COMMENT LETTER

March 14, 2013

ICI and ICI Global Comment Letter to Basel Committee and IOSCO in Response to Near-Final Proposal on Margin Requirements for Uncleared Derivatives (pdf)

March 14, 2013 Via Electronic Mail (baselcommittee@bis.org and wgmr@iosco.org) Wayne Byres Secretary General Basel Committee on Banking Supervision Bank of International Settlements Centralbahnplatz2 CH-4002 Basel Switzerland David Wright Secretary General International Organization of Securities Commissions C/ Oquendo 12 28006 Madrid Spain Re: Second Consultation Paper on Margin Requirements for Non-Centrally Cleared Derivatives Dear Mr. Byres and Mr. Wright: The Investment Company Institute ("ICI")1 and ICI Global2 appreciate the opportunity to provide comments on the second consultation paper issued by the Basel Committee on Banking Supervision ("BCBS") and the International Organization of Securities Commissions ("IOSCO") describing the "near-final policy framework" for margin requirements for covered entities (i.e., financial 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 $14.6 trillion and serve over 90 million shareholders. 2 ICI Global is the global association of regulated funds publicly offered to investors in leading jurisdictions worldwide. ICI Global seeks to advance the common interests and promote public understanding of global investment funds, their managers, and investors. Members of ICI Global manage total assets in excess of US $1 trillion. ICI/ICI Global Letter to Mr. Byres and Mr. Wright March 14, 2013 Page 2 of 13 firms and systemically-important non-financial entities) engaging in non-centrally cleared derivatives.3 The Consultation Paper sets out the BCBS' and IOSCO's policy through key principles and requirements addressing eight main elements. We generally support the near-final policy framework. In particular, we support the determination by the BCBS and IOSCO to require all covered entities to exchange on a bilateral basis initial and variation margin and to permit the use of a universal threshold (i.e., an amount under which a covered entity would have an option of not collecting initial margin) for all covered entities. We strongly agree with the proposal of the BCBS and IOSCO to require counterparties to post margin at the same level and in the same manner. Two-way margin is an essential component of managing risk for derivatives transactions as well as for reducing systemic risk. In addition, the Consultation Paper seeks comment on four questions relating to certain aspects of the framework. Specifically, the BCBS and IOSCO request comment on the following issues: (1) the treatment of physically-settled foreign exchange ("FX") forwards and swaps under the framework; (2) the ability to engage in limited re-hypothecation of collected initial margin; (3) the proposed phase-in schedule of the requirements; and (4) the adequacy of the quantitative impact study conducted by the BCBS and IOSCO. In this letter, we provide comments on the first three questions presented by the BCBS and IOSCO. First, we believe FX forwards and swaps should be exempt from margin requirements because the FX forwards and swaps market is markedly different than other derivatives markets and imposing margin requirements on these instruments would not likely produce the benefits that would result for other types of derivative instruments. Second, we support the BCBS and IOSCO proposal to impose restrictions on the re-hypothecation of collateral collected as initial margin and request within the framework the ability to use a third-party custodian to hold collateral. Third, we generally support the proposed phase-in schedule of the margin requirements but seek confirmation regarding the level at which the threshold and de minimis amounts would apply. Finally, we also provide comments on several other aspects of the margin framework. Background U.S. funds that are regulated under the Investment Company Act of 1940 ("ICA") and non- U.S. regulated funds publicly offered to investors (collectively, "Regulated Funds") use swaps and other derivatives in a variety of ways. Derivatives are a particularly useful portfolio management tool in that they offer Regulated Funds considerable flexibility in structuring their investment portfolios. Uses of 3 Second Consultative Document, Margin Requirements for Non-Centrally-Cleared Derivatives, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, February 2013, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD403.pdf ("Consultation Paper"). See Margin Requirements for Non- Centrally-Cleared Derivatives, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, July 2012, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD387.pdf ("First Consultation Paper"). ICI/ICI Global Letter to Mr. Byres and Mr. Wright March 14, 2013 Page 3 of 13 