INVESTMENT
COMPANY
INSTITUTE

1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

November 19, 2018

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 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)*

Dear Mr. Fields:

The Investment Company Institute[1] is submitting this letter in response to the Securities and Exchange Commission's reopening of the comment period and request for additional comments on several proposals relating to capital, margin, and segregation requirements regarding uncleared, security-based swaps ("SB swaps") for security-based swap dealers (SBSDs) and major security-based swap participants (MSBSPs) that do not have a prudential regulator.[2] The Reopened Proposing Release relates to three different proposals the SEC issued in 2012, 2013, and 2014, respectively (together, "SB Swaps Proposals").

Although we appreciate the opportunity to comment on the Reopened Proposing Release, we are deeply concerned that it proposes such a radically different framework for SBSD capital and margin, as compared to that which is applicable to swap dealers and non-SEC-regulated SBSDs, that the SEC's proposal, if adopted, is likely to lead to fragmentation of the SB swaps markets, a reduction in the ability

[1] The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$22.7 trillion in the United States, serving more than 100 million US shareholders, and US$7.0 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

[2] *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers*, Exchange Act Release No. 84409 (Oct. 11, 2018), 83 FR 53007 (Oct. 19, 2018) *available at* https://www.gpo.gov/fdsys/pkg/FR-2018-10-19/pdf/2018-22531.pdf ("Reopened Proposing Release").

of counterparties to net exposures, and substantial uncertainty regarding the treatment in bankruptcy of SEC-regulated SBSDs. We are also troubled that the Reopened Proposing Release does not address the many substantive comments that ICI and others submitted on the SB Swaps Proposals.

Congress, in adopting the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act")[3] expressly directed the SEC to seek consistency in its regulations, where practicable, with the Commodity Futures Trading Commission.[4] We do not see any evidence in the Reopened Proposing Release that the SEC has sought to coordinate with any of its fellow regulators or to take account of the significant changes in the SB swaps markets in the six years since the SEC proposed its capital, margin, and segregation rules for SBSDs and MSBSPs. In that regard, we note that the SB swap markets have changed greatly since 2012, driven in large part by market participants' response to the CFTC's regulation of swaps and the European Union's regulation of swaps and SB swaps.

The Reopened Proposing Release also fails to provide the public with an adequate basis to comment. It does not provide sufficient notice regarding how the SEC is considering altering the SB Swaps Proposals. Instead, the Reopened Proposing Release leaves market participants guessing about the potential changes that the SEC is considering.

To address these serious substantive and procedural concerns, we urge the SEC to re-propose margin rules that are consistent in all material respects with both the 2013 international framework governing margin requirements for uncleared derivatives, including SB swaps ("International Framework"),[5] and the final rules on margin for uncleared swaps that have already been adopted and implemented by the CFTC[6] and the US Prudential Regulators[7] (together, "Swap Margin Rules"). We also recommend that the SEC consider carefully and address the comments it receives in response to the Reopened Proposing Release and those comments it received in the past on the SB Swaps Proposals.

At a minimum, it is critical that the SEC include the following revisions in any final rules, consistent with the Swap Margin Rules and the International Framework:

---

[3] Public Law 111–203, 124 Stat. 1376 (2010).

[4] Section 712 of the Dodd-Frank Act.

[5] *See* Basel Committee on Banking Supervision, Board of the International Organization of Securities Commissions, *Margin Requirements for Non-Centrally Cleared Derivatives* (Sept. 2013).

[6] *See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Final Rule*, 81 FR 635 (Jan. 6, 2016), *available at* https://www.gpo.gov/fdsys/pkg/FR-2016-01-06/pdf/2015-32320.pdf.

[7] The term "Prudential Regulators" refers collectively to the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency. The margin and capital requirements adopted by the Prudential Regulators are published as follows: *Margin and Capital Requirements for Covered Swap Entities*, 80 FR 74840 (Nov. 30, 2015), *available at* https://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28671.pdf ("Prudential Rule Adopting Release").

- Adopt a margin-based approach rather than a capital-based approach that allows counterparties to close out and net positions, using posted collateral, upon the insolvency of an SBSD;
- Require bilateral exchange of collateral by SBSDs and MSBSPs and their counterparties in connection with SB swaps;
- Facilitate payment netting and close-out netting of SB swaps;
- Require only those counterparties that have "material swaps exposure" to post initial margin;
- Permit SBSDs to set a standard threshold for exchange of initial margin and raise the minimum transfer amount cap;
- Do not impose capital charges on SBSDs and MSBSPs when their counterparties elect to have their collateral held at a third-party bank custodian;
- To the extent the SEC includes an exception to capital charges, revise the proposed exception to make it workable;
- Expand permitted collateral to allow funds to post shares of registered investment companies and ETFs issued by an affiliate of the fund; and
- Do not adopt rules on portfolio margining without first issuing a proposal that provides significantly more detail and analysis regarding the legal implications of these arrangements.

In addition, we urge the SEC to develop a uniform substituted compliance framework in coordination with other US and global regulators. The substituted compliance framework should, at a minimum, allow for consistent collateral posting and segregation requirements globally for swaps and SB swaps.

The SEC also should provide an adequate compliance period for SBSDs and MSBSPs and their counterparties to implement any final SEC SB swap rules, following a re-proposal.

I. Background

Investment advisers to US registered investment companies, including mutual funds, ETFs and other funds that are regulated under the Investment Company Act of 1940 ("registered funds"), and non-US regulated funds that are authorized to be publicly offered to investors outside the United States[8] (together with registered funds, "Regulated Funds") rely on SB swaps for a number of critical portfolio management functions. SB swaps may provide Regulated Funds with exposure to single name securities or custom baskets in markets that may not be accessible directly or efficiently such as India, Brazil, Taiwan, and South Korea. SB swaps also allow Regulated Funds to hedge credit risks of bond holdings by purchasing credit protection, and may provide economic exposure to loans and bonds in smaller than denomination sizes. Some of these SB swaps provide greater liquidity to Regulated Funds with

[8] For purposes of this letter, the term "non-US regulated fund" refers to any fund that is organized or formed outside the United States, is authorized for public sale in the country in which it is organized or formed, and is regulated as a public investment company under the laws of that country. For example, UCITS, or "undertakings for collective investment in transferrable securities," are collective investment schemes established and authorized under a harmonized European Union (EU) legal framework, currently EU Directive 2009/65/EC, as amended (UCITS IV).

respect to loan and bond exposures than the loans or bonds themselves. Other types of SB swaps allow Regulated Funds to invest in securities or loan participations with limited or no currency risk. SB swaps are frequently used by Regulated Funds to equitize cash by obtaining exposure to related securities portfolios through a swap on an ETF or a fund pending investment of the cash and to achieve tax efficiencies. Like other types of swaps, SB swaps provide important benefits, allowing Regulated Funds, among other things, to enhance returns, risk manage their portfolios, and obtain customized economic exposure in a less costly and more efficient manner.

