MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

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Via Electronic Submission: https://comments.cftc.gov

David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street N.W.
Washington, DC 20581

Re: Notice of Proposed Rulemakings on Margin Requirements for Uncleared Swaps and Capital Requirements for Swap Dealers and Major Swap Participants: RIN 3038—AC97 and RIF 3038-AD54

Dear Mr. Stawick:

Managed Funds Association ("MFA")[1] appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the "Commission") on its proposed rules on "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants" (the "Proposed Margin Rules")[2] and on "Capital Requirements of Swap Dealers and Major Swap Participants" (the "Proposed Capital Rules", and together with the Proposed Margin Rules, the "Proposed Rules")[3] related to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[4] MFA strongly supports measures to reduce risk in the swap markets, including the imposition of appropriate margin and capital requirements. In this spirit, we are providing comments on the Proposed Rules that we believe will assist the Commission in promulgating final rules that balance the need to minimize risk with maintaining liquidity in the swap markets.

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1 MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $2 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

2 Notice of Proposed Rulemaking on "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants" 76 Fed. Reg. 23732 (Apr. 28, 2011) (the "Margin Proposing Release").

3 Notice of Proposed Rulemaking on "Capital Requirements of Swap Dealers and Major Swap Participants" 76 Fed. Reg. 27802 (May 12, 2011) (the "Capital Proposing Release").

4 Pub. L. 111-203, 124 Stat. 1376 (2010).

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I. Margin and Capital Requirements Affect Buy-Side Firms

The Proposed Rules place obligations on swap dealers ("SDs") and major swap participants[5] for which there is no prudential regulator (each, a "CSE"). Since the Proposed Rules will affect how CSEs trade uncleared swaps with their customers, they will materially affect buy-side firms when entering into uncleared swap transactions for hedging and investing activities. As discussed in this comment letter, MFA urges the Commission to evaluate and consider the effects of its Proposed Rules on non-CSEs and the broader swap markets.

In particular, the Commission should ensure that the Proposed Rules allow for a well functioning market for uncleared swaps. Even after central clearing of swaps has become commonplace, market participants will need a market for uncleared swaps to meet their trading needs, including entering into customized transactions. We recognize that the Commission expects the Proposed Rules to reduce unsecured counterparty credit risk and incentivize clearing,[6] and that the Proposed Rules also have the potential to bring consistency and transparency to margin practices. However, we believe that the Proposed Rules, while promoting such benefits, should not be so punitive with respect to uncleared swaps that the markets for uncleared swaps become destabilized. To allow for a transparent and efficient market for uncleared swaps, the Commission should capture the best of existing industry practices, such as the two-way exchange of variation margin and robust netting, while layering on appropriate additional safeguards.

As a result, MFA recommends that the Commission implement capital and margin regulations for uncleared swaps after the designated clearing organization ("DCO") infrastructure is in place to effect the Dodd-Frank Act's mandatory clearing requirements.[7] This ordering is necessary because since the capital and margin requirements for uncleared swaps

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[5] The Securities and Exchange Commission (the "SEC") and the Commission have not yet promulgated final rules defining swap dealer and major swap participant. Therefore, for the remainder of this letter, when reference is made to either swap dealers or major swap participants, it shall mean an entity likely to be included in such category based on the SEC's and the Commission's current joint proposed definitions. *See* SEC and Commission joint Notice of Proposed Rulemaking on "Further Definition of 'Swap Dealer,' 'Security-Based Swap Dealer,' 'Major Swap Participant,' 'Major Security-Based Swap Dealer' and 'Eligible Contract Participant'" 75 Fed. Reg. 80174 (Dec. 22, 2010).

[6] According to Secretary of the U.S. Treasury, Timothy Geithner, "imposing appropriate margin requirements on uncleared swaps will … help create incentives for market participants to use centralized clearing and standardized contracts." Timothy Geithner, Secretary, U.S. Dept. of the Treasury, Address to the International Monetary Conference (Jun. 6, 2011), Available at http://www.treasury.gov/press-center/press-releases/Pages/tg1202.aspx.

[7] The Commission can implement clearing and margin for uncleared swaps in a lockstep manner by asset class. Commission Chairman Gensler has suggested that the Commission may put the central clearing requirement for swaps in place with certain asset classes and/or participant types coming before others. See Remarks of Chairman Gary Gensler, Implementing the Dodd-Frank Act, FIA's Annual International Futures Industry Conference, Boca Raton, Florida, March 16, 2011. Available at: http://www.cftc.gov/pressroom/speechestestimony/opagensler-73.html.

likely will be significantly higher than those for cleared swaps,[8] it will encourage swap market participants to move to central clearing.[9] However, until the DCO infrastructure is established, swaps that might otherwise be deemed clearing-eligible would be given punitively higher capital and margin charges, simply because: (i) DCOs are not yet ready to accept them; (ii) regulators have not yet deemed the contracts eligible for clearing; or (iii) participants do not yet have access to DCOs. The consequence of temporarily excessive capital and margin requirements could be destabilizing to the swap markets as the higher costs discourage trading and cause the markets to lose depth. Throughout the legislative and regulatory processes, MFA has strongly supported central clearing and rational methods to incentivize its widespread usage. However, despite continued efforts, customers do not yet have sufficient access to DCOs. Thus, we respectfully request that the Commission coordinate the implementation of the capital and margin requirements for uncleared with the establishment of central clearing.[10]

II. Comments on Proposed Margin Rules

A. Importance of Margin Requirements to All Market Participants

In fulfilling its mandate to assure the soundness of CSEs, the Commission should consider how the Proposed Margin Rules would affect buy-side firms, which comprise a significant portion of the swap market and are customers of CSEs.