swaps and other derivatives include, for example, hedging positions, equitizing cash that a Regulated Fund cannot immediately invest in direct equity holdings, managing a Regulated Fund's cash positions more generally, adjusting the duration of a Regulated Fund's portfolio, managing bond positions in general, or managing a Regulated Fund's portfolio in accordance with the investment objectives stated in its prospectus. To employ non-centrally cleared derivatives in the best interests of fund shareholders, ICI and ICI Global members have a strong interest in ensuring that the derivatives markets are highly competitive and transparent. As we noted in our letter on the First Consultation Paper, ICI and ICI Global members, as market participants representing millions of shareholders, generally support the goal of providing greater oversight of the derivatives markets.4 In this regard, our members strongly support the BCBS' and IOSCO's efforts to implement consistent global standards for margin requirements for non- centrally cleared derivatives. Given that many derivatives transactions are conducted across multiple jurisdictions, ICI and ICI Global also support efforts for real and meaningful coordination among regulators on how these regulations will be applied to market participants that engage in cross-border transactions. Margin Requirements for FX Forwards and Swaps The Consultation Paper proposes to apply the margin requirements to all non-centrally cleared derivatives except for physically-settled FX forwards and swaps.5 With respect to physically-settled FX forwards and swaps, the BCBS and IOSCO seek comment on the margin requirements for these instruments. As we discussed in the September 2012 ICI and ICI Global Letter, we believe that the risk profile for the FX forwards and swaps market is markedly different from other derivatives markets and therefore warrants an exemption from the (initial and variation) margin requirements. First, the FX forwards and swaps market is highly transparent and liquid.6 Second, unlike other derivative instruments, counterparties exchange the full amount of the relevant currencies on pre-determined 4 Letter from Karrie McMillian, General Counsel, ICI, and Dan Waters, Managing Director, ICI Global, to Wayne Byres, Secretary General, Basel Committee on Banking Supervision, Bank for International Settlements, and David Wright, Secretary General, International Organization of Securities Commissions, dated September 27, 2012, available at http://www.ici.org/pdf/26529.pdf ("September 2012 ICI and ICI Global Letter"). 5 As noted above and in the September 2012 ICI and ICI Global Letter, we strongly agree with the BCBS and IOSCO to require two-way margining (i.e., counterparties to post margin at the same level and in the same manner) for non-centrally cleared derivatives except FX forwards and swaps. 6 Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act, 77 FR 69694, 69700 (Nov. 20, 2012) available at http://www.gpo.gov/fdsys/pkg/FR-2012-11-20/pdf/2012-28319.pdf ("U.S. Treasury Exemption") ("the market for foreign exchange transactions is one of the most transparent and liquid global trading markets"). terms that are, normally, clear and straightforward and do not change during the lifetime of the contract. Because the payment obligations on FX forwards and swaps are fixed and predetermined, FX forwards and swaps participants know their own and their counterparties' payment obligations and the full extent of their exposure throughout the life of the contract. Third, FX forwards and swaps are predominantly short-term instruments.7 As a result of having short maturities, FX forwards and swaps contracts pose significantly less counterparty credit risk than other derivatives. The primary risk of FX forwards and swaps is settlement risk, and the predominant way of settling FX forwards and swaps ensures that the risk is essentially eliminated. Settlement risk is the risk that one party to an FX transaction pays out the currency it sold but does not receive the currency it bought. In this situation, a party's FX settlement exposure equals the full amount of the purchased currency. Settlement risk is virtually eliminated when an FX transaction is settled using a "payment- versus-payment" ("PVP") settlement system, of which CLS Bank International ("CLS") is the most widely used. The role of PVP settlement systems in eliminating settlement risk has been recognized and acknowledged by the BCBS.8 One of the key risk mitigants utilized by a PVP settlement system is a simultaneous PVP settlement of matched payment instructions. The combination of simultaneous exchange of settlement payments and other risk management processes typically used by PVP settlement systems represents sufficient protection for FX forwards and swaps counterparties without