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

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Via Electronic Submission: regs.comments@occ.treas.gov; regs.comments@federalreserve.gov; Comments@FDIC.gov; reg-comm@fca.gov; and RegComments@fhfa.gov

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Re: Reopening of Comment Period for Notice of Proposed Rulemaking on Margin and Capital Requirements for Covered Swap Entities RIN 1557-AD43; RIN 7100-AD74; RIN 3064-AD79; RIN 3052-AC69; and RIN 2590-AA45.

Ladies and Gentlemen:

Managed Funds Association[1] appreciates the opportunity to provide supplemental comments to the prudential regulators (the "**Prudential Regulators**")[2] in response to the

[1] Managed Funds Association ("**MFA**") represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent and fair capital markets. MFA, based in Washington, DC, is an advocacy, education and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and all other regions where MFA members are market participants.

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reopened comment period for their proposed rules on "Margin and Capital Requirements for Covered Swap Entities" (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 swaps markets and to incentivize central clearing of clearable swaps, including the imposition of appropriate risk-based margin requirements. In this spirit, we are providing supplemental comments on the Proposed Rules to reinforce and update a number of our key positions that we believe will assist the Prudential Regulators in promulgating final rules that balance the need to minimize risk with maintaining liquidity in the non-cleared swaps markets.

I. Margin and Capital Requirements Affect Buy-Side Firms

The Prudential Regulators' Proposed Rules will place obligations on swap dealers ("**SDs**") and major swap participants, referred to in the Proposing Release as "covered swap entities" ("**CSEs**"). Because the Proposed Rules will affect how CSEs trade non-cleared swaps and security-based swaps[5] with their customers, they will materially affect buy-side firms when entering into non-cleared swap transactions for hedging and investing purposes. MFA thus urges the Prudential Regulators to evaluate and consider the effects of its Proposed Rules on non-CSEs and the broader swaps markets.

In particular, the Prudential Regulators should ensure that the Proposed Rules allow for a well-functioning market for non-cleared swaps. MFA remains supportive of clearing for swaps. Nonetheless, even after central clearing of swaps has become commonplace, market participants will need a market for non-cleared and non-clearable swaps to meet their trading needs, including, for example, customized transactions that will not be clearing-eligible, but are needed to manage particular risks. We recognize that regulators expect margin regulation to broadly reduce unsecured counterparty credit risk and incentivize clearing.[6] The Proposed Rules also have the potential to bring consistency and transparency to such margin practices. We fully support these broad objectives. However, we believe that the Proposed Rules, while promoting the benefits of such broad objectives and encouraging market participants to clear their swaps,

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2 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.

3 Notice of Proposed Rulemaking on "Margin and Capital Requirements for Covered Swap Entities", 76 Fed. Reg. 27564 (May 11, 2011) (the "**Proposing Release**"); and Notice of Proposed Rulemaking on "Margin and Capital Requirements for Covered Swap Entities; Reopening of Comment Period", 77 Fed. Reg. 60057 (Oct. 2, 2012).

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

5 For ease of reference herein, the term "swap" or "swaps" should be construed to also include a security-based swap or security-based swaps, as applicable.

6 According to Secretary of the U.S. Treasury, Timothy Geithner, "imposing appropriate margin requirements on non-cleared 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.

should appropriately address the particular risks posed by the relevant non-cleared swap transaction. If the final margin requirements do not properly reflect such risks, we are very concerned that the markets for non-cleared swaps will become destabilized and lose their economic viability, thereby compromising the ability of market participants to manage risk effectively.

II. Supplemental Comments on Proposed Rules

MFA appreciates the reopening of the comment period for the Proposed Rules as an opportunity to supplement, update and refine a number of our prior positions in light of the proposals set forth in the joint consultative document of the Working Group on Margining Requirements ("**WGMR**") of the Basel Committee of Banking Supervision and the International Organization of Securities Commissions (the "**Basel-IOSCO Consultation Paper**").[7] MFA urges the Prudential Regulators to issue final margin requirements that promote a fair and stable global market for non-cleared swaps. For the reasons more fully discussed in our prior comment letter,[8] we continue to believe that sound regulation of margin delivered in connection with non-cleared swaps includes, at a minimum, the following attributes:

- consistency of margin requirements among regulators;
- coordinated implementation of margin rules with the availability of central clearing;
- parity among market participants in their obligations to deliver variation margin;
- approved use of legally enforceable netting arrangements to both abate counterparty credit risk and to minimize the costs and capital inefficiencies resulting from over-collateralization of correlated positions;
- transparent and equitable methods for determining margin amounts that both CSEs and their counterparties can use independently; and
- risk-based margin requirements that are appropriately tailored to address the risks posed by the relevant non-cleared swap transaction.

A. Uniformity of Regulation

MFA applauds the formation of the WGMR, and its resulting publication of the Basel-IOSCO Consultation Paper, to develop a unified international framework for margining non-cleared derivatives. Such international coordination is, in our view, essential for the efficient and effective functioning of the global swaps markets. More specifically, we strongly believe that an internationally uniform set of margin requirements will facilitate orderly collateral management

[7] Consultative Document on "Margin Requirements for Non-Centrally-Cleared Derivatives," July 2012.

[8] MFA Letter to the Prudential Regulators in response to the Proposed Rules, dated July 11, 2011, available at: http://www.fdic.gov/regulations/laws/federal/2011/11c55ad79.PDF.

practices and minimize regulatory arbitrage in the non-cleared swaps markets. We append our comment letter in response to the Basel-IOSCO Consultation Paper as Annex A to this letter. We respectfully urge the Prudential Regulators to consider our comments and recommendations to the WGMR in finalizing the Proposed Rules.