The Proposed Margin Rules mandate the delivery of margin for uncleared swaps to CSEs.[11] Since buy-side firms are often counterparties to CSEs, this mandate will directly affect the cost to buy-side firms when entering into uncleared swaps. Many of the costs associated with the Proposed Margin Rules will be incremental to buy-side firms, which regularly post and collect margin for uncleared swaps; however, they may result in buy-side firms incurring costs beyond higher margin amounts and related operational expenses. For example, buy-side firms may incur increased trading costs in the form of adverse pricing, as SDs seek to pass along to their customers capital charges and expenses associated with new capital and margin requirements. In addition, if buy-side firms can no longer use robust netting arrangements, their overall funding costs for delivering margin will increase. In the aggregate, these incremental costs might be quite large. If the additional costs are excessive, they may effectively limit buy-side firms' access to the uncleared swap markets, which will likely adversely affect the swap markets as they lose liquidity and depth. Thus, MFA urges the Commission to be mindful of increased costs that margin regulation may impose upon buy-side firms.

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[8] *See e.g.*, Proposed Margin Rule 23.155(c)(1)(iv). The Commission has proposed an alternative method for determining initial margin in which a factor of 2.0 is applied to the initial margin associated with a referenced cleared swap to calculate initial margin for an uncleared swap.

[9] *Infra* at footnote 6.

[10] MFA also recommends that, if the Commission implement capital and margin requirements for swaps of a certain asset class when clearing becomes available for such asset class, so that some meaningful transition period is provided and so market participants do not incur higher costs associated with uncleared swaps without a meaningful opportunity to negotiate the operational issues of moving uncleared swaps into a cleared paradigm.

[11] Proposed Margin Rules 23.152 and 23.153.

Specifically, we urge the Commission to issue final margin requirements that promote a fair and stable market for uncleared swaps. As discussed in more detail below, we believe that sound regulation of margin delivered in connection with uncleared swaps includes at a minimum, the following attributes:

- consistency of margin requirements among regulators;
- parity among market participants in their obligations to deliver variation margin;
- extensive use of netting to both abate counterparty credit risk and lower costs associated with the delivery of margin;
- transparent methods for determining margin amounts that both CSEs and their counterparties can use independently; and
- determination of variation margin in a negotiated manner that need not be formula-based.

B. Uniformity of Regulation

MFA believes, as a general matter, that the swap markets will work most efficiently if one set of margin requirements applies for all uncleared swaps regardless of which regulator oversees a particular CSE. A uniform set of margin requirements will facilitate orderly collateral management practices. In the absence of such uniformity, buy-side firms will have to monitor and comply with multiple margin regimes, which is administratively difficult, costly and burdensome. Also, margin requirements that differ by regulator inherently create advantages for certain regulated entities over others.[12] Accordingly, we urge the Commission to coordinate with the prudential regulators[13] and the SEC to assure a uniform set of margin requirements in U.S. swap markets.

C. Mandatory Bilateral Exchange of Variation Margin

The Proposed Margin Rules require CSEs to collect (but not post) variation margin when they enter into swaps with counterparties that are financial entities.[14] The Commission requested

[12] For example, under the Proposed Margin Rules, SDs that are subject to those rules can enter into margin arrangements with non-financial end users that allow the non-financial end user to deliver non-cash collateral as margin. However, SDs cannot accept non-cash collateral as margin under the prudential regulators' proposed margin rules. *See* Proposed Rule 6 as set forth in the prudential regulators' Notice of Proposed Rulemaking on "Margin and Capital Requirements for Covered Swap Entities", 76 Fed. Reg. 27564 (May 11, 2011) (the "Proposed Prudential Margin Rules"). This limitation may put SDs subject to the Proposed Prudential Margin Rules at a competitive disadvantage relative to SD's subject to the Commission's Proposed Margin Rules when attempting to enter into uncleared swaps with certain non-financial end users.

[13] Collectively, the Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; Farm Credit Administration and the Federal Housing Finance Agency.

[14] Proposed Margin Rule 23.153.

comment as to whether they should include additional language in the Proposed Margin Rules requiring CSEs to both post and collect variation margin with regard to swaps entered into with financial entity counterparties.[15] As we explain further below, MFA strongly encourages the Commission to require CSEs to post and collect variation margin with all non-CSE financial entities because such bilateral exchange of variation margin is crucial to the proper functioning of the swap markets and abatement of counterparty and systemic risk therein.

1. Current Widespread Best Practice

The Proposed Margin Rules do not prevent CSEs from posting variation margin to their financial entity counterparties. However, because the Proposed Margin Rules do not include an express requirement that CSEs post variation margin, they create a presumption that it may not be either necessary or important for a CSE to do so. MFA is concerned that CSEs may use this presumption created by the Proposed Margin Rules to retreat from the current market "best practice" of posting variation margin to their counterparties.

A wide range of market participants currently exchange variation margin bilaterally for uncleared swaps,[16] and buy-side firms largely have adopted this sound market practice as "best practice" for collateral management. Bilateral margin arrangements between buy-side firms and CSEs reflect that buy-side firms trade with CSEs most often as peers, with comparable expertise, technical proficiency and understanding of the risks inherent in trading swaps. Bilateral margin arrangements also reflect that both parties have counterparty credit risk when trading swaps. The collection of margin, together with netting, are effective means for any market participant to reduce counterparty credit risk. Just as banks are responsible for protecting the interests of depositors, so too are buy-side firms responsible for the interests of their investors, which include pension plans and university endowments. Thus, shielding assets invested with buy-side firms from financial contagion is important to the U.S. and global economy. Recognizing the immense protections that the collection of variation margin offers, swap market participants have historically delivered variation margin on a bilateral basis. To support this practice, market participants have efficient contractual arrangements and extensive operational infrastructure for bilateral variation margin exchange. Thus, the Commission would not be imposing a material incremental burden or a change from "best practice" for CSEs if it requires CSEs to deliver variation margin to their counterparties.