The SB Swaps Proposals included: (i) amendments and new rules the SEC proposed in October 2012 covering SB swaps, capital, margin, segregation, and related notification requirements for SBSDs and MSBSPs that do not have a Prudential Regulator ("SB Swaps Capital and Margin Proposal");[9] (ii) amendments the SEC proposed in May 2013 for cross-border treatment of the capital, margin, and segregation requirements relating to SB swaps ("SB Swaps Cross-Border Proposal");[10] and (iii) an amendment the SEC proposed in April 2014 that would establish an additional capital requirement for SBSDs that do not have a Prudential Regulator ("Proposed Additional Capital Proposal").[11]

ICI submitted a total of four letters on the SB Swaps Proposals: three on the SB Swaps Capital and Margin Proposal,[12] as well as a letter on the SB Swaps Cross-Border Proposal.[13] In our 2015 letter on the SB Swaps Capital and Margin Proposal, we urged SEC Chair Mary Jo White to re-propose the rulemaking in a form consistent with both the International Framework and then-recent proposals of other US regulators. ICI recently joined with several other trade associations, again urging the SEC to

---

[9] *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers*, Exchange Act Release No. 68071 (Oct. 18, 2012), 77 FR 70214 (Nov. 23, 2012), *available at* http://www.gov.gov/fdsys/pkg/FR-2012-11-23/pdf/2-12-26164.pdf ("Original Proposing Release").

[10] *Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants*, Exchange Act Release No. 69490 (May 1, 2013), 78 FR 30968 (May 23, 2013), *available at* http://www.gpo.gov/fdsys/pkg/FR0213-05-23/pdf/2013-1-835.pdf.

[11] *Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swap Dealers*, Exchange Act Release No. 71958 (Apr. 17, 2014), 79 FR 25194, 25254 (May 2, 2014), *available at* https://www.gpo.gov/fdsys/pkg/FR-2104-05-02/pdf/2014-09108.pdf.

[12] *See* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated February 4, 2013, *available at* https://www.ici.org/pdf/26967.pdf; Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated December 5, 2013, *available at* https://www.ici.org/pdf/27742.pdf; Letter from Paul Schott Stevens, President and CEO, Investment Company Institute, to the Honorable Mary Jo White, Chair, Securities and Exchange Commission, dated May 11, 2015, *available at* https://www.ici.org/pdf/28969.pdf.

[13] *See* Letter from Karrie McMillan, General Counsel, Investment Company Institute, and Dan Waters, Managing Director, ICI Global, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated August 21, 2013, *available at* https://www.ici.org/pdf/27482.pdf.

re-propose the rulemaking, and to extend the comment period of the Reopened Proposing Release for an additional 30 days to provide the opportunity for thoughtful public feedback.[14]

II. Need for Regulatory Coordination

The SB Swaps Proposals, as revised by the Reopened Proposing Release, reflect a distressing lack of coordination with the CFTC and other US and global derivatives markets regulators. This "go it alone" approach is inconsistent with Congress's directive in Section 712 of the Dodd-Frank Act that the SEC should " . . . consult and coordinate to the extent possible with the Commodity Futures Trading Commission and the prudential regulators for the purposes (*sic*) of assuring regulatory consistency and comparability, to the extent possible [with respect to regulations regarding SB swaps, SBSDs and MSBSPs]."[15]

Since the SEC first published the SB Swaps Proposals for comment, other US and global regulators have adopted and implemented margin requirements for uncleared derivatives. The Swap Margin Rules were implemented in the United States beginning in September 2016 in coordination with implementation of European regulators' margin rules for uncleared derivatives.[16] The CFTC and Prudential Regulators worked together to establish consistent rules that are aligned with the International Framework. Market participants have devoted considerable resources to amending their trading agreements, reorganizing their operations, and enhancing their compliance infrastructure to comply with these new rules.

Variation margin requirements became mandatory for all swap counterparties in the United States and Europe on March 1, 2017, and initial margin requirements are being rolled out in a staged manner in the United States and Europe with the final implementation scheduled to occur on September 1, 2020.[17] Many market participants are already subject to these rules, with a significant number of market participants expected to become subject to the rules in the final phases of their implementation. US swap dealers and major swap participants subject to Prudential Regulators' rules have been required for the past several years to satisfy enhanced capital requirements related to uncleared swap transactions. The CFTC has proposed but has not finalized capital requirements for swap dealers and major swap participants. The CFTC adopted a cross-border framework in May 2016, which became

---

[14] *See* Letter from International Swaps and Derivatives Association, Inc., et al., to Mr. Brent Fields, Secretary, US Securities and Exchange Commission, dated Oct. 24, 2018, *available at* https://www.ici.org/pdf/31458a.pdf.

[15] Public Law 111–203, 124 Stat. 1376 (2010) Section 712 at 267.

[16] The rules adopted by the European regulators do not distinguish between swaps and SB swaps. As a result, the margining regime for both swaps and SB swaps in Europe is substantially similar to the Swap Margin Rules.

[17] Initial margin will become mandatory in 2020 for the group of Swap Entities and Financial End-Users, both as defined under the Swap Margin Rules, that have material swaps exposure but are categorized at the lowest end of the material swaps exposure definition. Such entities and their related entities have average aggregate notional amount of swaps, SB swaps, FX swaps and other derivatives, as defined under the Swap Margin Rules, of more than $8 billion but less than $750 billion.

effective in August 2016, and market participants have been operating under that framework since that time.

The SB Swaps Capital and Margin Proposal differs materially from the Swap Margin Rules and the International Framework. These differences will require market participants to establish an entirely different set of operational and risk management procedures for SB swaps traded by an SEC-regulated SBSD than for SB swaps traded by any other entity globally. The balkanization of the portion of the SB swaps market subject to SEC regulation from the rest of swaps and SB swaps market will have significantly negative implications for both investors and the markets generally. If adopted as proposed, the SB Swaps Capital and Margin Proposal would:

- Require market participants to comply with a different set of requirements for similar products;
- Create substantial uncertainty regarding the bankruptcy regime applicable to SB swaps traded by an SEC-regulated SBSD and the application of close-out netting;[18]
- Make payment netting across SB swaps and swaps more difficult due to fragmentation of the market;
- Incentivize SB swaps counterparties to transact with firms regulated by the Prudential Regulators to allow for more favorable treatment upon the insolvency of an SBSD and to avoid the higher costs inherent in transacting with SBSDs subject to the SEC SB swaps rules;
- Materially increase operational costs for counterparties transacting in SB swaps globally;[19]
- Likely reduce market quality by increasing transaction costs for SB swaps and impairing liquidity by concentrating SB swaps dealing activity in a smaller number of firms; and
- Potentially make it more difficult for the SEC to permit non-US SBSDs to meet their obligations under the SEC SB swaps rules through substituted compliance and, conversely, potentially frustrate efforts of foreign jurisdictions to find the SEC's SB swaps rules comparable to their own.