B. Coordinated Implementation of Margin Rules with a Single Compliance Date for all Market Participants

MFA recommends that the Prudential Regulators' final margin rules for non-cleared swaps (the "**Final Margin Rules**") should apply: (1) to all market participants at the same time; (2) only after the central counterparties ("**CCPs**") and other market participants have implemented a working central clearing infrastructure; and (3) the relevant regulators have adopted the regulatory framework needed to implement the Dodd-Frank Act's mandatory clearing requirements for swaps and security-based swaps. We endorse an implementation plan that is simple and predictable for all market participants with a single compliance date of one year from the publication date of the Final Margin Rules in the *Federal Register*. We believe that this compliance period would reduce systemic risk by facilitating and motivating the industry's transition to clearing. We also believe that this compliance period would address and mitigate the expected spike in market demand for eligible collateral to secure non-cleared swaps by providing CSEs with sufficient time to adapt existing initial margin models to the new model requirements, to achieve the intended model benefits of netting and risk offsets on a portfolio basis, and to secure the requisite regulatory approvals for such models.

As a threshold matter, MFA strongly believes that the margin requirements for non-cleared swaps should not be phased-in by type of counterparty at staggered intervals, as proposed by the Commodity Futures Trading Commission ("**CFTC**"). We understand that there were logistical and operational factors supporting a phased implementation plan for the clearing mandate for different categories of market participants,[9] but we do not believe that those factors apply with respect to initial margin levels for non-cleared swaps. We believe that the Prudential Regulators would not achieve any public policy benefit by implementing the Final Margin Rules with respect to a certain type of swap or asset class on one category of market participants before another category of market participants. Such an implementation approach would in fact distort pricing and competition across the marketplace, forcing certain counterparties to pay higher margin amounts before other counterparties with longer phase-in schedules. We see no justification from a cost-benefit perspective to impose disparate and prejudicial cost burdens on different categories of market participants.

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[9] *See* MFA's comments on the CFTC's Notice of Proposed Rulemakings on "Swap Transaction Compliance and Implementation Schedule: Clearing and Trade Execution Requirements under Section 2(h) of the CEA", 76 Fed. Reg. 58186 (Sept. 20, 2011) and on "Swap Transaction Compliance and Implementation Schedule: Trading Documentation and Margining Requirements Under Section 4s of the CEA", 76 Fed. Reg. 58176 (Sept. 20, 2011) filed with the CFTC on November 4, 2011, available at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=.

Accordingly, our overarching implementation recommendation is that there should be one Final Margin Rules compliance date for all relevant market participants after a reasonable compliance period. We believe a compliance date of one year would provide a reasonably sufficient period of time for: (1) the Securities and Exchange Commission to finalize its clearing rulemakings for security-based swaps; (2) the clearinghouses to make clearing available for products in their clearing pipelines; (3) the dealers to adapt their existing initial margin models to account for the new model requirements, and to secure regulatory approvals for these models; and (4) the industry as a whole to better understand the scope of products that can and will be cleared, and the scope of products that will remain in the non-cleared markets. This better understanding will inform business and trading decisions by all market participants, and will give them the time they need to safely and soundly clear their sufficiently liquid and standardized swaps, and to prepare for the full impact of higher margin requirements for their non-cleared swaps. As indicated above, such an approach will also mitigate the risk of a marketwide collateral "crunch" that could result if participants did not have sufficient time to adapt to both new margin requirements associated with mandatory clearing and a rapid introduction of higher non-cleared swap margin requirements.

C. Mandatory Bilateral Exchange of Variation Margin

The Proposed Rules require CSEs to collect but not post (*i.e.*, pay) variation margin when they enter into swaps with counterparties that are financial entities.[10] The Prudential Regulators previously requested comment as to whether the Proposed Rules should require CSEs to both collect and post variation margin with regard to swaps that they enter with financial entity counterparties.[11] MFA continues strongly to encourage such requirements, because such bilateral exchange of variation margin is crucial to the proper functioning of the swaps markets and abatement of counterparty and systemic risk therein. We note that the need for this requirement is even more compelling to achieve international uniformity with the WGMR's proposal for universal two-way exchange of variation margin.[12]

Lacking a regulatory requirement for two-way posting would create a presumption on the part of CSEs that their variation margin posting is neither necessary nor important for prudent risk management. This presumption would be directly contrary to derivatives reform goals of ensuring that the risks of derivatives are appropriately internalized by each derivatives market participant. The absence of a mandate for two-way posting would represent a step back from current market "best practice" of variation margin exchange by both parties, would potentially significantly increase systemic risk, and would lead to a loss of transparency for the Prudential Regulators into an observable measure of a CSE's gains and losses by virtue of the daily discipline of two-way variation margin exchange.

[10] Proposed Rule 4(a).

[11] Proposing Release at 27577 (Questions 44 through 52).

[12] Basel-IOSCO Consultation Paper at p. 14.

1. Current Widespread Best Practice

A wide range of market participants currently exchange variation margin bilaterally for non-cleared swaps,[13] and buy-side firms largely have adopted this sound market practice as "best practice" for collateral management. Bilateral margin arrangements among 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. Bilateral margin exchange further ensures that both parties continuously reconcile their views on the price of their open positions, avoiding disputes particularly in dislocation periods. As fiduciaries, buy-side firms are responsible for protecting 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 Prudential Regulators would not be imposing a material incremental burden or a change from "best practice" for CSEs if they require 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 entities such as AIG were "too interconnected to fail" and "too big to fail."[14] 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 systemic risk reducing benefits, the Prudential Regulators should further their mission to ensure the soundness of all market participants,[15] including CSEs, by requiring CSEs

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

[14] 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".

[15] Section 731 of the Dodd-Frank Act provides a new Section 4s(e)(3) to the Commodity Exchange Act, which section instructs regulators, including the Prudential Regulators, to set capital and margin requirements "[t]o offset the greater risk to the swap dealer or major swap participant *and the financial system* arising from the use of swaps that are not cleared" (emphasis added).