2. Reduction of Systemic Risk

The bilateral exchange of variation margin prevents either party to a swap from accumulating substantial unsecured exposures, thus limiting both counterparty and systemic risk. The ability of market participants to accumulate an unlimited amount of unsecured obligations to counterparties was one of the primary causes of the recent financial crisis and, in part, was why

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[15] Margin Proposing Release at 23736.

[16] MFA understands that one-sided variation margin arrangements are an exception to established market practices for collateral arrangements.

entities such as AIG were "too interconnected to fail" and "too big to fail."[17] As a result, the failure to mitigate current counterparty credit exposures through the daily bilateral exchange of variation margin could exacerbate system-wide losses in the event of a CSE default. Such losses could cause serious harm to the financial system.

Given the potential systemic benefits, the Commission should require CSEs to deliver variation margin to their customers. In the absence of CSEs delivering variation margin, if a CSE were to default, the uncollateralized swap positions might result in other market participants suffering losses, which could potentially be significant for an individual firm or in the aggregate across market participants. In turn, these market participants might become less stable and may experience difficulty fulfilling their obligations to other financial institutions for swaps and other financial products. Thus, by requiring CSEs to deliver variation margin to all their customers for uncleared swap transactions, the Commission prevents the possibility of that CSEs financial contagion spreading among other market participants, not by direct firm-to-firm relationships among financial institutions, but through indirect transmission through the swap markets.

Given the asymmetry that exists currently in swap markets with respect to the delivery of initial margin (*i.e.,* dealers collect initial margin from their customer counterparties but do not concomitantly post initial margin to them), and the higher degree of interconnectedness and systemic risk that such asymmetry engenders, it is even more imperative that the Commission require the "best practice" of bilateral exchange of variation margin.

3. Increased Transparency

Bilateral exchange of variation margin will increase the transparency of the swap markets, which is a key goal of the Dodd-Frank Act.[18] As a general matter, margin exchange is an observable measure of a CSE's gains and losses with respect to its swaps. A CSE's ability to conceal losses associated with its swap portfolio is difficult if that CSE must deliver variation margin to its counterparties on a frequent basis. Such transparency could enhance reporting to regulators and the ability of the regulators to gauge counterparty credit quality. Critically, such transparency would be advantageous to regulators evaluating and monitoring systemic risk as the Commission will be notified when substantial collateral disputes occur.[19] We believe that

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[17] Oversight of the Federal Government's Intervention at American International Group, House Committee on Financial Services, 111th Cong. (Mar. 24, 2010) (statement of Hon. Ben S. Bernanke, Chairman, Federal Reserve Board of Governors), in which he addresses "why supporting AIG was a difficult but necessary step to protect our economy and stabilize our financial system".

[18] S. Rep. No. 111-176 at 32 (2010), Available at: http://www.gpo.gov/fdsys/pkg/CRPT-111srpt176/pdf/CRPT-111srpt176.pdf.

[19] The Commission has proposed rules with respect to the documentation of swap transactions that would require CSEs to report any valuation dispute with another CSE that is not resolved within one business day and any valuation dispute with a non-CSE counterparty that is not resolved within five business days to the Commission (or SEC if the transaction in question is a security-based swap) and any applicable Prudential Regulator. *See* Commission Proposed Rule 23.504(e) at "Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants" 76 Fed. Reg. 6715, 6726 (Feb. 8. 2011) (the "Proposed Documentation Rules").

requiring CSEs to post variation margin would ensure that they engage in proper risk management and alert regulators to an impending failure, which would enable them to intervene promptly and thus limit the degree to which a default by a CSE could impact the U.S. financial system.

4. Facilitation of Central Clearing

One of the key goals of the Dodd-Frank Act is to move the swap markets towards greater central clearing.[20] When CSEs enter into cleared swap transactions, the relevant DCO requires them to post variation margin on such swaps.[21] Requiring CSEs to also post variation margin on uncleared swaps would create symmetry between the cleared and uncleared swap markets. In addition, the bilateral exchange of variation margin would make the transition to central clearing less burdensome and operationally easier to integrate. If CSEs are required to deliver variation margin on uncleared swaps, then they will have to adapt their working capital and collateral management systems and policies to account for such obligations across their entire portfolio. Because these systems would then already be in place when the central clearing mandate becomes effective, they will reduce the financial and operational burden of progressively moving eligible portions of swap portfolios to central clearing.

D. Netting Under the Proposed Margin Rules

MFA appreciates that the Proposed Margin Rules clearly permit the netting of variation margin and, to a more limited extent, initial margin.[22] Effective netting agreements lower systemic risk by reducing both the aggregate requirement to deliver margin and trading costs for market participants. In addition, by allowing counterparties to net margin when they have an enforceable netting agreement in place, the Proposed Margin Rules allow swap market participants to continue current "best practices" with regard to the collateralization of uncleared swaps. However, the Proposed Margin Rules appear to limit the efficacy of netting as a risk reduction tool, expressly placing restrictions in certain places while remaining silent or vague in others, as we discuss further below. MFA urges the Commission to explicitly permit robust netting practices with respect to both initial and variation margin when crafting final rules.