the need for the mandatory margin requirements. Moreover, we are concerned that subjecting these instruments to margin requirements could drain significant liquidity from global markets as a whole (given the volume of FX trading) and could threaten practices in the FX forwards and swaps market that help limit risk and ensure that the market functions effectively. Regulators also have a long history and extensive experience in monitoring the FX forwards and swaps market and its major market participants. In addition, we believe that imposing margin requirements on FX forwards and swaps would increase the potential for conflicting margin requirements and may result in regulatory arbitrage and market fragmentation. As the BCBS and IOSCO are aware, in November 2012, the U.S. Department 7 Id. at 69697. 8 See, e.g., Supervisory Guidance for Managing Risks Associated with the Settlement of Foreign Exchange Transactions, Basel Committee on Banking Supervision, Section 2.11, February 2013, available at http://www.bis.org/publ/bcbs241.pdf ("BCBS Supervisory Guidance") ("In addition, investment in infrastructures that facilitate PVP settlement across many participants, currencies and products can play a significant role in the elimination of principal risk and other FX settlement- related risks."). See also, Progress in Reducing Foreign Exchange Settlement Risk, Bank for International Settlements, Committee on

Payment and Settlement Systems, p. 10, May 2008, available at http://www.bis.org/publ/cpss83.pdf ("CLS provides a payment-versus-payment (PVP) service that virtually eliminates the principal risk associated with settling FX trades."). ICI/ICI Global Letter to Mr. Byres and Mr. Wright March 14, 2013 Page 5 of 13 of the Treasury ("U.S. Treasury") issued a written determination exempting FX forwards and swaps from the definition of "swap," in accordance with the applicable provisions of the Commodity Exchange Act ("CEA").9 The U.S. Treasury determined that FX forwards and swaps should not be regulated as swaps under the CEA and should be exempted from the definition of the term "swap" because of the distinctive characteristics of these instruments. Unlike most other swaps, FX forwards and swaps have fixed payment obligations, are settled by exchange of actual currencies, and are predominantly short-term instruments. As a result of the U.S. Treasury's exemption, FX forwards and swaps will not be subject to margin requirements under the CEA.10 We believe a recommendation by the BCBS and IOSCO for margin requirements on FX forwards and swaps (which may be adopted by other jurisdictions) under these circumstances would undermine two primary goals of the BCBS and IOSCO in developing an international margin framework – to avoid the application of "conflicting margin requirements to the same transaction or activity" and to ensure "regulatory arbitrage opportunities are limited."11 We similarly believe imposing only variation margin requirements on these instruments would result in conflicting requirements around the world and promote regulatory arbitrage.12 The BCBS and IOSCO also request comment on whether FX forwards and swaps with different maturities should be subject to different margin treatments. As noted above, FX forwards and swaps are predominately short-term transactions with more than 98 percent of the market maturing in one year or less and 68 percent of the market maturing in one week or less.13 Imposing different margin requirements on FX forwards and swaps with differing maturities would add an unnecessary level of complexity that is unwarranted given that most of the market is short term. Moreover, differing margin treatment for FX forwards and swaps of different durations also may cause market participants in structuring their contracts to consider not only their investment or hedging needs but the costs savings from more favorable margin treatment. Different margin treatment also may result in market 9 U.S. Treasury Exemption, supra note 6. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") authorizes the Secretary of the Treasury to issue a written determination that FX swaps, FX forwards or both should not be regulated as swaps under the CEA. 10 FX forwards and swaps continue to be subject to reporting, business conduct standards, and anti-fraud and anti- manipulation provisions of the CEA. 11 Consultation Paper, supra note 3, at 20. 12 The new BCBS Supervisory Guidance provides that a bank should "exchange (ie both receive and deliver) the full amount of variation margin necessary to fully collateralise the mark-to-market exposure on physically settled FX swaps and forwards with counterparties that are financial institutions and systemically important non-financial entities. Variation margin should be exchanged with sufficient frequency (eg daily) with a low minimum transfer amount." BCBS Supervisory Guidance, supra note 8, at 15. 