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 non-cleared swap transactions, the Prudential Regulators prevent the possibility of a CSE's 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 Prudential Regulators codify the "best practice" of bilateral exchange of variation margin.

3. *Increased Transparency*

Bilateral exchange of variation margin will increase the transparency of the swaps markets, which is a key goal of the Dodd-Frank Act.[16] 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 regulators to gauge counterparty credit quality. Critically, such transparency would be advantageous to regulators evaluating and monitoring systemic risk since the CFTC and the Prudential Regulators will be notified by CSEs when substantial collateral disputes occur.[17] We believe that 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 regulators in turn to intervene promptly and thus limit the degree to which a default by a CSE could impact the U.S. financial system.

Daily variation margin exchange would enable Prudential Regulators to detect earlier a CSE's financial troubles that would otherwise go undetected if a CSE was not required to post

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

[17] The CFTC has adopted final rules with respect to the documentation of swap transactions that would require CSEs to "promptly notify the CFTC and any applicable prudential regulator, or with regard to swaps defined in section 1a(47)(A)(v) of the Act, the [CFTC, SEC], and any applicable prudential regulator, of any swap valuation dispute in excess of $20,000,000 (or its equivalent in any other currency) if not resolved within: (1) Three (3) business days, if the dispute is with a counterparty that is a [SD/MSP]; or (2) Five (5) business days, if the dispute is with a counterparty that is not a [SD/MSP]." *See* CFTC final rule §23.502(c) in "Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants", 77 Fed. Reg. 55904, 55963 (Sept. 11, 2012) (the "**CFTC Final Documentation Rules**").

variation margin, and acts as a limiting factor on the total amount of exposure a CSE can take. Otherwise, a CSE could mask its losses or hide the amount of its unsecured obligations to its swap counterparties if it had no requirement to post variation margin, and could potentially increase its exposures beyond the level its capital can support. We respectfully reiterate our view that this transparency to Prudential Regulators and their counterparties would better serve the public policy objectives of (1) enhancing the safety and soundness of banks; and (2) promoting financial stability.

D. Netting and Portfolio Margining Under the Proposed Rules

MFA appreciates that the Proposed Rules clearly permit initial margin models to account for risk on a portfolio basis, specifically accounting for risk offsets within four broad risk categories of swaps that are subject to the same qualifying master netting agreement.[18] 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 Rules allow swaps market participants to continue current "best practices" with regard to the collateralization of non-cleared swaps.

MFA urges the Prudential Regulators to consider our accompanying letter that more fully discusses the benefits and legal analysis supporting the continued use of cross-product portfolio margining arrangements by market participants. Such arrangements allow portfolio margining across suitably correlated cleared and non-cleared swaps and non-derivative products in a buy-side firm's portfolio that are subject to a cross-product master netting agreement. As our accompanying letter demonstrates, such arrangements account adequately for risks of a portfolio, while avoiding the capital inefficiencies of over-collateralization. We attach our accompanying letter at Annex B hereto.

E. Transparency and Equitable Treatment Under Initial Margin Models

MFA continues to urge the Prudential Regulators to adopt final 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. The ability of customers to replicate initial margin models enables them to anticipate how margin might change over 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 or inability to devote its resources strategically to other investments or obligations.

The Proposed 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 Prudential Regulators in setting minimum standards for all tools for determining margin that promote fairness and transparency.

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[18] *See* Proposed Rules §__.8(b)(1) and §__.8(d)(3) at 27590.

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 swaps 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 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 Prudential Regulators 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 Prudential Regulators prohibit CSEs from varying their initial margin models based solely on the identity of their counterparties. For example, the Prudential Regulators 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 that such a prohibition on varying initial models by counterparty is necessary to provide proper transparency into initial margin calculations for market participants to ensure that initial margin amounts are not arbitrarily high, and to prevent discriminatory practices in the swaps markets.

F. Margin Requirements Should be Risk-Based and Appropriately Tailored to the Relevant Non-Cleared Swap Transaction

Given the importance of certain non-cleared swaps as customized risk management tools, we respectfully urge the Prudential Regulators to set non-cleared margin levels in such a way that they appropriately address the particular risks posed by the relevant non-cleared swap transaction.

1. Improving the Grid-Based Method

As proposed, the Grid-Based Method set forth in Proposed Rule 8(a) is a non-granular approach to the determination of initial margin. While we appreciate the simplicity and predictability provided by the Grid-Based Method, we are concerned that the Grid-Based Method does not properly account for the diversity of products in the swaps markets and the risk characteristics of such products. For example, the proposed Grid-Based Method has a single category for equity swaps, which would place a call option on a highly liquid equity security in the same category as a total return swap on an illiquid security. In this example, the equity option and the total return swap would each be subject to an initial margin requirement of at least 10% of notional exposure, a high initial margin requirement for the equity option (given the payment of premium and lack of continuing credit exposure), but a potentially appropriate initial margin requirement for the total return swap. As a result, we request that the Prudential Regulators revise the Grid-Based Method to properly account for the variety of swaps by: (i) increasing the number of subcategories in the asset classes and assigning appropriate initial margin ranges to such subcategories; (ii) lowering the initial margin floor on the broader asset classes to allow counterparties to account for lower risk positions;[19] or (iii) a combination of (i) and (ii).

We have included as Annex C to this letter a proposed sample of an initial margin grid that provides some additional specificity.[20] The sample initial margin grid annexed hereto is not an exhaustive revision and does not propose to address all concerns relating to the Grid-Based Method, but seeks to enhance the usefulness and reliability of the Grid-Based Method for non-cleared derivatives with embedded optionality, as described below. We offer our sample initial margin grid to assist the Prudential Regulators in refining and improving the Grid-Based Method in their Final Margin Rules.