We therefore urge the SEC to revise and re-propose the SB Swaps Proposals to be consistent with the Swap Margin Rules and the International Framework. This would fulfill the SEC's obligation under Section 712 of Dodd-Frank to promote "regulatory consistency and comparability, to the extent possible." If the SEC does not believe it is possible or appropriate to substantially harmonize its SB Swaps Proposals with the Swap Margin Rules and the International Framework, it should clearly explain its reasoning, provide an economic justification for the proposal in light of current market conditions, and provide market participants the opportunity to publicly comment on its determination.

---

[18] Based on the SEC's references in the SB Swaps Proposals to counterparties as "customers" and the SEC's discussion of priority treatment of such "customers" upon insolvency of a dealer, the SEC appears to contemplate that SBSDs will be liquidated under the Securities Investor Protection Act (SIPA). This assumption is confusing because, as a statutory matter, it is not clear that SIPA would apply to the insolvency of SBSDs (other than SBSDs that are also broker-dealers). 15 U.S.C. §78aaa.lll (defining "debtor" as a member of SIPC, which must be a registered broker-dealer).

[19] Transacting in SB swaps would be more expensive than transacting in uncleared swaps and other derivatives that are subject to consistent rules on margin adopted by the CFTC and global regulators.

III. SB Swaps Capital and Margin Proposal

In our view, the SEC's approach to SB swap capital and margin should be consistent with the frameworks already implemented by other US and global regulators. Inconsistencies between these rule sets will impose unnecessary costs on market participants and, ultimately, may reduce the quality of the SB swap markets to the detriment of Regulated Funds and other investors.

The swap and SB swap markets are global in nature and counterparties generally treat these markets as one for netting and other risk management purposes.[20] This practice has resulted in important efficiencies that improve market quality and substantially mitigate systemic risk, both of which benefit investors. Today, for example, swaps and SB swaps can fall into the same netting sets, which in many cases reduces both operational and credit risk. The presence of similar regulation also ensures that market participants can source liquidity from the broadest possible pool of counterparties, which improves market resilience and reduces transaction costs. The SB Swaps Capital and Margin Proposal, as revised by the Reopened Proposing Release, would reduce the ability to mitigate operational and credit risks through netting and could result in liquidity fragmenting between SBSDs subject to the SEC's SB swap rules and swap market dealers subject to margin rules that are consistent with the International Framework.

While it is appropriate for the SEC to address any concerns that are specific to the US SB swap markets, we urge the SEC to do so in a manner that is consistent with practices in other markets. Put simply, the overall capital, margin, and segregation framework for SB swaps should be consistent with the International Framework – which global regulators, including the SEC as a member of IOSCO, endorsed – as well as the Swap Margin Rules.

The Reopened Proposing Release falls short of this standard in several critical ways. Importantly, the proposal omits key safeguards of the International Framework and other margin regimes, including bilateral margin exchange. Other margin regimes also include efficiency-enhancing provisions, such as the use of thresholds, provisions to ensure that margin requirements apply only to counterparties that have material swaps exposure, and static minimum transfer amounts. These provisions ensure counterparties do not expend resources exchanging *de minimis* amounts of margin and thereby mitigate operational risk. We urge the SEC to address these and other concerns to ensure that the US SB swaps markets include the same protections and efficiencies as provided to participants in the broader global derivatives markets. Revised and re-proposed SEC SB swap rules should, at a minimum, include the material safeguards discussed below.

[20] As noted above, the International Framework, as well as EU regulations, do not distinguish between swaps and SB swaps. As a result, non-US dealers and counterparties already margin SB swaps in the same manner as they do swaps.

A. The SEC should take a margin-based approach rather than a capital-based approach

The SEC's approach differs materially from the approach under the Swap Margin Rules and the International Framework. The SEC relies solely on enhanced capital levels at the dealer level to address systemic risk concerns, rather than on the combination of enhanced capital and two-way margining, which is the approach followed by the Prudential Regulators and CFTC as well as by the international regulators.[21]

We are concerned that the SEC's approach fails to reflect lessons learned from the 2007-2008 financial crisis. During the financial crisis, the most significant insolvencies were those of dealers, not end-user counterparties. It has taken years for those counterparties who were unable to net down and close out derivatives positions, and foreclose on dealer-posted collateral, to pursue their rights in bankruptcy to recover a portion of their losses.

We are also concerned that a purely capital-based approach to margin would adversely affect the SB swap market by causing pricing of SB swaps traded by SEC-regulated SBSDs to be disproportionately higher than that of bank SBSDs and many non-US SBSDs[22] that are not subject to higher capital costs. Counterparties therefore will likely gravitate to banks and SBSDs that are not required to offset the steep capital costs that would be imposed on SEC-regulated SBSDs. This would, in turn, likely cause the pool of SBSDs to shrink substantially and reduce liquidity for SB swaps in the US markets. Such a result would directly harm the retail investors in Regulated Funds by limiting the portfolio and risk management tools available to manage the retirement and other savings of those investors.

B. Require bilateral exchange of collateral by SBSDs and MSBSPs

Consistent with the Swap Margin Rules and the International Framework, SEC-regulated SBSDs and MSBSPs should be required to post initial and variation margin[23] to their non-SBSD counterparties at the same level and in the same manner as required for the counterparty. Under the Swap Margin Rules,

[21] The SEC's reasoning for not providing for two-way margining is to maintain liquidity at the SBSD so as to facilitate prompt liquidation upon insolvency. Original Proposing Release at 70303. The SEC argues that because nonbank SBSDs do not have access to the Federal Reserve's discount window, they should not be required to post collateral so as to preserve liquidity needed in an insolvency. We do not agree with that argument and note that, because substantially all nonbank SBSDs are affiliated with banks that have access to the Federal Reserve's discount window, SBSDs are likely to enjoy an indirect liquidity benefit from the bank's access.

[22] Banks and investment firms in the European Union that conduct swap and SB swap trading or dealing businesses are generally subject to the European Union's Capital Requirements Directive IV, in accordance with Basel III, as implemented by the central banks or supervisory authorities of individual European countries. The Prudential Regulators have looked to Basel III in establishing capital requirements for US entities regulated by the Prudential Regulators that carry out swap and SB swap dealing businesses.

[23] Instead of using the terms "initial" margin and "variation" margin, the SEC's proposal uses the terms "equity" and "margin" amounts to refer to current exposure and potential future exposure, respectively. In this comment letter, we use the terminology used in the Swap Margin Rules and the International Framework.

defined categories of counterparties, composed of "Covered Swap Entities,"[24] "financial end users with material swaps exposure,"[25] "financial end users without material swaps exposure,"[26] and other counterparties, are subject to specified margin posting and collection requirements if they trade with a Covered Swap Entity. The Swap Margin Rules require Covered Swap Entities (which are the equivalent of SBSDs and MSBSPs) to collect variation margin from, and post variation margin to, other swap entities and with all financial end users (including those without material swaps exposure) and to post initial margin to, and collect initial margin from, only those financial end users with material swaps exposure (other than, generally speaking, those that are affiliates).[27]

The financial crisis of 2007-2008 demonstrated that the premise of one-way margining is flawed.[28] Two-way margin requirements aid safety and soundness by helping an SBSD or MSBSP and its counterparty offset their exposures and preventing them from building up exposures they cannot fulfill. Two-way margining therefore is critical to protecting counterparties (including investors, such as Regulated Funds) and reducing a buildup of systemic risk in the SB swap market. The rigor imposed by bilateral posting of collateral is likely to have a beneficial effect on SBSDs as well, by requiring them to reduce overall leverage.