13 U.S. Treasury Exemption, supra note 9, at 69697 (citing BIS data). In contrast, interest rate swaps and credit default swaps generally have maturity terms between two and thirty years, and five to ten years, respectively. ICI/ICI Global Letter to Mr. Byres and Mr. Wright March 14, 2013 Page 6 of 13 participants foregoing the slightly longer-term instruments. We do not believe, in a robust well- functioning FX forwards and swaps market, imposing margin requirements on a small percentage of the market is necessary, and it may artificially force all of the FX forwards and swaps to a shorter maturity term. Accordingly, for all of these reasons discussed above, we believe that margin requirements should not apply to any type of FX forwards or swaps.14 Re-Hypothecation of Collected Margin The Consultation Paper proposes that initial margin should be exchanged by the counterparties without netting of amounts. The initial margin exchanged also should be held in such a way to ensure that (i) the margin collected is immediately available to the collecting party in the event of the counterparty's default and (ii) the collected margin must be subject to arrangements that fully protect the posting party in the event that the collecting party enters bankruptcy (to the extent possible under applicable law). The BCBS and IOSCO propose that cash and non-cash collateral collected as initial margin should not be re-hypothecated, re-pledged or re-used. The BCBS and IOSCO request comment on whether re-hypothecation should be allowed to finance/hedge customer positions if re-hypothecated customer assets are provided certain protections. ICI and ICI Global support restrictions on re-hypothecation of collected margin. Re- hypothecation of collected margin by a counterparty may make it more difficult for the posting counterparty to retrieve the collateral that has been posted in the event of a collecting counterparty's default. Moreover, in the United States, collateral posted by a U.S. regulated fund is an asset of the U.S. regulated fund and, therefore, may not be maintained in a manner that is inconsistent with custody provisions under the ICA and the custody rules adopted by the U.S. Securities and Exchange Commission ("SEC") as discussed in more detail below.15 These rules generally do not permit custodians to re-hypothecate collateral posted by a U.S. regulated fund. For non-U.S. regulated funds that may not be subject to similar custodial requirements, assets that are re-hypothecated should be protected as customer assets and provided first priority claim under the relevant laws or pursuant to contractual terms agreed upon by the counterparties. 14 We also believe that non-deliverable forwards ("NDFs"), which are economically and functionally equivalent to FX forwards, should be provided the same regulatory (including margin) treatment as FX forwards. See Letter from Karrie McMillian, General Counsel, ICI, Dan Waters, Managing Director, ICI Global, Cecelia Calaby, Executive Director and General Counsel, ABA Securities Association, and Timothy E. Keehan, Vice President and Senior Counsel, American Bankers Association, to Melissa Jurgens, Secretary, CFTC, dated February 26, 2013, available at http://www.ici.org/pdf/27057.pdf (petition for exemptive relief for NDFs so that they are regulated in the same manner as FX forwards and swaps). 15 U.S. regulated funds are required to custody their assets in accordance with Section 17 of the ICA. In addition to Section 17, the SEC has adopted 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). In discussing the different ways to protect provided margin, the Consultation Paper briefly notes the use of third party custodians. We agree with the BCBS and IOSCO that the use of third- party custodians is generally considered to "offer the most robust protection."16 In this regard, Regulated Funds should be provided the right to use a third-party custodian to hold collateral of a Regulated Fund, which is a common method by which Regulated Funds maintain collateral for non- centrally cleared derivatives transactions. We continue to believe that the framework should specifically provide for Regulated Funds to elect the option for collateral for non-centrally cleared derivatives transactions to be held by third-party custodians for a couple of reasons. First, third-party custodial arrangements provide important protections for Regulated Funds that post collateral. The third-party custodian assumes certain responsibilities with respect to safeguarding the interests of both counterparties, including maintaining custody of the collateral, and is involved in effecting the transfer of funds and securities between the two parties. This arrangement helps to avoid