More specifically, where the buyer and seller have asymmetric risk/reward profiles under products with embedded optionality, such as CDS, the margin requirements for those products should be more granular to avoid over-posting or under-posting of initial margin. More granularity would be consistent with existing market practice that reflects differences in the risk profile between the party acquiring protection from the debtor's default under the terms of a CDS, for example, and the party providing protection. In the case of a CDS transaction, the risk profile of the protection buyer is lower than the risk profile of the seller given the seller's contingent payout obligation if a credit event is triggered. The prospective default of a buyer therefore presents a lower systemic risk than the prospective default of a seller, and a buyer

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[19] MFA believes that the upper limits of the proposed initial margin ranges under the Grid-Based Method are appropriate, but the lower limits do not allow CSEs to assign appropriate initial margin requirements for certain lower risk positions.

[20] MFA also included the same sample initial margin grid or schedule to the WGMR in response to the Basel-IOSCO Consultation Paper, because the proposed initial margin schedule in Appendix A thereto similarly lacked sufficient specificity.

should accordingly be subject to lower margin requirements. For example, the buyer of a CDS should be subject to an initial margin requirement which is a lower proportion of the notional exposure compared to the seller, while the seller should be subject to an initial margin requirement that is a higher proportion of the notional exposure. MFA therefore recommends that, where appropriate, the Grid-Based Method should differentiate between the risk profiles of parties buying protection under a derivative contract (lower risk) and parties selling such protection (higher risk).

With our suggested improvements, we believe the utility of the Grid-Based Method would be greatly enhanced for market participants. With respect to the proposed discounts or haircuts on the value of eligible collateral as set forth in Appendix B to the Proposed Rules, we applaud the Prudential Regulators' decision not to apply them to the cash collateral described in paragraph (a)(1) of Proposed Rule 6(a). Such discounts would apply only to the eligible collateral described in paragraphs (a)(2) and (a)(3).[21] Thus, cash collateral denominated either in U.S. dollars or in the currency in which payment obligations under the relevant non-cleared swap are required to be settled would retain 100% of its value. We note by contrast that the WGMR's Basel-IOSCO Consultation Paper recommended an 8% haircut for eligible collateral in the form of "cash in different currency". We respectfully submit that an 8% haircut is unwarranted for cash and does not clearly or directly correspond to actual foreign exchange risk.[22]

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

Under the Proposed 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.[23] We understand the rationale for maintaining such requirements at a level equal to or greater than margin requirements for comparable cleared swaps,[24] and recognize that the CFTC's final DCO initial margin requirements for most swaps require a minimum five-day time horizon that the CFTC subsequently could choose to shorten.[25] However, the current Proposed Rules provide little support for applying a blanket ten-day time horizon (*i.e.*, double the time horizon for cleared swaps) versus a more risk-specific approach. In part, the Prudential Regulators may assume that a non-cleared swap will be substantially less liquid than a comparable cleared swap, but, as discussed above, this will likely not be the case prior to the implementation of the Dodd-

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21 The eligible collateral in Proposed Rule 6(a)(2) would include: "Any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, the United States". The eligible collateral with respect to initial margin only in Proposed Rule 6(a)(3) would include: "(i) Any senior debt obligation of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Federal Home Loan Banks and the Federal Agricultural Mortgage Corporation; and (ii) Any obligation that is an 'insured obligation,' as that term is defined in 12 U.S.C. 2277a(3), of a Farm Credit System bank."

22 *See* Appendix B to Basel-IOSCO Consultation Paper at p. 33.

23 Proposed Rule 8(d)(1).

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

25 *See* CFTC Final Rule on "Derivatives Clearing Organization General Provisions and Core Principles", 76 Fed. Reg. 69334 (Nov. 8, 2011) at 69438, §39.13(g)(2)(ii).

Frank Act's mandatory clearing requirement, and may not be the case after the mandatory clearing requirement's implementation. Consequently, MFA respectfully requests that the Prudential Regulators reassess the selection of a blanket ten-day time horizon as the basis for their initial margin requirements.

In our experience, current market practice with respect to many asset classes of non-cleared swaps results in a liquidation time horizon that is shorter than ten days. It is market practice[26] to obtain one or more market quotations in order to terminate a non-cleared swap position, which position is then liquidated using that valuation. Under market standard bilateral contractual arrangements, where market quotations cannot be obtained, it is possible to use a mark obtained from an alternative pricing source, such as derived from a pre-agreed model. As such market practice allows for simple liquidation rather than requiring a replacement transaction, liquidating a position in a non-cleared swap based on the mark obtained may be completed relatively quickly, without material delay. Although the non-cleared swaps markets may be less liquid in certain cases, as liquidation is permitted on a payment basis without the need to ensure a replacement transaction, it does not necessarily follow that liquidation of a position taken in a non-cleared swap will require more time than liquidating a position in a cleared swap. Thus, the blanket ten-day liquidation time horizon may prove to be inaccurate or unjustified. MFA therefore respectfully requests that the Prudential Regulators reconsider the appropriateness of the ten-day liquidation time horizon in light of current market practice regarding the liquidation of non-cleared swaps. The final framework for margining non-cleared swaps should allow for flexibility in setting the appropriate liquidation time horizon by product type or asset class, and provide for further adjustment of the baseline liquidity horizon over time as the non-cleared swaps markets evolve.

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[26] As set out in the the market standard ISDA documentation for non-cleared swaps.