Providing for the posting of margin by SBSDs would be consistent with the longstanding market practice of Regulated Funds and swap dealers. Uncleared swaps between Regulated Funds and swap dealers are frequently margined on a bilateral basis with net exposures calculated daily by both parties, and variation margin (and sometimes initial margin) exchanged on a same-day or next-day basis. Margin requirements are generally documented in an industry standard International Swaps and Derivatives Association ("ISDA") 1994 form of Credit Support Annex, which contemplates use of two-way margining as a standard option.[29] Consistent with the requirements of the Investment

[24] The term "Covered Swap Entity" is defined in the applicable CFTC regulations to mean a swap dealer or major swap participant for which there is no Prudential Regulator. *See* 17 CFR §23.151.

[25] The term "financial end user" is defined in the Swap Margin Rules to include a broad range of financial intermediaries and market participants. Investment advisers and funds are financial end users because they raise money from investors for the purpose of investing in loans, securities, swaps, funds or other assets. *See Margin and Capital Requirements for Covered Swap Entities,* 80 FR 74840 (Nov. 30, 2015) at 74853.

[26] "Material swaps exposure" means that the entity and its affiliates have an average daily aggregate notional amount of non-cleared swaps, non-cleared SB swaps, foreign exchange forwards, and foreign exchange swaps with all counterparties for June, July, and August of the previous calendar year that exceeds $8 billion, where such amount is calculated only for business days. *See id.* at 74901.

[27] *See* 17 CFR 23.152(a) and definition of "covered counterparty" at 17 CFR 23.151. For CFTC requirements for the collection of margin from certain affiliates, see 17 CFR 23.159.

[28] *See* Letter from Karrie McMillan, General Counsel, ICI, to David Stawick, Secretary, CFTC (July 11, 2011), *cited by the SEC in SB Swaps Capital and Margin Proposal* at 70268.

[29] A sample of the standard ISDA CSA is available at https://www.isda.org/a/PkMDE/ICM-15001524-v19-SCSA_-_New_York_Law-1.pdf. *See also* User's Guide to the 1994 ISDA Credit Support Annex, including Appendix C thereto, *available at* https://www.isda.org/a/aUMDE/UG-to-1994-ISDA-Credit-Support-Annex.pdf.

Company Act of 1940 ("1940 Act"), margin under agreements between registered funds and swap dealers is held by a fund's third-party custodian in accordance with a collateral control agreement. Under these arrangements, there is either no, or very limited, fellow customer risk, fraud or malfeasance risk, investment risk, or operational risk.

Two-way margining has been widely used both before and after the financial crisis of 2007-2008, although its use by market participants increased substantially after the financial crisis, suggesting a market-wide consensus regarding the effectiveness of margin to prevent losses in the event of a counterparty's insolvency.[30] Regulatory bodies have endorsed two-way margining as a critical risk mitigant for uncleared derivatives,[31] and have interpreted the requirements underlying Title VII of the Dodd-Frank Act itself as indicative of Congressional support for two-way margining as a critical risk management tool.[32] The mitigating role that two-way margining played during the financial crisis in preventing losses for Regulated Funds and other counterparties of Lehman entities in the face of those entities' bankruptcies is a testament to the effectiveness of two-way margin to prevent loss and reduce systemic risk.

We do not believe that the SEC has adequately considered the potential for one-way margining to harm investors and the SB swap markets. In the six years since the SEC's issuance of the SB Swaps Capital and Margin Proposal, regulators have determined that margin requirements for uncleared swaps protect *both* dealers and their counterparties and, consequently, two-way margining regimes are now the global standard. Dealers and their counterparties have been required to post and collect margin under this standard, in some cases, for more than two years. We recommend that the SEC modify its SB Swaps Capital and Margin Proposal to incorporate bilateral collateral posting requirements to ensure that markets and investors are protected.

We recognize that the SB Swaps Capital and Margin Proposal does not prohibit an SBSD and its counterparty from negotiating a two-way margining agreement, as is the practice now. Making two-way margining mandatory, however, would provide important risk mitigation benefits to the markets,

---

[30] *See, e.g., ISDA Margin Survey 2006*, *available at* https://www.isda.org/a/ieiDE/isda-margin-survey-2006.pdf, *ISDA Margin Survey 2007*, *available at* https://www.isda.org/a/KeiDE/isda-margin-survey-2007.pdf, *ISDA Margin Survey 2008*, *available at* https://www.isda.org/a/SeiDE/isda-margin-survey-2008.pdf, *ISDA Margin Survey 2009*, *available at* https://www.isda.org/a/eeiDE/isda-margin-survey-2009.pdf, and *ISDA Margin Survey 2010*, *available at* https://www.isda.org/a/UeiDE/isda-margin-survey-2010.pdf. Additional surveys are available at https://www.isda.org/category/research/surveys/.

[31] *See Margining in Agency MBS Trading*, Federal Reserve Bank of New York, Treasury Market Practices Group, (Nov. 2012) ("[A]fter the failure of Lehman Brothers in 2008, dealers and customers alike began to move toward greater use of margining on a bilateral basis. The movement in policy and industry practice toward margining accelerated in November 2008, when the G-20 Summit on Financial Markets called for measures to reduce systemic risks in the OTC derivatives markets—a general call that has since been interpreted as supporting the use of margining.").

[32] *Id.* at 2

described above, and protect counterparties of all sizes, not just those large enough to negotiate for two-way margining.[33]

C. Facilitate payment netting and close-out netting of SB swaps

Derivatives are typically traded under master netting agreements (MNAs), such as the Master Agreement published by ISDA. An MNA creates a single contract between the two parties under which all transactions between the parties under the MNA can offset each other. Each day, the MNA allows for the aggregation of the mark-to-market value of all trades under the MNA and a resulting reduction of payment obligations between the parties to a single net amount due from one party to the other. There are two primary forms of netting: (i) close-out netting, which involves terminating and netting of open contracts between parties with a single net balance owing to one or the other party; and (ii) payment netting, which involves combining offsetting cash flow obligations between two parties on a given day in a given currency into a single net payable or receivable amount.

