division of Trading and Markets, SEC Norm Champ, Director, Division of Investment Management, SEC Ananda Radhakrishnan, Director, Division of Clearing and Risk, CFTC Robert Wasserman, Chief Counsel, Division of Clearing and Risk, CFTC