MFA appreciates the opportunity to comment on the Proposed Rules during the reopened comment period and respectfully submits these supplemental comments for the Prudential Regulators' consideration. If the Prudential Regulators or their staffs have any questions, please do not hesitate to call Laura Harper, Assistant General Counsel, or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

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

Annex A
MFA Letter Filed in Response to the Basel-IOSCO Consultation Paper

September 28, 2012

Via Electronic Submission: baselcommittee@bis.org
wgmr@iosco.org

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

International Organization of Securities Commissions
C/ Oquendo 12
28006 Madrid
Spain

Re: Basel-IOSCO Consultative Document on Margin Requirements for Non-Centrally-Cleared Derivatives

Dear Sir or Madam:

Managed Funds Association[1] welcomes the opportunity to provide comments to the Working Group on Margining Requirements of the Basel Committee of Banking Supervision and the International Organization of Securities Commissions ("**WGMR**") in response to its Consultative Document on "Margin Requirements for Non-Centrally-Cleared Derivatives" (the "**Consultation Paper**").[2] MFA strongly supports the efforts by the WGMR to provide for an international framework for measures to reduce risk in the derivatives markets. Indeed, MFA commends the commitment of the WGMR to establish a single unified framework that will provide a global standard for margining non-centrally-cleared derivative contracts ("**non-cleared derivatives**"). Accordingly, in providing comments to the Consultation Paper, MFA seeks to assist with the development of an effective, appropriate and consistent international regime for margin requirements for non-cleared derivatives.

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[1] Managed Funds Association ("**MFA**") represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent and fair capital markets. MFA, based in Washington, DC, is an advocacy, education and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and all other regions where MFA members are market participants.

[2] The Consultation Paper is available at: www.bis.org/publ/bcbs226.pdf.

Non-cleared derivatives provide an important, and at times the only practically available, mechanism for market participants to manage risk effectively. While MFA supports the transition of standardized derivatives to clearing, we appreciate that the WGMR recognizes that central clearing will not be suitable for all derivatives, and that market participants will therefore continue to use certain non-cleared derivatives to address specific risk scenarios on a bespoke basis. In light of the importance of the risk management function of non-cleared derivatives, MFA members welcome the initiative to establish a margin requirements framework for non-cleared derivatives that ensures that the margin requirements applied to non-cleared derivative transactions appropriately reflect and address the risks to the financial system presented by such transactions.

I. Executive Summary: Overarching Comments on the Margin Proposals in the Consultation Paper

MFA supports the efforts of the WGMR to provide for an international framework for bilateral exchange of initial and variation margin. MFA particularly supports the requirement to exchange variation margin on a bilateral basis, which reflects and reinforces the current market "best practice". However, MFA respectfully urges the WGMR to consider the cumulative effect of the Consultation Paper's further proposals on the liquidity of the non-cleared derivatives markets. The proposals should not unduly impinge on market participants' ability to transact on the non-cleared derivatives markets, given their critical role in allowing market participants to meet their risk management needs. Unless carefully managed and monitored, the aggregate impact of the proposals could place unwarranted burdens on market participants, particularly in the period before the market has transitioned to mandatory clearing. Thus, MFA respectfully urges the WGMR in the final recommendations to take into consideration the risk management needs of participants in the non-cleared derivatives markets and to avoid recommendations that could compromise their ability to manage risk effectively. Further, MFA looks forward to the results of the quantitative impact study to assess the effect of the proposed margining requirements on the orderly functioning and liquidity of the non-cleared derivatives markets, and urges the WGMR to consider the results of the study when finalizing the proposals.[3]

In light of our overarching concerns, and more specifically as set out below, we respectfully urge the WGMR in the final recommendations to take into consideration the importance and continued viability of certain non-cleared derivatives as customized risk management tools.

Initial margin. MFA supports the bilateral exchange of initial margin, provided that the initial margin requirements appropriately reflect and address the risks to the financial system presented by the relevant non-cleared derivative transaction. However, we are concerned that buy-side market participants will bear their sell-side counterparties' costs associated with negotiating, establishing and maintaining segregated custodian accounts for counterparties. We are also concerned that the increased cost of trading non-cleared derivatives could reduce liquidity and adversely impact market participants' ability to properly hedge their portfolios. We

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[3] *Id.* at 31.

therefore respectfully request that the WGMR's final recommendations consider the overall cost and liquidity impact of the proposed margining requirements.

Portfolio margining. MFA strongly supports the proposal to allow quantitative initial margin models to account for risk on a portfolio basis. For portfolio margining to achieve the intended risk offset benefits, initial margin models should account for risk offsets across suitably correlated cleared and non-cleared derivative and non-derivative products. MFA strongly believes that such portfolio margining within a single cross-product master netting agreement is instrumental in mitigating the potential shortfall in eligible collateral while still ensuring sufficient reserves to preserve systemic safety. Such portfolio margining arrangements account adequately for the risks of a portfolio, while avoiding the capital inefficiencies of over-collateralization. In addition, such portfolio margining arrangements encourage market participants to enter into mutually offsetting transactions, and to maintain balanced and appropriately hedged portfolios.

Margin thresholds. MFA does not believe that thresholds are an appropriate tool for managing the liquidity impact of the proposed initial margin requirements. We are concerned that the introduction of thresholds would result in counterparties being treated unequally, with some counterparties being required to post no initial margin, or a significantly reduced amount after application of a high threshold.

IM schedule. MFA welcomes the proposed option for market participants to choose between using an approved initial margin model or a standardized initial margin schedule. We include a proposed amended sample schedule introducing greater granularity to the initial margin requirements applicable to different asset classes. Such granularity would enhance the utility of the initial margin schedule to market participants.

Ongoing review of requirements. We believe that both the cleared and the non-cleared derivatives markets will undergo substantial evolution over the coming years. Accordingly, we recommend that the WGMR plan for a regular review and, when appropriate, periodic adjustment, of the international standards for margin requirements in response to developments in the non-cleared derivatives markets.