Close-out netting is a valuable tool for reducing counterparty credit exposure in the case of counterparty default or bankruptcy because it allows a party to close out all contracts between the solvent and the insolvent counterparties and reduce them to a single obligation. The ability to net down to a single position thereby eliminates the risk of "cherry-picking" in the bankruptcy of the insolvent counterparty.[34] In addition, close-out netting allows the solvent counterparty to benefit from protections in the US Bankruptcy Code for derivatives contracts (including those for SB swaps), such as exclusion from certain types of avoidance actions including a "preference" or "constructive fraudulent conveyance"[35] and, most importantly, exclusion from the "automatic stay" for purposes of exercising certain contractual rights triggered by the counterparty's bankruptcy filing.[36] As a result of these protections and the availability of close-out netting, counterparties may terminate contracts with a debtor in bankruptcy and foreclose on the underlying collateral.[37]

---

[33] Some counterparties—likely the largest ones—might be able to negotiate two-way margining from SBSDs subject to the SEC's SB swap rules. Smaller counterparties, however, may not have the negotiating power to obtain such benefits, and may elect to transact exclusively with SBSDs that are subject to Prudential Regulator margin rules. Even larger counterparties might find it easier to transact primarily with these SBSDs—under existing agreements—rather than incurring the costs associated with attempting to negotiate two-way margin agreements under the SEC's SB swap rules.

[34] In a bankruptcy, the bankruptcy trustee is generally entitled to assume or reject executory contracts held by the debtor. Because bankruptcy trustees generally elect to enforce those contract that are in-the-money to the debtor and to reject those that are out-of-the-money to the debtor, this right is often referred to as "cherry-picking."

[35] *See, e.g.,* US Bankruptcy Code §§555 and 556.

[36] *See, e.g.,* US Bankruptcy Code §362(b)(17) and (27).

[37] Close-out netting is also recognized, subject to potential brief stays of close-out rights, under the Federal Deposit Insurance Act with respect to the Federal Deposit Insurance Corporation's bank receiverships and under Title II of the Dodd-Frank Act with respect to orderly liquidation authority proceedings of insolvent "systematically important financial institutions" and similar foreign regimes. Regulations adopted by the Prudential Regulators also impose certain limits on cross-default rights and claims against guarantors.

The concept of close-out netting is based on common law setoff rights which, in turn, are based on the existence of "mutuality," both with respect to the parties and the obligations. As a result, in order to ensure that close-out netting will be enforceable, insolvency proceedings relating to swaps and SB swaps generally must be subject to appropriate documentation and sufficient mutuality.

First, the SB Swaps Proposals may undermine the mutuality of parties required for close-out netting by fragmenting the marketplace. The significant differences between the SB Swaps Proposals and the Swap Margin Rules may cause dealers to not engage in derivatives business other than SB swaps through an SEC-regulated SBSD. Upon the insolvency of the SEC-regulated SBSD and its related swap dealer affiliate, a counterparty likely would not be able to close out and net swaps entered into with the swap dealer with SB swaps entered into with the SBSD because the counterparties are not the same (*i.e.*, insufficient mutuality of parties).

Second, the SB Swaps Proposals may undermine the mutuality of obligations required for close-out netting. Unlike a typical MNA, under which both parties post collateral and are "counterparties" rather than "agents" of the other, the SEC appears to treat the SBSD as an agent of the counterparty and the counterparty as a "customer" of the SBSD. The SEC describes the SB swap as a security held in an "account." Bankruptcy law jurisprudence suggests that counterparties having different status may undermine the ability to enforce netting between the parties (*e.g.*, a fiduciary may not offset claims it owes to a debtor of its beneficiary or customer). It is possible that the SEC's characterization of an SBSD as an agent of the counterparty rather than as a direct counterparty may cause a bankruptcy court to reject attempts by a counterparty to close out its derivatives positions with the debtor.

The potential inability to net swaps and SB swap obligations with an SEC-regulated SBSD may lead counterparties to reduce credit exposure by consolidating their SB swap trades and entering into trades only with those dealers that transact in both swaps and SB swaps under the Swap Margin Rules. Such a result would reduce the number of potential SB swap counterparties, making the market less resilient and, potentially, less liquid.

In addition, the SB Swaps Proposals may also undermine operational efficiencies and protections offered as a result of payment netting. To the extent that the SEC's proposals lead to fragmentation of the swap market, counterparties will not be able to consolidate payments across multiple transactions. In addition, because collateral posting by the counterparty would not be offset against posting by the dealer, there may be a greater number of movements of collateral back and forth between the parties, thereby increasing operational risks. This is particularly likely to occur in the case of registered funds, which the SEC requires to withdraw excess margin held at a nonbank custodian on a daily basis.[38]

[38] *See* Rule 17f-6 under the 1940 Act.

D. Only require counterparties that have "material swaps exposure" to post initial margin

Under the International Framework and the Swap Margin Rules, Covered Swap Entities are required to post initial margin to, and collect initial margin from, only specified types of counterparties. The specified counterparties are composed primarily of "financial end users with material swaps exposure."[39] A financial end user (which includes Regulated Funds) is defined to have "material swaps exposure" only if the entity, together with its affiliates, has an average daily aggregate notional amount of uncleared swaps, SB swaps, FX forwards and FX swaps, and SB swaps with all counterparties on business days during June, July, and August of the previous year that exceeds $8 billion (or €8 billion under the International Framework). As a result, a number of financial end users that, together with their affiliates, do not maintain large notional size uncleared swap and SB swap books will not be required to post initial margin under the International Framework and Swap Margin Rules. This is consistent with the CFTC's recognition that "a financial end user that has relatively smaller positions does not pose the same risks as a financial end user with larger positions" and that "financial end users with material swaps exposure potentially pose greater risk to [covered swap entity counterparties] and to the financial system than non-financial end users or financial end users with smaller aggregate exposures."[40] It is also consistent with the importance placed by the Prudential Regulators and the CFTC alike on providing a standard that is consistent with the International Framework.[41]

The SB Swaps Capital and Margin Proposal, on the other hand, requires *all* counterparties to post initial margin and exempts all SBSDs from posting initial margin to counterparties. We urge the SEC to similarly adopt an $8 billion "material swaps exposure" threshold for the exchange of initial margin between counterparties and SBSDs. The SEC's failure to adopt a material swaps exposure threshold, consistent with the International Framework and the Swap Margin Rules, would make it significantly more complex for financial end users to post margin, make netting more difficult, and would create an unlevel playing field by incentivizing counterparties to transact with bank SBSDs and non-US SBSDs whose margining framework includes consistent material swaps exposure thresholds.

E. Permit SBSDs to set a standard threshold for exchange of initial margin and raise the minimum transfer amount consistent with the Swap Margin Rules

The SB Swaps Capital and Margin Proposal should be revised to provide for a standard initial margin threshold amount (*i.e.*, the amount under which an entity would have the option of not collecting

[39] *See supra* notes 25 and 26.

[40] *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*; *Proposed Rule*, 79 FR 59898, 59904-5, 59907 (2014).