Many market participants currently have netting agreements that allow them to net initial and variation margin amounts across many different exposures and assets. We urge the Commission, when adopting final margin rules, to allow for such broad netting arrangements. For example, the margin requirements might provide for netting among, but not limited to, the following items:

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[20] S. Rep. No. 111-176 at 32.

[21] The Commission has proposed rules that require DCOs to settle margin payments and collections of initial and variation margin. *See* Commission proposed rule 39.14(b) at "Risk Management Requirements for Derivatives Clearing Organizations", 76 Fed. Reg. 3698, 3722 (Jan. 20, 2011) (the "Proposed Risk Management Rules").

[22] Proposed Margin Rule 23.153(b)(5).

- margin for swaps of the same or similar asset classes (*e.g.*, interest rate swaps, commodity swaps, equity swaps, etc.), but cleared by one FCM through different DCOs;

- margin for swaps with highly correlated assets or other financial products (*e.g.*, a credit default swap with referenced bond or a interest rate swap and Eurodollar futures);

- margin for swap exposures of one asset class with margin for swaps of another asset class (*e.g.*, interest rate swaps and commodity swaps);

- margin between swaps and security-based swaps;

- margin for cleared swaps with margin for uncleared swaps;

- margin for swap exposures with margin for other financial product types (*e.g.*, physically-settling forwards, repurchase agreements, security lending agreements); and

- margin for swap exposures with other financial or liened account assets (*e.g.,* securities in a securities account).

Permitting CSEs to net across a wide variety of offsetting exposures with their financial entity counterparties, in addition to reducing aggregate counterparty credit risk and lowering trading costs, would: (i) allow entities to make efficient use of their capital; (ii) provide market participants and regulators with better transparency as to the overall amount of counterparty risk between two parties, which is informative of risk in the swap markets; and (iii) reduce complexity and settlement risk.[23] In contrast, without adequate allowances for netting, the Proposed Margin Rules would drain liquidity from the swap markets as participants seek other execution strategies to prevent the over-collateralization of otherwise offsetting positions.

1. Recommended Clarifications to Proposed Netting Provisions

The Commission should clarify that a CSE, when using an initial margin model, may offset initial margin requirements for certain uncleared swaps. Proposed Margin Rule 23.155(b)(2)(v) states that, "any portfolio offsets or reductions shall have a sound theoretical basis and significant empirical support". While this rule indicates that some netting is permitted, it is not explicit that the Proposed Margin Rules would permit netting of initial margin. Without a clear delineation of what forms of netting the Commission permits CSEs to use for initial margin models, and without the transparency discussed below in Section II.D.2. below, it could be difficult for swap market participants to evaluate each CSE's approach to initial margin. Therefore, we respectfully request that the Commission amend the Proposed Margin Rules to state clearly that initial margin for swaps can be offset when a CSE uses an initial margin model.

[23] Conversely, placing an artificial prohibition on offsetting margin requirements for cleared and uncleared swaps will impede a voluntary transition to the use of central clearing.

In addition, the Commission should permit CSEs and their financial entity counterparties to offset initial margin requirements to the fullest extent possible. Under the alternative initial margin method set forth in Proposed Margin Rule 23.155(c) (the "Alternative Method"), CSEs and their financial entity counterparties can only offset positions in the same asset class, with one exception,[24] and that reduction cannot "exceed 50% of the amount that would be required for the uncleared swap in the absence of a reduction."[25] Using the Alternative Method, a market participant that has entered into two fully offsetting uncleared swaps with the same CSE would be required to post 50% of the initial margin requirement on those two swaps, even though their net counterparty exposure would always be zero. That result is unreasonable because if the market participant defaulted, it would default on both swaps, so its obligations under the out-of-the-money swap would completely offset its exposure under the in-the-money swap, leaving the CSE with no counterparty exposure. MFA requests that the Commission amend the Proposed Margin Rules to allow CSEs and their financial entity counterparties, when transacting with each other, to offset initial margin requirements to the fullest extent possible, regardless of asset class and not bound by a 50% cap, where the counterparties have determined (based on basic parameters set by the Commission) that there is a sound theoretical basis and significant empirical support for such offset.[26]

Moreover, the Commission should modify the Proposed Margin Rules to allow operational netting of initial and variation margin transfers.[27] From an operational perspective, swap market participants currently view counterparty exposure on an aggregate basis. As a result, swap market participants often exchange a net amount of collateral, not separate amounts for variation and initial margin. We respectfully request that the Commission amend the Proposed Margin Rules to align with this current market best practice.

2. *Netting of Initial Margin Requirements between Cleared and Uncleared Swaps*

It is unclear whether the Proposed Margin Rules permit CSEs and their counterparties to net initial margin requirements between cleared and uncleared swaps.[28] Currently, master netting agreements allow counterparties to net exposures between cleared and uncleared swaps with the same counterparty or affiliated counterparties. For example, if a market participant enters into a cleared swap through a futures commission merchant (an "FCM") and then hedges that cleared swap with an uncleared swap with the FCM (or an affiliate of the FCM), the FCM or its affiliate might allow the market participant to reduce any initial margin required to be posted

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[24] Interest rate and foreign exchange positions may be offset.

[25] Proposed Margin Rule 23.155(c)(2)(iii).

[26] The Proposed Margin Rules do not define the term "asset class". We request that the Commission clarify what this term means.

[27] The Proposed Margin Rules are silent as to whether the operational netting of initial and variation margin transfers is permitted.