II. Uniformity of Regulation

MFA believes, as a general matter, that the derivatives markets operate most efficiently where the margin requirements are harmonized and applied uniformly with respect to all non-cleared derivatives. A uniform set of margin requirements will facilitate orderly collateral management practices. In the absence of such uniformity, market participants, including MFA members, will have to monitor and comply with multiple margin regimes, which would be administratively difficult, costly and burdensome, and may increase the likelihood for errors and instances of non-compliance. Further, margin requirements that differ according to the jurisdiction encourage regulatory arbitrage and create market advantages for market participants established in certain jurisdictions over other market participants. Accordingly, we urge regulators across jurisdictions to coordinate with each other in order to ensure a uniform set of margin requirements in non-cleared derivatives markets.

III. MFA Responses to the Consultation Paper Questions

Implementation

Q1. What is an appropriate phase-in period for the implementation of margining requirements on non-centrally-cleared derivatives? Can the implementation timeline be set independently from other related regulatory initiatives (e.g. central clearing mandates) or should they be coordinated? If coordination is desirable, how should this be achieved?

MFA believes that the implementation of the margin requirements should be coordinated with the implementation of the central clearing requirements to ensure that the higher margin requirements applicable to non-cleared derivatives do not apply before central clearing is required. MFA also believes that non-cleared margin levels should appropriately address the particular risks posed by the relevant non-cleared derivative transaction. Further, with respect to the appropriate implementation timeline, the final margin requirements for non-cleared derivatives should be implemented only after mandatory clearing is fully phased in for a particular class of derivatives, and should then apply to all relevant categories of market participants simultaneously. Application of the margin requirements for non-cleared derivatives before central clearing is required and the requisite central clearing infrastructure is in place could penalize market participants for dealing in non-cleared derivatives without central clearing being available. Similarly, inconsistent implementation of the margin requirements in different jurisdictions, or within jurisdictions by different regulatory authorities, might fragment and unnecessarily disrupt the operation of the markets in non-cleared derivatives.

Element 1: Instruments subject to the margin requirements

Q2. Should foreign exchange swaps and forwards with a maturity of less than a specified tenor such as one month or one year be exempted from margining requirements due to their risk profile, market infrastructure, or other factors? Are there any other arguments to support an exemption for foreign exchange swaps and forwards?

Subject to the modified application of the prescriptive initial margin model requirements, as discussed below, MFA believes that foreign exchange swaps and forwards, regardless of their maturity, should be subject to margining requirements. However, such margining requirements should be set at appropriate levels that take into consideration the unique liquidity characteristics of foreign exchange swaps and forwards as compared to other non-cleared derivatives. In MFA's view, while the risk profile of foreign exchange swaps and forwards may merit their exemption from the central clearing requirement, the counterparty credit risk associated with non-cleared foreign exchange swaps and forwards should nevertheless be effectively addressed by requiring the bilateral exchange of margin.

However, as certain non-cleared foreign exchange swaps and forwards, such as foreign exchange swaps or forwards on the currencies of the G7 countries, are highly liquid, it would not be appropriate to apply all of the prescriptive initial margin model requirements to them. For example, a ten-day liquidation horizon would be manifestly inappropriate in relation to a short-term (*e.g.*, 30-day tenor) U.S. dollar/Euro foreign exchange forward. MFA therefore recommends that the initial margin requirements applicable to foreign exchange swaps and forwards be subject to the same liquidation time horizon as cleared derivatives, or lower, as appropriate.

Element 2: Applicability of margin requirements to different types of market participant

Q4. Is the proposed key principle and proposed requirement for scope of applicability appropriate? Does it appropriately balance the policy goals of reducing systemic risk, promoting central clearing, and limiting liquidity impact? Are there any specific adjustments that would more appropriately balance these goals? Does the proposal pose or exacerbate systemic risks? Are there any logistical or operational considerations that would make the proposal problematic or unworkable?

MFA supports the principle set out in the Consultation Paper that market participants that are financial firms, regardless of their type, size or systemic importance, as well as systemically important non-financial entities, be required to post initial and variation margin to secure their non-cleared derivative trades. MFA believes that if the initial and variation margin required is appropriately calculated and calibrated to reflect the risk profile of a particular non-cleared derivative trade, posting bilateral margin is an appropriate and effective tool to manage and reduce systemic risk. However, MFA believes that it is important to ensure that the margin requirements applicable to non-cleared derivatives appropriately reflect the risks presented by non-cleared derivatives to the markets. Such non-cleared margin levels should allow for the proper operation of the markets in those derivatives which are not suitable for central clearing and should not impair their liquidity.

Q5. Are initial margin thresholds an appropriate tool for managing the liquidity impact of the proposed requirements? What level of initial margin threshold(s) would be effective in managing liquidity costs while, at the same time, not resulting in an unacceptable level of systemic risk or inconsistency with central clearing mandates? Is the use of thresholds inconsistent with the underlying goals of the margin requirements? Would the use of thresholds result in a significant amount of regulatory arbitrage or avoidance? If so, are there steps that can be taken to prevent or limit this possibility?

Q6. Is it appropriate for initial margin thresholds to differ across entities that are subject to the requirements? If so, what specific triggers would be used to determine if a smaller or zero threshold should apply to certain parties to a non-centrally-cleared derivative? Would the use of thresholds result in an unlevel playing field among market participants? Should the systemic risk posed by an entity be considered a primary factor? What other factors should also be considered? Can an entity's systemic risk level be meaningfully measured in a transparent fashion? Can systemic risk be measured or proxied by an entity's status in certain regulatory schemes, e.g. G-SIFIs, or by the level of an entity's non-centrally-cleared derivatives activities? Could data on an entity's derivative activities (e.g. notional amounts outstanding) be used to effectively determine an entity's systemic risk level?