[41] Prudential Rule Adopting Release at 74857 ("The material swaps exposure threshold of $8 billion in the final rule is broadly consistent with the €8 billion established by the 2013 international framework . . . At this time, the Agencies believe the better course is to calibrate the final rule's material swaps exposure threshold to the higher international amount, in recognition of each financial end user's overall potential future swaps exposure to the market rather than its potential future exposure to one dealer.").

initial margin). Under the Swap Margin Rules, swap dealers are permitted to negotiate initial margin posting levels with a counterparty that has material swaps exposure – including not requiring posting of initial margin at all with respect to uncleared swaps[42] – so long as the aggregate credit exposure of all non-exempt uncleared swaps between the counterparty and the dealer and its affiliates does not exceed the "initial margin threshold amount" of $50 million.[43] In other words, initial margin is subject to a threshold amount below which initial margin need not be posted and collected.[44]

The Reopened Proposing Release requests comment on whether the SEC should establish a risk-based threshold below which initial margin need not be collected by a counterparty. The SEC's proposed threshold limit, however, differs from the standard under the International Framework and the Swap Margin Rules. The SEC's proposal does not rely on a fixed dollar amount but instead relies on a formulaic analysis based on a weighting of the capital held by the SBSD and the net worth of the counterparty.[45] The SEC's proposed formulaic approach would result in significant compliance challenges for market participants. Trading desks that trade both swaps and SB swaps would be required to establish different thresholds for swaps and SB Swaps with the same counterparty based on, in the case of SB swaps, capital and net worth variables that are dynamic and, thus, potentially may change on a daily basis. Inconsistent standards would also make it extremely challenging for SBSDs to document swaps and SB swaps under the same agreements and to net exposures, with adverse implications for systemic risk. Finally, because capital levels are confidential and not shared by SBSDs with counterparties (just as broker-dealers today do not share their capital levels with counterparties) counterparties will have no ability to gauge how a threshold is calculated or to audit an SBSD's determination. This could increase the risk of loss through defalcations.

While we support the SEC's intention to include thresholds as part of the final rule, we believe that the SEC's current proposal is unworkable and unsound. We recommend that the SEC, instead, adopt a fixed, dollar-based initial margin threshold amount of $50 million, consistent with the threshold under the Swap Margin Rules and the equivalent under the International Framework.

In addition, we recommend that the SEC raise the proposed cap for the minimum transfer amount for initial and variation margin from $100,000 to $500,000 consistent with the Swap Margin Rules. Proposed Rule 18a-3 provides that SBSDs need not collect collateral if the amount due, combining both

---

[42] Under the Swap Margin Rules, the threshold is based on swaps and does not include SB swaps.

[43] The swap margin regulations adopted by the European Union establish a similar threshold maximum of €50 million.

[44] Under the Swap Margin Rules and the International Framework, Covered Entities must collect and post variation margin on uncleared swaps and SB swaps with all counterparties that are financial end users, including financial end users without material swaps exposure. The Swap Margin Rules do not allow a Covered Entity to agree to a threshold amount below which it needs not collect or post variation margin, although variation margin requirements are subject to a minimum transfer amount value of $500,000, calculated by combining amounts for initial and variation margin.

[45] In the Reopened Proposing Release, the SEC requests comment on an approach under which an SBSD would not be required to collect initial margin from a counterparty when "the amount is less than one percent (1%) or some other percent of a nonbank SBSD's tentative net capital and is less than ten percent (10%) or some other percent of the counterparty's net worth." Reopened Proposing Release at 53013.

initial and variation margin, is $100,000 or less. The Swap Margin Rules also allow dealers and their counterparties to establish a minimum transfer amount value for initial and variation margin but cap the amount at $500,000 rather than $100,000. The SEC did not provide any rationale regarding why the cap should be $100,000 rather than $500,000. In order to ensure consistency and alleviate the operational burdens associated with making *de minimis* margin transfers we urge the SEC to revise the minimum transfer amount to $500,000.

F. Do not impose capital charges on SBSDs and MSBSPs when their counterparties elect to have collateral held at a third-party bank custodian

We have serious concerns with the proposed requirement for an SBSD to take a capital charge in situations in which collateral posted by a counterparty with respect to uncleared SB swaps is not deemed by the SEC to be under the "possession and control" of the SBSD. The proposed amendments to Rule 15c3-1 and proposed Rule 18a-1 would impose a capital charge if a counterparty elects to hold initial margin at an independent third-party custodian, which is explicitly permitted by Section 3E(f) of the Securities Exchange Act of 1934, as amended ("Exchange Act"). Although Section 3E(f) applies only to initial margin,[46] the rationale provided by the SEC in the SB Swaps Capital and Margin Proposal suggests that a capital charge would also be imposed in the event that a counterparty elects to hold variation margin with an independent third-party custodian.

An SBSD likely will pass on the costs associated with the capital charge to its counterparty, thus penalizing the counterparty for exercising its statutory right to hold its collateral with a third-party custodian.[47] We are concerned that the additional costs associated with the capital charge in the SB Swaps Capital and Margin Proposal will cause SEC-regulated SBSDs to further increase pricing, potentially to a level that makes it uneconomic for market participants that elect segregation to enter into SB swaps with such SEC-regulated SBSDs.

Imposition of a capital charge unfairly penalizes registered funds. As discussed in our prior letters,[48] registered funds are strictly limited in their ability to maintain collateral with an SBSD or MSBSP that is not a bank. Under the 1940 Act, registered funds are required to custody their assets in accordance

---

[46] Section 3E(f) of the Exchange Act specifically provides that a counterparty of an SBSD or MSBSP in an uncleared swaps transaction may require any collateral posted as initial margin to be maintained by an independent third-party custodian and be designated as a segregated account for and on behalf of the counterparty. This provision, which was added by the Dodd-Frank Act, allows a counterparty to request an additional level of protection for the collateral it has posted.

[47] Just as dealers increase pricing to counterparties on SB swaps to take account of the dealer's lost opportunity cost of not being able to rehypothecate collateral held at a third-party custodian, we expect that SBSDs would increase the pricing for counterparties even more to account for the capital charges proposed by the SEC.

[48] *See* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated February 4, 2013, *available at* https://www.ici.org/pdf/26967.pdf; Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated December 5, 2013, *available at* https://www.ici.org/pdf/27742.pdf.

with Section 17 of the 1940 Act. Nearly all registered funds use a US bank custodian for domestic securities although the 1940 Act permits other limited custodial arrangements.[49] Rule 17f-1 under the 1940 Act permits registered funds to use a broker-dealer custodian, but the rule imposes conditions that are difficult to satisfy in practice.[50]

We believe that registered funds should not be subject to additional costs to enter into custodial arrangements that are required by the 1940 Act and are consistent with the segregation right specifically provided by the Dodd-Frank Act. If SEC-regulated SBSDs pass on these capital charges to counterparties in the form of higher prices, as they are likely to do, registered funds will be incentivized to enter into SB swaps with a bank dealer, rather than an SBSD that is subject to the SEC's capital charges.