[28] Neither the requirements for initial margin models set forth in Proposed Margin Rule 23.155(b)(2) nor the Alternative Method expressly address whether parties may net initial margin requirements for cleared and uncleared swaps.

on the uncleared swap to the degree that the exposure under the uncleared swap was offset by the liquidation value of the cleared swap account.

> *Example*: A customer trades both cleared and uncleared swaps with an SD that is a registered FCM. The customer's cleared swap collateral account has a balance of $10,000. However, the aggregate requirement for initial margin with respect to the cleared swaps is $3,000, so the account holds $7,000 in excess margin. The SD estimates that, if it were to terminate the cleared swaps and liquidate the account assets to satisfy obligations to the derivatives clearing organization ("DCO"), the SD would return $5,000 to the customer as the "liquidation value" of the cleared swap account.
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> The customer seeks to execute an uncleared swap with the SD that has an associated initial margin of $2,000. In lieu of the customer delivering $2,000 (and having an aggregate of $12,000 on deposit with the SD), the SD might offset the initial margin amount due from the customer on the uncleared swap to the extent of the liquidation value of the cleared swap account. To accomplish this offset, the customer and the SD may enter into a netting agreement in which the customer grants to the SD a second-priority lien on the cleared swap account and the assets in that account. This lien provides the SD with recourse to the liquidation value should the customer default.[29]

It is important to note that under such an arrangement the FCM and, consequently, the DCO that clears the initial swap will always receive the entire initial margin amount[30] required under the

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[29] MFA is concerned that the Proposed Rules might make netting of cleared and uncleared swaps extremely difficult, if not impossible, if applied in conjunction with certain of the Commission's other proposed rules. In the Commission's proposed rules on the "Protection of Cleared Swaps Customer Contracts and Collateral: Confirming Amendments to the Commodity Broker Bankruptcy Provisions" (76 Fed. Reg. 33818 (Jun. 9, 2011), the Commission proposed to prohibit an FCM from imposing, or permitting the imposition of, a lien on collateral delivered by a counterparty to support a cleared swap. (*Id*. at 33833). Moreover, the FCM cannot use such collateral to margin, guarantee or secure the non-cleared swap contracts. (*Id.* describing proposed Commission Rule 22.2(d)). The problem this restriction creates is that it frustrates many cross-product netting agreements and many multi-lateral netting agreements. In these arrangements, a party might agree to netting on the basis that, if there were losses in one asset class (*e.g.*, non-cleared commodity options), it could have recourse to collateral for another asset class (*e.g.*, cleared interest rate swaps). Without this lien, it is very difficult, if not impossible, to allow either party recourse to collateral in a default situation.

The ability to net across cleared and uncleared swap positions depends on both: (i) the FCM's ability to lien the cleared swap account; and (ii) the margin regulations permitting a reduction in the delivery requirements because of such lien. If the margin requirements mandate a counterparty deliver margin regardless of the lien, then netting across cleared and uncleared swap position is frustrated. Thus, the Commission's final margin rules should contain an explicit provision that netting (against the assets in a cleared swap account) obviates a party's obligation to deliver initial margin with respect to uncleared swaps.

Should the FCM become insolvent, the lien on cleared swap account might impair an efficient porting of the cleared swap positions and related collateral. Buy-side firms understand this risk and often accept it for the immediate benefits afforded by netting cleared and uncleared positions.

[30] The relevant DCO would set the initial margin requirement for the cleared swap.

DCO's margin rules.[31] In fact, because a substantial portion of the swap market remains uncleared, we believe that allowing market participants to net cleared and uncleared margin requirements in the manner described above will lower the effective cost of, and promote a transition to, central clearing because it will allow market participants to net naturally offsetting exposures.[32] In addition, it will facilitate efficient margin practices when paired products (*e.g.*, single-name credit default swaps and index credit default swaps) migrate to central clearing at different times. Therefore, we suggest that Commission permit CSEs to consider both cleared and uncleared positions when determining the initial margin requirement for an uncleared swap.

3. Customer Consent to Netting of Pre-Effective Date Swaps

The Proposed Margin Rules provide that a CSE, at its option, may net variation margin for uncleared swaps it has with a financial entity so long as it applies the Commission's margin regulations with respect to all uncleared swaps, regardless of when such swaps were executed.[33] This option, if exercised, would result in the retroactive application of the Commission's requirements to swaps entered into before the effective date of the Commission's margin rules, which would cause the partial frustration of the economic terms of private contractual arrangements. This retroactive application, therefore, is a limitation on the use of netting, the benefits of which we have discussed above. To preserve these benefits of netting, the Commission should allow a CSE to elect to net variation margin associated only with uncleared swaps entered into after the effective date of the Commission's final margin rules. In the alternative, if the retroactive application of the Commission's margin rules is a necessary condition for the netting variation margin for uncleared swaps, then all stakeholders subject to the economic consequences of that retroactive application should have to consent to the election to net variation margin. Accordingly, the Commission's final rules should explicitly require the consent of a CSE's counterparty should the CSE wish to net variation margin at the cost of retroactive application of the Commission's margin rules. Otherwise, the Proposed Margin Rules will empower CSEs with the ability to make unilateral decisions that could materially and adversely affect buy-side firms.[34]

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[31] The netting arrangements never reduce a party's obligations with respect to cleared swaps; rather only that party's obligations with respect to its uncleared swaps are affected.

[32] Netting of cleared and uncleared swaps also saves both the FCM and the counterparty costs of supporting separate collateral arrangements. Under such an arrangement, the counterparty would be obligated to post full initial margin amounts on all cleared swaps as well as initial margin amounts on uncleared swaps to the extent that cleared swaps do not offset them.