MFA strongly supports the equal treatment of market participants with respect to the appropriate margining requirements. As we view initial margin thresholds as unsecured credit extensions, we believe there is a risk of unequal treatment resulting in select counterparties not collecting any initial margin, or significantly reduced amounts of initial margin, with respect to certain of their counterparties. This unequal treatment would create or exacerbate existing market asymmetries to the detriment of buy-side firms, including MFA members, and undermine the systemic risk reduction benefits of a truly universal requirement to exchange initial margin on a bilateral basis. We believe that bilateral initial margin exchange requirements should be applied consistently, subject to appropriate minimum transfer amounts ("**MTAs**"), rather than optional thresholds that would vary by type of counterparty. Indeed, it is current market practice to use MTAs to improve the operational efficacy of variation margin exchange. Thus, the use of MTAs for both initial and variation margin exchange would not result in a significant deviation from current market practice.

Q9. What are the potential practical effects of requiring universal two-way margin on the capital and liquidity position, or the financial health generally, of market participants, such as key market participants, prudentially-regulated entities and non-prudentially regulated entities? How would universal two-way margining alter current market practices and conventions with respect to collateralising credit exposures arising from OTC derivatives? Are there practical or operational issues with respect to universal two-way margining?

Current market practice. MFA welcomes the requirement for bilateral exchange of initial and variation margin in non-cleared derivatives transactions, provided that the margin requirements appropriately reflect the relevant risks associated with a particular derivative transaction. We applaud the WGMR for proposing universal two-way exchange of variation margin. In MFA's view, this requirement not only represents "best practice," but actually represents what has become standard practice, as a broad spectrum of market participants, including MFA members, currently exchange variation margin bilaterally for non-cleared derivatives. Bilateral variation margin exchange permits market participants to eliminate substantial counterparty credit risk by daily liquidating their obligations to each other arising through daily price variation of their bilateral contracts. In light of the substantial risk management benefits that the collection of variation margin offers, market participants in derivatives markets have historically exchanged bilateral variation margin and typically have in place efficient contractual arrangements and extensive operational infrastructure for such bilateral variation margin exchange. In addition, all market participants post variation margin to clearing houses when trading centrally cleared derivatives. The requirement to post bilateral variation margin for non-cleared derivatives therefore ensures such practice is consistently applied to both cleared and non-cleared derivatives. This requirement thus facilitates a more seamless transition as non-cleared derivatives that become clearing-eligible move to mandatory clearing.

Mandatory two-way exchange of variation margin reduces systemic and counterparty risk by preventing both regulated and unregulated market participants from accumulating an unlimited amount of unsecured obligations to their derivative counterparties. We believe that not requiring bilateral exchange of variation margin for non-cleared derivatives would be regressive in light of current market practice, could adversely affect market participants' counterparty and systemic risk management, and could distort the incentives for central clearing of derivatives.

We believe that the arguments above for the bilateral exchange of variation margin apply equally to the bilateral exchange of initial margin. However, if the proposals result in materially higher initial margin requirements than under current market practice, this may severely limit the ability of market counterparties to transact in the non-cleared derivatives markets. Although it is current market practice for buy-side firms to post initial and variation margin to their counterparties, it is likely that buy-side firms will bear the bulk of the cost increases attributable to higher margin requirements and related operational costs across the market. In addition to the aggregate increase in their own trading costs, buy-side firms may also incur increased costs through adverse pricing as sell-side firms seek to pass on to their counterparties not only their increased margin and capital expenses, but also the significant costs associated with negotiating, establishing and maintaining thousands of segregated custodian accounts for counterparties as a result of the proposed initial margin requirements. In the aggregate such increased trading costs may be material and, if excessive, could limit access to the derivatives markets and therefore result in the non-cleared derivatives markets losing liquidity and depth. We therefore respectfully request that WGMR's final recommendations regarding the initial margin requirements take into account the overall cost and liquidity impact of the proposed margining requirements on buy-side firms.

Restrictions on market liquidity. Further, MFA is concerned that the universal two-way initial margin proposals may have the unintended consequence of limiting some existing sources of market liquidity. As bank/dealer counterparties do not currently post initial margin, the introduction of the new requirements to provide initial margin is likely to result in greater operational complexity and expense for those counterparties than is currently the case. This result may act as a disincentive for bank/dealer counterparties to enter into transactions that require more operational and capital resources. For example, in the case of the market for credit default swaps ("**CDS**"), most of the liquidity in the market is provided through novation of positions, and such novations are often entered into by two bank/dealer counterparties. Typically, when a CDS portfolio between original counterparties ("**Remaining Party**" and "**Party Stepping Out**") is novated to a new party ("**Party Stepping In**"), the Remaining Party and the Party Stepping In, as the novating parties, will subsequently exchange variation margin based on the new market value of the portfolio, including the market value of the novated transactions. Under the proposals set out in the Consultation Paper, the novating parties would also be required to exchange initial margin. As the initial margin will depend on the portfolio that is subject to the novation arrangements between the Remaining Party and the Party Stepping In, which portfolio may not be identical to the portfolio between the Remaining Party and the Party Stepping Out, the initial margin requirements relating to the portfolio to be novated between the Remaining Party and the Party Stepping In are likely to be different from the initial margin provided to the Remaining Party by its original counterparty, the Party Stepping Out. Initial margin requirements may also materially vary depending on the differences between the margin model used by the Remaining Party and that used by the Party Stepping In, even if both of the models used have been approved by a regulator. MFA members wish to highlight to the WGMR the risk that the resulting greater complexity of collateral management, together with a potentially significant cost increase in entering into such novation arrangements, may cause the market in novations effectively to cease. The resulting unintended consequence may be CDS unwinds becoming the sole liquidity mechanism, exerting further constraints on liquidity in the CDS markets.