market disruptions in the case of a default by a counterparty or other event necessitating access to the collateral. The protections provided to the counterparties from this structure are important to managing the risk created by exposure to a particular counterparty. Similarly, this structure serves to reduce the risk to the financial system associated with the particular counterparty. These third-party custodial arrangements also can help prevent fraud and misappropriation of collateral. In addition, bankruptcy laws in some jurisdictions will keep collateral held by third-party custodians bankruptcy-remote of the counterparties. The BCBS and IOSCO note that the level of protection would be affected by the local bankruptcy regime, which would vary across jurisdictions. We agree that protections provided to collateral in various jurisdictions may differ. We encourage jurisdictions around the world to review their bankruptcy regimes to ensure protection of customer assets.17 We do not believe, however, the imperfect protections currently provided by the bankruptcy regimes should preclude the use of third-party custodians (which provides other benefits). Second, Regulated Funds often are required by their home country regulations to hold their assets with a third-party custodian. In the United States, for example, under the ICA and the custody rules adopted thereunder by the SEC, collateral posted by a U.S. regulated fund is an asset of the fund and, therefore, must be maintained in a manner consistent with the ICA and its rules. For non- centrally cleared derivatives transactions, U.S. regulated funds generally enter tri-party collateral control agreements ("CCAs") with their custodian and applicable counterparty to post collateral to satisfy their collateral obligations. Under these arrangements, a fund is able to post margin for the benefit of the counterparty with its own custodian consistent with the custody requirements under Section 17(f) of 16 Consultation Paper, supra note 3, at 18. 17 Jurisdictions around the world should ensure that their bankruptcy laws protect collateral held by third-party custodians in the event of a bankruptcy of a counterparty and prevent such collateral from being included in the estate of the bankrupt counterparty. ICI/ICI Global Letter to Mr. Byres and Mr. Wright March 14, 2013 Page 8 of 13 the ICA. These types of agreements create a security interest for the benefit of the counterparty in the collateral posted by the U.S. regulated fund. Regulated funds from other jurisdictions, such as Hong Kong and Ireland, also have similar requirements depending on whether the title to a Regulated Fund's posted collateral transfers to the counterparty.18 If only a security interest in the collateral is transferred to the counterparty, fund regulations generally impose safekeeping and custodial requirements on the collateral as fund assets. In the Consultation Paper, the BCBS and IOSCO raise the concern, with respect to third-party custodial arrangements, that "access to assets held by third party custodians has been limited or practically difficult."19 This concern regarding the ability to access promptly collateral held by an independent custodian could be adequately addressed by requiring that the custodial agreements contain certain provisions that are currently included in the CCAs for swaps. These types of agreements would provide the collecting counterparty with access to the collateral in a timely manner in the event of a counterparty default. For example, we understand that the terms in the tri-party arrangements permit the pledgee of the collateral to issue an "entitlement order," in the event of a default of the pledgor or certain other enumerated termination events. The entitlement order would give the pledgee the right to exercise exclusive control over the posted collateral by providing the custodian with a notice. Upon receipt of the notice, the custodian will follow the "entitlement order" instructions without further consent by the pledgor. We understand that entitlement orders are carried out promptly by the custodians, and the collecting counterparties can have immediate access to the collateral. We believe requiring these types of terms in a custodial agreement would give collecting counterparties ready access to the collateral.20 Phase-In Requirements Recognizing the need to balance the benefits of the new requirements in reducing systemic risk and promoting central clearing with the liquidity, operational, and transition costs associated with 18 See Letter from Karrie McMillian, General Counsel, ICI, and Dan Waters, Managing Director, ICI Global, to Sui Hui Lim, Monetary Authority of Singapore, dated February 14, 2013, available at http://www.ici.org/pdf/27011.pdf (the appendix to the letter describes the custodial requirements for funds regulated under the laws of the United States, Hong Kong and Ireland (Undertakings for Collective Investment in Transferable Securities)). 