[33] Propose Margin Rule 23.153(b)(5). We note that the Proposed Margin Rules are silent about netting initial margin among uncleared swaps entered into before and after the effective date of the Commission's final margin rules.

[34] Typically, counterparties will negotiate heavily for unilateral legal rights with respect to trading contracts. Unlike a negotiation where a party might grant a concession in return for benefit, if the Commission's margin rules require retroactive application of margin rules when a CSE elects to net margin, CSEs will have gained unilateral right without their counterparties receiving any consideration for such right.

E. Calculation of Initial and Variation Margin

The Commission should promote margin practices that are fair and understood by all market participants. Initial margin should be determined in a transparent way that allows both parties to a swap to determine independently the applicable margin for any swap. The ability of customers to replicate initial margin models enables them to anticipate how margin obligations might change of the life of the swap and how much they should hold in reserve. Such replicability is fundamental to conducting capital planning and underlies a customer's ability to devote its resources strategically to other investments or obligations.

The Proposed Margin Rules contemplate the use of models or reference methods of determining initial margin amounts; however, they do not mandate the use of one method or another. MFA believes that a CSE and its counterparty should negotiate the selection of a calculation tool that is best suited to them. We support the Commission in setting minimum standards for all tools for determining margin that promote fairness and transparency.

1. Initial Margin Calculations Under the Alternative Method

The Alternative Method in Proposed Margin Rule 23.155(c) would require CSEs to set initial margin requirements for other CSEs and for financial entities by using a comparative approach. That proposed rule would require CSEs to identify the cleared swap or future (if no comparable cleared swap exists) that "most closely approximates the terms and conditions of the uncleared swap."[35] Then, the CSE would use a multiplier of 2.0 for the identified cleared swap, or 4.4 for the comparable future, to determine the initial margin requirement for the uncleared swap.[36] The proposed multipliers assume that an uncleared swap is substantially less liquid than a comparable cleared swap and that the cleared and uncleared swaps are comparable. However, the fact that that one is liquid enough to facilitate clearing and the other is not indicates that the swaps may be so substantively different as to not be readily comparable. We question whether these assumptions hold true. For instance, there are classes of uncleared swaps that have a high degree of liquidity, notably many interest rate swaps. If a class of uncleared swaps remains liquid, it would be unnecessary to impose a margin requirement double that of a comparable cleared swap. Even after implementation of the mandatory clearing requirement, there will likely be varying degrees of liquidity across classes of swaps, and a multiplier of 2.0 or 4.4 will not properly reflect the risk posed by each class of swaps. Therefore, MFA requests that the Commission provide further discussion and analysis as to why the multipliers of 2.0 and 4.4 are appropriate.

We are also concerned that the Proposed Margin Rules do not provide an adequate solution for uncleared swaps that have no readily comparable cleared swap or future. The Commission does not explain the criteria for properly selecting a reference cleared swap or futures contract, and it does not provide guidance on how parties set initial margin if they cannot

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[35] Proposed Margin Rule 23.155(c)(1)(i).

[36] Proposed Margin Rule 23.155(c)(1)(iv).

find such reference cleared swap or futures contract.[37] We respectfully request the Commission clarify in its final rules for margin how parties should determine margin if the CSE does not use a model or cannot use the Alternative Method to determine the appropriate amount of margin.

To eliminate uncertainty about the utility of the Alternative Method, MFA recommends that the Commission adopt, as an additional alternative, a grid-based method similar to that set forth in Appendix A of the prudential regulators' proposed margin requirements, adjusted to allow offsets of initial margin and more granularity as to the appropriate level of initial margin for classes of swaps.[38] Ideally, initial margin determined under the grid-based method should closely match the actual market risk associated with the uncleared swap. Such a modified grid-based method would provide a simple and certain alternative to the use of initial margin models.

2. Equitable Treatment Under Initial Margin Models

Allowing CSEs to use proprietary models to determine initial margin requirements introduces a potential impediment to transparency because the counterparties of CSEs will not have insight into how a CSE establishes the initial margin requirements. Transparency in the use of a model to establish initial margin directly correlates to a buy-side firm's ability to replicate any determination of an amount of initial margin. The ability of a buy-side firm to replicate initial margin determinations is critical to that firm's capacity to anticipate and adjust to changes in its obligations. If swap market participants do not have the information necessary to predict with reasonable certainty potential changes in initial margin requirements, there are two possible outcomes. Under the first possible outcome, swap market participants would hold excess capital to account for an unanticipated initial margin change, which would necessarily limit swap market participants' ability to invest capital elsewhere or meet other cash flow needs. Under the second possible outcome, swap market participants would not hold additional capital in reserve and then an unanticipated change in an initial margin requirement could result in a series of defaults, which could have pro-cyclical effects if a class or multiple classes of participants have the same undisclosed margin models and are forced into closing or covering their positions all at the same time. Requiring transparency with respect to initial margin will allow a CSE's counterparties to model for and anticipate margin changes and to avoid these two outcomes.

Generally, initial margin models should be objective (*i.e.*, a model should arrive at the same initial margin amount for identical swaps regardless of the counterparty's identity or creditworthiness). CSEs might use a multiplier that is distinct from the base initial margin model to address any concerns about a counterparty's creditworthiness. We are concerned that, without legally required transparency: (i) CSEs will potentially alter their models to produce a more

[37] The ability to identify a reference swap for purposes of setting initial margin is another reason MFA recommends the Commission establish central clearing of swaps before imposing margin and capital requirements.

[38] The alternative grid-based method for initial margin requires CSE to determine initial margin amounts based on the characteristics of a swap such as duration and the underlying asset. The relevant characteristics are set forth in Appendix A to the Proposed Prudential Margin Rules.