In our view, a capital charge is unwarranted when an SBSD holds an "entitlement interest" in collateral maintained with a custodian pursuant to a customary control arrangement subject to Articles 8 and 9 of the Uniform Commercial Code (UCC). 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. 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." The drafters noted that this 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 pledgor or for the secured party.[51] Section 9-104 of Article 9 provides a similar right with respect to security entitlements over deposit accounts holding cash collateral. A "security entitlement" is a property right that a person obtains in the contents of a securities account with a

---

[49] Under Section 17 of the 1940 Act, 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). Foreign securities are required to be held in the custody of a foreign bank or securities depository.

[50] Similar to bank custodians, broker-dealer custodians must physically segregate fund assets from other assets held by the broker-dealer and mark such assets to identify them as the fund's property. The rule prohibits the broker-dealer from having any power to assign, hypothecate, pledge, or otherwise dispose of the fund's assets, except at the fund's direction and for its account. Furthermore, the fund's assets cannot be subject to a lien or charge of any kind in favor of the broker-dealer.

In 2015, the SEC brought an enforcement action against a registered fund's investment adviser that caused the fund to post contractually required cash collateral relating to swaps transactions directly with broker-dealer counterparties, instead of keeping the cash collateral at the fund custodian or otherwise maintaining it in accordance with Section 17 of the 1940 Act. *In the Matter of Water Island Capital LLC,* SEC Rel. IC-31455 (Feb. 12, 2015). The International Framework and the Swap Margin Rules, unlike the SB Swaps Capital and Margin Proposal, impose strict limitations on rehypothecation of collateral.

[51] *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.").

"securities intermediary."[52] 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 securities intermediary's creditors.[53] As a result, SBSDs that are secured parties under control agreements should be deemed to be in the same position with respect to their rights to protect themselves in the event of a default under the SB swaps as they would be if they possessed the collateral directly.

Tri-party arrangements provide safety for counterparties through the existence of an independent "gatekeeper" and should be encouraged, not discouraged.[54] The presence of a gatekeeper removes the possibility that an SBSD, as financial intermediaries have in the past, may remove segregated assets and use them for its own benefit.[55] Under a tri-party agreement, the custodian takes responsibility for safeguarding the interests of both counterparties to an SB swap transaction, including maintaining custody of the collateral posted to an SBSD or MSBSP secured party and effecting the transfer of funds and securities between the two parties in an operationally secure and auditable manner. This arrangement helps to avoid market disruptions in the case of a default or similar event necessitating access by one of the parties to the collateral.[56]

We believe that tri-party arrangements offer important protections for counterparties and the financial markets generally. These arrangements should be available to counterparties for both initial margin, as contemplated by the Dodd-Frank Act, and for variation margin for SB swaps, subject to compliance with state UCC requirements and the use by custodians of collateral transfer and recordkeeping safeguards typical in the SB swap market today. In both cases, the election should be available without imposition of a capital charge.[57]

---

[52] *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.").

[53] 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) (The term securities 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).

[54] Tri-party collateral arrangements reduce operational risk and complexity, allow market participants to have increased access to collateral to continue to manage portfolio exposure, help to manage counterparty exposure, and allow both the pledgor and the pledgee to more easily identify the owner of collateral upon the bankruptcy of the other.

[55] *See, e.g., Complaint For Injunctive And Other Equitable Relief And For Civil Monetary Penalties Under The Commodity Exchange Act, CFTC v. MF Global Inc., et al*, (S.D.N.Y. 2013) (alleging, among other things, that MF Global unlawfully used customer segregated funds to support its own proprietary operations and the operations of its affiliates).

[56] Although the focus of our comments is on margining of uncleared SB swaps, we also support use of tri-party arrangements with respect to cleared SB swaps. In particular, we do not believe that the SEC should impose capital charges on a clearinghouse member to the extent that the customer of the member elects to hold collateral at a third-party bank under a control arrangement that complies with Articles 8 and 9 of the UCC.

[57] We also request that the SEC clarify in any final rule 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

G. Revise proposed exception to capital charges for collateral posted to a third-party custodian

We appreciate that the SEC has requested comment, in the Reopened Proposing Release, on a potential exception to the capital charge if a counterparty elects to hold margin at an independent, third-party custodian. The exception that the SEC proposes, however, includes conditions that are inconsistent with market practice and are unworkable. In addition, the proposed exception imposes unnecessary costs on counterparties by requiring them to obtain legal opinions supporting the enforceability of tri-party arrangements.

The proposed exception would apply if: (i) the independent third-party custodian is a bank as defined in Section 3(a)(6) of the Exchange Act and is not affiliated with the counterparty; (ii) the SBSD, the independent third-party custodian, and the counterparty that delivered the collateral to the custodian have executed an account control agreement governing the terms under which the custodian holds and releases collateral pledged by the counterparty and providing the SBSD with "the same control over the collateral as would be the case if the SBSD controlled the collateral directly;" and (iii) the SBSD obtains a written opinion from outside counsel that the account control agreement is "legally valid, binding, and enforceable in all material respects."[58]

First, the proposed exception should not require the arrangement to provide the SBSD with the "same control" with respect to collateral held through the custodian as it would have if the SBSD were to hold collateral directly. The reference to "same control" suggests that the SEC anticipates that SBSDs, like broker-dealers, would be allowed to re-hypothecate and use collateral posted to them in connection with funding their businesses.[59] These rights are precisely the reason why Congress provided counterparties with a statutory right to elect to hold collateral with a third-party custodian.[60]

Second, we do not believe that requiring a counterparty to obtain an enforceability opinion from outside counsel is necessary. Existing control agreements and laws governing such agreements provide substantial protections and, pursuant to the UCC, are subject to uniform laws in effect in all fifty states

---

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's name and post with the clearinghouse the counterparty's required margin for the cleared SB swap.

[58] *See* Reopened Proposing Release at 53012.

[59] *See, e.g.,* Original Proposing Release at 70277 (explaining that only excess securities collateral would be required to be subject to the SBSD's possession and control, consistent with the corresponding provisions of Rule 15c3-3, which allow broker-dealers to rehypothecate up to 140 percent of the total of the debit balance in the customer's account).

[60] Section 724(c) of the Dodd-Frank Act imposes requirements regarding protection of collateral of counterparties to uncleared swaps and SB swaps. The provision was added in response to the Lehman Brothers bankruptcy and customers' losses as well as other dealer failures, such as MF Global, in which commingled, rehypothecated customer collateral was difficult to identify, trace and recover. *See* 111 Cong. Rec. H14, 707 (daily ed. Dec. 10, 2009) (statement of Rep. Garrett). *See also* Practical Law Finance, *Financial Rules on Segregation of Initial Margin for Uncleared Swaps Issued by CFTC* (Nov. 7, 2013).

and the District of Columbia.[61] The concept of an "entitlement holder," which is a person who holds financial assets through a securities intermediary, is well established and has been in use since the 1994 amendments to Article 8 were adopted.[62]

Under the typical tri-party arrangements used in connection with SB swaps today, the SBSD issues an "entitlement order" in the event of a default of the counterparty or certain other enumerated termination events which the custodian is required to honor (*i.e.*, without diligence as to the right of the SBSD to issue such entitlement order or foreclose upon the collateral). We understand that entitlement orders are carried out promptly by the custodians, and the SBSDs have immediate access to the collateral. This type of arrangement provides SBSDs with ready and immediate access to the collateral.[63]