19 Consultation Paper, supra note 3, at 18-19. 20 The Consultation also notes that the SEC has pointed out that the requirement for collateral to be held by a third-party custodian may have disproportionate impact on SEC-registered broker-dealers in comparison to banks because of the difference in regulatory capital treatment. If the SEC is referring to its proposal to impose capital charges on security-based swap dealers and broker-dealers with respect to the collateral when a counterparty elects an independent custodian, we have argued that the imposition of capital charges would not be necessary in those circumstances. See Letter from Karrie McMillan, General Counsel, ICI, to Elizabeth M. Murphy, Secretary, SEC, dated February 4, 2013, available at http://www.ici.org/pdf/26967.pdf. ICI/ICI Global Letter to Mr. Byres and Mr. Wright March 14, 2013 Page 9 of 13 implementing the requirements, the BCBS and IOSCO propose a multi-year phase-in schedule. First, the requirement to exchange variation margin would become effective on January 1, 2015 for all new contracts entered into after that date.21 The requirement to exchange two-way initial margin with a threshold of up to €50 million will be phased-in as follows: • In 2015, any covered entity whose aggregate month-end average notional amount of non-centrally cleared derivatives for the last three months of 2014 exceeds €3.0 trillion would be subject to the requirements when transacting with another covered entity that meets that condition;22 • In 2016, any covered entity whose aggregate month-end average notional amount of non-centrally cleared derivatives for the last three months of 2015 exceeds €2.25 trillion would be subject to the requirements when transacting with another covered entity that meets that condition; • In 2017, any covered entity whose aggregate month-end average notional amount of non-centrally cleared derivatives for the last three months of 2016 exceeds €1.5 trillion would be subject to the requirements when transacting with another covered entity that meets that condition; and • In 2018, any covered entity whose aggregate month-end average notional amount of non-centrally cleared derivatives for the last three months of 2017 exceeds €.75 trillion would be subject to the requirements when transacting with another covered entity that meets that condition. In 2019 and thereafter, any covered entity whose aggregate month-end average notional amount of non-centrally cleared derivatives for the last three months of the preceding year is less than €8 billion would not be subject to the initial margin requirements. Initial margin requirements would apply to all new contracts entered into after each of the dates specified above. Covered entities would not be required to apply the initial margin requirements to existing derivative contracts. The Consultation Paper requests comment on whether the proposed phase-in arrangements are appropriate. We generally support the phase-in schedule proposed by the BCBS and IOSCO for implementation of the margin requirements. We believe that a gradual and multi-year transition to the new margin framework will minimize disruptions to the markets while being fully consistent with the goals and benefits of the margin regime. We also support the proposal not to apply the requirements to contracts entered into before each of the compliance dates. These steps will minimize the complexity and disruptions but will in time provide the non-centrally cleared derivatives market with the benefits 21 Exchange of variation margin for other contracts would be subject to bilateral agreement. 22 The computation will encompass all non-centrally cleared derivative activities of a consolidated group. Therefore, the threshold would apply to a group's aggregate amount. ICI/ICI Global Letter to Mr. Byres and Mr. Wright March 14, 2013 Page 10 of 13 intended by the margin framework. As noted in the September 2012 ICI and ICI Global Letter, when the proposals by the BCBS and IOSCO are finalized, the margin framework will need to be implemented by national governments and could result in potentially very lengthy and politically sensitive review and amendment of national insolvency laws. Accordingly, we appreciate the BCBS and IOSCO proposing a gradual implementation of these proposals and providing for sufficient time for coordination of efforts by national regulators to implement these proposals around the world on a consistent basis. In transitioning into the new regulatory framework, we also support the universal threshold of €50 million for all types of counterparties. As we discussed in the September 2012 ICI and ICI Global Letter, the