MFA, in its comment letter filed on July 11, 2011 with the prudential regulators, recommended that the prudential regulators amend the alternative grid-based method to provide for the offset of initial margin amount and to provide for a more granular approach to the determination of initial margin amounts within asset classes.

favorable output when determining initial margin requirements for a particular counterparty or class of counterparties; and (ii) counterparties to CSEs will not have the information necessary to anticipate potential changes in initial margin requirements. Neither potential outcome is desirable. Therefore, MFA recommends that the Commission continue to allow CSEs to use their proprietary models to determine initial margin amounts, but require CSEs to make the basic functionality of their initial margin models available to and replicable by their counterparties.

In addition, we request that the Commission prohibit CSEs from varying their initial margin models based solely on the identity of their counterparties. For example, the Commission should not permit a CSE to use different initial margin models for swaps with other CSEs and swaps with financial entities. As mentioned above, CSEs might use a multiplier that is distinct from the base initial margin model to address any concerns about a counterparty's creditworthiness. We believe such a prohibition is necessary to prevent discriminatory distortions in the swap markets and eliminate unfair competitive advantages among market participants.

3. Ten-Day Liquidation Time Horizon for Initial Margin Determinations

Under the Proposed Margin Rules, a CSE's initial margin model is required to set initial margin at a level that covers at least 99% of price changes over at least a ten-day liquidation time horizon.[39] We understand that such requirements arguably must be equal to or greater than margin requirements for comparable cleared swaps,[40] and that proposed DCO margin requirements would require a five-day time horizon.[41] However, the Commission provides little explanation as to why a ten-day time horizon (*i.e.,* double the time horizon for cleared swaps) is appropriate. In part, the Commission may assume that an uncleared swap will be substantially less liquid than a comparable cleared swap, which, as discussed above in Section I.D.1., will likely not be the case prior to the implementation of the Dodd-Frank Act's mandatory clearing requirement, and may not be the case after the mandatory clearing requirement's implementation. Consequently, MFA requests that the Commission clarify why they selected a ten-day time horizon as the basis for their initial margin requirements.

4. Variation Margin Valuation

MFA recommends that the Commission's final margin rules allow parties to negotiate methods for determining variation amounts with little or no regulatory constraints. Proposed Margin Rule 23.156(b) requires that the valuation of each swap be determined in accordance with a method, to be agreed upon in applicable credit support documents, required under the Commission's Proposed Documentation Rule 23.504(b). Proposed Margin Rule 23.156(b)(2) requires that the valuation methodology used must be independently calculable by the Commission and any prudential regulator, and Proposed Margin Rule 23.156(c) appears to

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39 Proposed Margin Rule 23.155(b)(2)(vi).

40 Section 4s(e)(3)(A) of the Commodity Exchange Act states: "to offset the greater risk …arising from swaps that are not cleared, the [margin and capital] requirements imposed under paragraph (2) shall…"

41 *See* the proposing release for the Commission Proposed Risk Management Rules at 3704–05.

contemplate that specific, detailed methodology be provided for each transaction type in the underlying documentation. The Commission appears to be requiring pre-specified mathematical calculations with respect to a range of transaction types, which is not practicable for market participants to work into documentation for uncleared swap transactions.

As discussed in a prior comment letter to the Commission,[42] we recommend that the Commission not mandate that counterparties agree upon objective and alternative valuation methodologies in their swap documentation. We think that these requirements will not work in practice and we do not see an obvious regulatory or market benefit to imposing these requirements. Rather, we believe that the valuation of swap transactions needs to be flexible to adapt to new market information.

F. Clarification of Segregation Requirements

MFA supports and applauds the Commission's recognition of the value of segregation of customer assets, particularly with respect to initial margin.[43] The Proposed Margin Rules state that, "upon request of [a] financial entity . . . initial margin shall be held at a custodian".[44] However, the Proposed Margin Rules also state later that, "for each uncleared swap between a covered swap entity . . . [and] a financial entity, the covered swap entity shall enter into a tri-party custodial agreement with the counterparty".[45] We request that the Commission clarify that the Proposed Margin Rules do not require an independent third party custodian to hold the collateral posted on an uncleared swap between a CSE and a financial entity, even though the financial entity has the right to request such level of segregation.

III. Comments on Proposed Capital Rules

A. Capital Requirements Limiting Available Pool of Swap Dealers

The Commission's Proposed Capital Rules will affect the price at which CSEs will enter into uncleared swaps because SDs will likely pass through the capital costs associated with uncleared swaps. As customers of SDs, MFA's members are interested in the Commission's Proposed Capital Rules, even though the direct application of such capital requirements to its members is uncertain. In particular, capital requirements are of significance because they will determine the composition and breadth of the SD community by either becoming a "barrier to entry" for certain dealers or causing existing dealers to exit the market.[46] For buy-side firms, a

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42 *See* MFA's comments on the Proposed Documentation Rules filed with the Commission on April 11, 2011. Available at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=35513&SearchText=.

43 *See* MFA's comments on the Commission's proposed rule on "Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy", 75 Fed. Reg. 75,432 (Dec. 3, 2010) filed with the Commission on January 31, 2011. Available at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27450&SearchText=.