H. Expand permitted collateral to allow funds to post shares of affiliated registered funds

The SB Swaps Capital and Margin Proposal provides that eligible collateral may include cash, securities, and/or money market instruments but they "must not consist of securities issued by the counterparty or a party related to the nonbank SBSD, or to the counterparty."[64] We are concerned that this limitation could prevent a registered fund that is a fund of funds from posting as collateral shares of affiliated funds held by the upper tier fund. Such an interpretation would be problematic for registered funds that operate as fund of funds because in some cases, the only investments held by the upper tier fund will be swaps and SB swaps together with shares of affiliated funds. For example, call overwrite funds often achieve their exposure by investing in a fund that provides the desired equity exposure and then enters into derivatives designed to provide the overwrite exposure. In that situation, the SB swap margin rules should make clear that shares of the underlying fund would be eligible as collateral. We therefore request that the SEC eliminate this limitation or clarify explicitly that it does not apply with respect to funds of funds.

---

[61] S. Rocks and P. Christophorou, *Memorandum Regarding the Uniform Version of Article 8 of the Uniform Commercial Code and the Treatment of Investment Property under the Uniform Version of Article 9, with Addenda Regarding Federal Book-Entry Regulations and International Developments* (April 2007).

[62] *Id.*

[63] To ensure that the SBSD or MSBSP, which is the secured party, receives the initial margin promptly and that the initial margin is returned to the counterparty when it is entitled to such return, the CFTC requires that the custody arrangement provide that turnover of control shall be made promptly upon presentation of a statement in writing that one party is entitled to such turnover pursuant to an agreement between the parties. *Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy,* 78 FR 66621 (Nov. 6, 2013). We urge the SEC to incorporate an identical provision in its rules in lieu of the proposed requirement that a tri-party arrangement provide an SBSD with the "same control" over collateral as if the SBSD held the collateral directly and the requirement that the SBSD obtain a written opinion from outside counsel on the validity and enforceability of the agreement.

[64] *See* Original Proposing Release at 70264-70265.

I. Do not adopt rules on portfolio margining without first issuing a more detailed proposal

In the Reopened Proposing Release, the SEC requests comment on whether swaps should be permitted to be held in an SB swaps account at an entity that is registered as a nonbank SBSD and swap dealer (but not as a broker-dealer or FCM) to provide a means to portfolio margin SB swaps and swaps in an SB swap account. Similarly, the SEC requests comment on whether SB swaps should be permitted to be held in a swap account at an entity that is registered as a swap dealer and SBSD (but not as a broker-dealer or FCM) to provide a means to portfolio margin SB swaps and swaps in a swaps account.

While we support efforts to portfolio margin SB swaps and swaps, in order to provide an opportunity for meaningful public comment, the SEC must provide substantially more detail and analysis regarding how these proposed portfolio margining arrangements would operate, and the legal framework that would apply to each. In particular, we would want to understand how the combined positions would be treated upon the bankruptcy of the SBSD and swap dealer, depending on whether the positions are held in an SB swaps account or a swap account. In connection with any such proposal, it would also be important to understand what offsets SBSDs and swap dealers could apply that would reduce margin requirements, whether the SEC would impose any capital charge on SBSDs in connection with such arrangements, and how such arrangements would be viewed by the SEC under Section 17 of the 1940 Act and related SEC rules.

IV. The SEC Should Take a Consistent Approach to Substituted Compliance under its SB Swaps Rules

Aligning margin requirements for SB swaps with the Swaps Margin Rules and the International Framework would facilitate the ability of the SEC and other regulators to recognize one another's margin rules as comparable. The SEC has developed a "substituted compliance" framework under which it will consider written applications to permit compliance with regulatory requirements in a foreign jurisdiction to substitute for compliance with the SB swap margin rules. We fully support this framework, which has the potential to decrease burdens on market participants and promote the continuation of a global SB swaps market.

We do not believe, however, that the SEC should address substituted compliance independently. Instead, we urge the SEC to work together with the CFTC and the Prudential Regulators, as well as with global regulators, to develop a uniform "substituted compliance" framework approach that would apply both to swaps and to SB swaps. The framework should build on the SEC's substituted compliance process in rule 240.0-13 as well as the existing comparability determinations issued by the CFTC.[65]

[65] *See, e.g.,* 82 FR 48394 (Oct. 13, 2017) (finding the European Union's margin requirements for uncleared swaps to be comparable to the CFTC's uncleared swap margin requirements); s*ee also* 81 FR 633376 (Sept. 15, 2016); 78 FR 78852 (Dec. 27, 2013); 78 FR 78890 (Dec. 27, 2013); 78 FR 78890 (Dec. 27, 2013); 78 FR 78899 (Dec. 27, 2013); 78 FR 78839

V. Compliance Period

The proposed compliance period for implementation of the SB Swaps Proposals is six (6) months after the date of publication in the Federal Register of final rules. Even if the final rules are identical to the Swap Margin Rules, we believe that market participants would require at least twelve (12) months to transition to the new regime. If the final rules are not consistent with the Swap Margin Rules, we believe that it would take several years for both counterparties and dealers to be in a position to comply. Accordingly, at a minimum, implementation of any final rules, if adopted as proposed, should be twenty-four (24) months from the date of publication of final rules in the Federal Register.

* * *

(Dec. 27, 2013); 78 FR 78923 (Dec. 27, 2013); 78 FR 78878 (Dec. 27, 2013). The Prudential Regulators have not yet published any comparability determinations with respect to the Swap Margin Rules.

We appreciate the opportunity to comment on the reopening of the SB Swaps Proposals. ICI recommends that the SB Swaps Proposals be modified and reproposed to take into account significant developments in the SB swap markets in the past six years, including global acceptance of the International Framework, adoption and implementation of the Swap Margin Rules, as well as the many comments that the SEC has received on these proposals. We believe that this approach would better address the needs of investors and better protect participants in the SB swap markets and the US capital markets generally.

If you have any questions on our comment letter, please feel free to contact me at (202) 326-5813, Sarah A. Bessin at (202) 326-5835, or George M. Gilbert at (202) 326-5810.

Sincerely,

/s/ Susan M. Olson

Susan M. Olson
General Counsel

cc: The Honorable Jay Clayton, Chairman
The Honorable Kara M. Stein
The Honorable Robert J. Jackson, Jr.
The Honorable Hester M. Peirce
The Honorable Elad L. Roisman

Brett Redfearn, Director, Division of Trading and Markets
Michael A. Macchiaroli, Associate Director, Division of Trading and Markets

Securities and Exchange Commission

The Honorable J. Christopher Giancarlo, Chairman
The Honorable Brian D. Quintenz
The Honorable Rostin Behnam
The Honorable Dawn DeBerry Stump
The Honorable Dan M. Berkovitz

Commodity Futures Trading Commission