use of thresholds may alleviate the potential liquidity impact of margin requirements for non-centrally cleared derivatives. We appreciate the determination by the BCBS and IOSCO in the Consultation Paper not to limit the use of thresholds to certain types of market participants as we believe it avoids creating an inappropriately unlevel playing field in this area. Moreover, we also support the proposal by the BCBS and IOSCO (when the transition phase completes in 2019) not to subject to the initial margin requirements any covered entity whose aggregate month-end average notional amount of non-centrally cleared derivatives for the last three months of the preceding year is less than €8 billion. This approach will minimize liquidity effects of the margin requirements and is consistent with the goal of reducing systemic risk by focusing on covered entities that engage in higher amounts of derivatives transactions. We request confirmation regarding the threshold level and the de minimis amount of non- centrally cleared derivatives in two respects. First, the BCBS and IOSCO state that the amounts would apply on a fully "consolidated group" basis to "prevent the proliferation of affiliates and other legal entities within larger entities for the sole purpose of circumventing the margin requirements (emphasis added)."23 Given the unique structure of Regulated Funds, we encourage the BCBS and IOSCO to confirm that the universal €50 million threshold and €8 billion de minimis would apply at an individual portfolio level rather than at the level of the series company or fund complex. For example, in the United States, in creating funds, a sponsor may establish a "series company," which has the ability to create multiple sub-portfolios.24 Each portfolio is a separate pool of securities with its own assets, liabilities, and shareholders. U.S. federal securities laws safeguard the assets in an individual portfolio from market or other risks that may negatively affect another portfolio, and consequently, protect the shareholders invested therein and the fund complex more broadly.25 We understand that similar 23 Consultation Paper, supra note 3, at 9. 24 Series funds are effectively independent in economic, accounting, and tax terms but share the same governing documents and governing body. For example, liquidation of one portfolio in the series is isolated to that portfolio. Shareholders must look solely to the assets of their own portfolio for redemption, earnings, liquidation, capital appreciation, and investment results. 25 See Regulation of Series Investment Companies under the Investment Company Act of 1940, Joseph R. Fleming, Business Lawyer, August 1989. ICI/ICI Global Letter to Mr. Byres and Mr. Wright March 14, 2013 Page 11 of 13 considerations apply in the case of "umbrella" fund structures established in certain EU jurisdictions (such as Luxembourg). Similarly, a fund within a fund complex is isolated in terms of assets and liabilities from other funds in the fund complex. Investment decisions, including regarding the use of derivatives, are made at the portfolio level. Moreover, it is the portfolio rather than the series company or fund complex that enters into a derivatives transaction, and the potential counterparty risk should be assessed at the individual portfolio level. Finally, multiple sub-portfolios and affiliated funds are created for business reasons and not for the purpose of circumventing the margin requirements. We, therefore, urge the BCBS and IOSCO to confirm our understanding that the threshold and de minimis calculations would apply at the individual portfolio level. Second, if the BCBS and IOSCO exempt FX forwards and swaps from margin requirements as requested, the BCBS and IOSCO should specifically confirm that covered entities will not be required to include those instruments in the threshold or the de minimis calculations. If FX forwards and swaps are exempt, there is no reason to include them for purposes of the threshold or the de minimis calculations. Other Comments In addition to the specific areas in which the Consultation Paper requests comment, ICI and ICI Global have two additional comments for consideration by the BCBS and IOSCO. Calculation of Margin For initial margin, the Consultation Paper proposes that the requirements reflect an extreme but plausible estimate of an increase in value of the instrument that is consistent with a one-tailed 99 percent confidence interval over a 10-day horizon based on historical data that incorporates a period of significant financial stress. We remain concerned that the 10-day liquidation period requirement is too long for initial margin requirements. As proposed, an initial margin model for non-centrally cleared derivatives would need to set initial margin at a level to cover 99 percent of price