44 Proposed Margin Rule 23.153(a)(1).

45 Proposed Margin Rule 23.158(b)(1).

46 *See e.g.,* statement of Mr. Eric Chern, Chicago Trading Company at the Joint Commission-SEC Staff Roundtable Discussion on Proposed Dealer and Major Participant Definitions Under the Dodd-Frank Act at 110.

limited number or concentration of firms acting as SDs may impair competitive pricing and terms for tailored products. Moreover, a limited number of SDs will likely result in less negotiating power for customers as there will be fewer counterparties offering viable alternatives in both pricing and products. Thus, the Commission should ensure that the Proposed Capital Rules are not overly burdensome such that only the largest financial firms can or are willing to be SDs.

B. Reporting of Capital Requirements

Increasing transparency in the swap markets is a key goal of Title VII of the Dodd-Frank Act.[47] The Commission, under Proposed Capital Rule 23.106(i), would provide the public with certain financial information about CSEs and their compliance with the Commission's capital requirements. MFA supports this proposed rule. While counterparties can always negotiate for the delivery of additional financial information, the Proposed Capital Rules provide current and prospective counterparties to any CSE with some basic financial information with which the counterparty can evaluate or monitor a CSE and compare its relative financial strength with other counterparties. To maximize the usefulness of this financial information, the Commission should provide it to market participants on both a frequent and timely basis.

Moreover, we recommend that the Commission specifically report to the public if it receives notice from a CSE that its capital has fallen below 95% of the required amount.[48] The Commission should make such reports available to all market participants two weeks after the CSE's capital has fallen below 95% of the required amount and should disclose the period of time required by the CSE to rectify the shortfall. Such public disclosure will allow counterparties to CSEs to take appropriate measures if they believe the financial strength of a CSE is deteriorating, but allowing for a two-week lag in reporting will limit "run-on-the-bank" behavior.

C. Failure to Maintain Sufficient Capital

The Proposed Capital Rules do not require swap documents to contain a termination provision based upon a failure by a CSE to maintain adequate capital. Instead, in the Capital Proposing Release, the Commission reminded market participants that, under its Proposed Documentation Rules, the documents should merely contain provisions to address this event.[49] MFA agrees with this approach because we believe that it facilitates the ability of parties to negotiate termination events, but ultimately does not disadvantage one party.

Available at: http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission2_061611-trans.pdf.

[47] S. Rep. No. 111-176 at 32.

[48] Proposed Capital Rule 23.105(f) requires that CSEs report to the Commission that their capital is less than 110% of the required amount within 24 hours of the occurrence.

[49] Capital Proposing Release at 27813.

We support the Proposed Capital Rules allowing both netting arrangements and the delivery of collateral to reduce a CSE's overall capital requirement. The formula for the proposed "credit risk requirement", which is one component of a CSE's overall capital requirement, adequately reflects the benefits of netting and collateral delivery.[50] Netting and the delivery of collateral are important tools for the reduction of counterparty risk, and we appreciate the Commission recognizing these benefits as part of the capital requirements set forth in the Proposed Capital Rules.

In addition, we encourage the Commission to provide greater recognition of the benefit of netting by modifying the Proposed Capital Rules to allow CSEs to reduce their capital requirement by netting positions across several counterparties on a portfolio basis as well as across products. For example, if a CSE had exposure to counterparties through certain uncleared swaps, but also had offsetting liabilities to such counterparties under repurchase agreements, the CSE should not have to hold capital for the uncleared swap positions if its true counterparty exposure is fully offset. If CSEs receive full credit for robust netting arrangements, it will benefit their customers because SDs will be less inclined to pass through capital-based charges (or at least small charges) to their customers.

D. Capital Relief for Cleared Swaps

The Proposed Capital Rules do not require firms to maintain capital for cleared swaps.[51] Central clearing reduces counterparty credit risk associated with swaps because, with regard to CSEs, it is likely that their DCO counterparty will be more creditworthy than their current counterparties.[52] We believe that the Commission should reflect the lower risk associated with central clearing by ensuring that the capital charge for a CSE's cleared swap exposures is lower than any capital charge for equivalent uncleared swap exposures. A lower capital charge would appropriately lower the cost of central clearing for CSEs and, ultimately, their customers. We believe that creating such incentives to clear swaps will reduce systemic risk in swap markets.

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[50] Proposed Capital Rule 23.104(e). The credit risk requirement is a factor of how much counterparty credit risk a CSE has. This requirement is determined on a counterparty-by-counterparty basis, and in determining the credit risk requirement for any counterparty (other than insolvent one), the CSE must first determine a "counterparty credit equivalent amount". This amount is the sum of current and potential future exposure a CSE has to a given counterparty as result of unsecured swaps. The current exposure, however, is reduced to the extent of any offsetting positions under a netting agreement. Once the counterparty credit equivalent amount has been established, it is then reduced by the value of collateral that the CSE has collected from the counterparty. The remainder is then multiplied by a credit risk factor (a default of 0.5) and then 0.08 to arrive at the credit risk requirement

[51] The Proposed Capital Rules account for margin posted with respect to swaps, but do not afford separate capital treatment for cleared and uncleared swaps.

[52] *See* Darrell Duffie et al. *Policy Perspectives on OTC Derivatives Market Infrastructure*, Federal Reserve Bank of New York Staff Reports No. 424 (January 2010) at 4-5, Available at: https://gsbapps.stanford.edu/researchpapers/library/RP2046.pdf.

MFA appreciates the opportunity to comment on the Proposed Rules and respectfully submits these comments for the Commission's consideration. If the Commission or its staff has any questions, please do not hesitate to call Carlotta King or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President, Managing Director & General Counsel

cc: The Hon. Gary Gensler, Chairman
The Hon. Michael Dunn, Commissioner
The Hon. Bart Chilton, Commissioner
The Hon. Jill E. Sommers, Commissioner
The Hon. Scott D. O'Malia, Commissioner