changes by product and portfolio over at least a 10-day liquidation horizon. ICI and ICI Global believe that initial margin should be set at a level that reflects a close-out, offset or other risk mitigation that occurs more or less simultaneously with the default. In light of the relatively high 99 percent confidence interval, we recommend that a 5-day liquidation period is appropriate for non-centrally cleared derivatives transactions. Furthermore, we note that the 5-day liquidation period is market practice under International Swaps and Derivatives Association Master Agreements. By requiring that initial margin be calculated using a liquidation period that exceeds the actual timeframe for liquidation, the proposed requirements would add unnecessary cost to non-centrally cleared derivatives. ICI/ICI Global Letter to Mr. Byres and Mr. Wright March 14, 2013 Page 12 of 13 Cross-Border Derivative Transactions and Coordination of Derivatives Regulations We agree with the BCBS and IOSCO that regulatory regimes around the world should interact to provide consistent and non-duplicative regulatory margin requirements for non-centrally cleared derivatives transacted across jurisdictions. The Consultation Paper proposes that the margin requirements in a jurisdiction should be applied to legal entities established in that local jurisdiction in relation to the initial and variation margin that they collect. Moreover, home-country supervisors should permit a covered entity to comply with the margin requirements of a host-country margin regime with respect to the derivatives activities of the covered entity if the home-country supervisor considers the host-country margin regime to be consistent with the margin requirements described in the Consultation Paper. We appreciate the description of the principle of international regulatory cooperation envisioned by the BCBS and IOSCO and the examples provided to illustrate how such coordination might work. We believe, however, that regulatory coordination will be much more complex than is depicted in the examples provided, and there continue to be numerous questions on how margin requirements would apply to cross-border transactions. For example, if a Regulated Fund subject to a two-way margin regime engages in a transaction with a bank regulated in another jurisdiction that requires only one-way margining, could the Regulated Fund collect collateral from the bank? What happens if the jurisdictions adopt different threshold amounts or de minimis amounts? Could a home-country supervisor find a host-country margin regime to be consistent with the BCBS and IOSCO framework if the host jurisdiction only imposes one-way margin requirements? If the threshold amounts or de minimis amounts were different from those proposed in the Consultation paper, would a country’s margin regime still be consistent with the BCBS and IOSCO margin framework? We recommend that the BCBS and IOSCO develop a more detailed framework (perhaps separately from the margin proposals) for how derivatives regulations (including margin requirements) will apply to transactions conducted across borders. There must be agreement on what triggers the laws of a particular jurisdiction and which law would apply (and to which aspects of the transaction) when the laws of more than one jurisdiction could apply to a transaction. A coordinated framework is necessary to avoid duplicative or conflicting requirements. Without a thoughtful and clear approach to how cross-border transactions will be regulated by multiple jurisdictions, there may be reluctance to engage in cross-border derivatives transactions, thereby impeding the ability of Regulated Funds to hedge their exposures effectively and efficiently. We strongly urge the BCBS and IOSCO to continue to tackle this difficult task of developing a true cross-border framework for the regulation of derivatives. * * * * * ICI/ICI Global Letter to Mr. Byres and Mr. Wright March 14, 2013 Page 13 of 13 If you have any questions on our comment letter, please feel free to contact the undersigned or Giles Swan at 011-44-203-009-3103, Sarah Bessin at 202-326-5835 or Jennifer Choi at 202-326-5876. Sincerely, /s/ Karrie McMillan /s/ Dan Waters Karrie McMillan Dan Waters General Counsel Managing Director Investment Company Institute ICI Global 202-326-5815 44-203-009-3101 kmcmillan@ici.org dan.waters@ici.org cc: Michael Gibson Board of Governors of the Federal Reserve System Alexa Lam Hong Kong Securities and Futures Commission The Honorable Gary Gensler The Honorable Jill E. Sommers The Honorable Bart Chilton The Honorable Scott D. O' Malia The Honorable Mark Wetjen The Honorable Elisse B. Walter The Honorable Luis A. Aguilar The Honorable Troy A. Paredes The Honorable Daniel M. Gallagher

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