Element 3: Baseline minimum amounts and methodologies for initial and variation margin

Q13. Are the proposed methodologies for calculating initial margin appropriate and practicable? With respect to internal models in particular, are the proposed parameters and prerequisite conditions appropriate? If not, what approach to the calculation of baseline initial margin would be preferable and practicable, and why?

Q14. Should the model-based initial margin calculations restrict diversification benefits to be operative within broad asset classes and not across such classes as discussed above? If not, what mitigants can be used to effectively deal with the concerns that have been raised?

MFA strongly supports the proposed requirement in the Consultation Paper that, when calculating the appropriate initial margin, market participants must make the choice between using a margin model and using the standardized margin schedule consistently in order to avoid "cherry-picking" to achieve the preferred margin outcome in a given trading scenario. MFA requests that the final requirements retain such an express requirement. Indeed, we applaud the WGMR for providing market participants a choice between using an initial margin model and using a standardized initial margin schedule.

Ten-day liquidation horizon. Under the proposals in the Consultation Paper, the initial margin models are 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. MFA understands that such requirements arguably must be equal to or greater than margin requirements for comparable centrally cleared derivatives, and that proposed margin requirements for centrally cleared derivatives under current U.S. and European Union initiatives[4] would require a five-day liquidation time horizon. However, the Consultation Paper does not explain why such a long ten-day liquidation time horizon (*i.e.*, double the liquidation time horizon for centrally cleared derivatives) is appropriate. Doubling the liquidation time horizon for cleared derivatives is, in our view, overly simplistic and disregards current market practice.

In our experience, current market practice with respect to many asset classes of non-cleared derivatives results in a liquidation time horizon that is shorter than ten days. It is market practice[5] to obtain one or more market quotations in order to terminate a non-cleared derivative position, which position is then liquidated using that valuation. Under market standard bilateral contractual arrangements, where market quotations cannot be obtained, it is possible to use a mark obtained from an alternative pricing source, such as derived from a pre-agreed model. As such market practice allows for simple liquidation rather than requiring a replacement

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[4] The mandatory clearing requirements under the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") and the European Union's European Market Infrastructure Regulation ("**EMIR**").

[5] As set out in the the market standard ISDA documentation for non-cleared derivatives.

transaction, liquidating a position in a non-cleared derivative based on the mark obtained may be completed relatively quickly, without material delay. Although the non-cleared derivatives markets may be less liquid in certain cases, as liquidation is permitted on a payment basis without the need to ensure a replacement transaction, it does not necessarily follow that liquidation of a position taken in a non-cleared derivative will require more time than liquidating a position in a centrally cleared derivative. Thus, the ten-day liquidation horizon may prove to be inaccurate or unjustified. MFA therefore respectfully requests that the WGMR reconsider the appropriateness of the ten-day liquidation time horizon, *inter alia*, in light of current market practice regarding the liquidation of non-cleared derivatives.

As the derivatives markets evolve, it is probable that the baseline liquidation time horizons determined now will require adjustment over time. MFA recommends that the framework for the margining requirements for non-cleared derivatives should be sufficiently flexible to allow for periodic adjustments to the liquidation time horizon in response to developments in the liquidity of such markets.

Based on the foregoing, MFA respectfully urges the WGMR to further investigate current market practices regarding the liquidation of different classes of non-cleared derivatives in determining the appropriate liquidation time horizon. We respectfully suggest that the initial liquidation time horizon should be shortened from the proposed ten-day period, and that the framework for margining non-cleared derivatives should allow for further adjustment of the baseline liquidity horizon over time, as appropriate, in order to preserve flexibility in the framework as the non-cleared derivatives markets evolve.

Portfolio margining. MFA strongly agrees with the proposal that quantitative initial margin models may account for risk on a portfolio basis, specifically accounting for risk offsets within asset classes of derivatives that are subject to a single, legally enforceable netting agreement. MFA believes that this concept should also allow portfolio margining between cleared derivatives and non-cleared derivatives within the same asset class of derivatives in a buy-side firm's portfolio that are subject to a master netting agreement. We urge the WGMR to explicitly include in its final recommendations the principle of portfolio margining which confirms that initial margin models may take into account portfolio margining arrangements commonly referred to as "cross-product master netting agreements." Cross-product master netting agreements account for risk offsets among different types of financial instruments, rather than merely among non-cleared derivatives. For example, a cross-product master netting agreement today might include different instruments in the currency/ interest rates asset class, including U.S. Treasury futures, Eurodollar futures, non-cleared interest rate swaps, and repurchase agreements. In the future, the same cross-product master netting agreement could logically incorporate futures, centrally cleared interest rate swaps, non-cleared interest rate swap options, and repurchase agreements. Portfolio margining under cross-product master netting agreements is permitted under existing regulatory regimes and is consistent with current market practice in the derivatives markets.

MFA strongly believes that such portfolio margining arrangements would substantially mitigate the potential issue of a shortfall in eligible collateral in the wake of global regulatory reforms in the derivatives markets by allowing counterparties to recognize offsets for correlated financial instruments, including cleared and non-cleared derivatives. Such portfolio margining arrangements therefore free up excess collateral while adequately reflecting the risks of the portfolio. We applaud the WGMR for recognizing this potential shortfall, and determining that it is necessary to conduct a quantitative impact study to gauge the impact of the margin proposals, particularly, to assess the amount of available collateral that could be used to satisfy these requirements.

Ensuring the continued viability of cross-product master netting agreements would also facilitate the transition to central clearing of derivatives by minimizing the need of market participants to post excessive collateral for portfolios that incorporate positions in both centrally cleared derivatives and non-cleared derivatives. During the transition to mandatory clearing, market participants will necessarily hold non-cleared derivative positions. Without the ability to margin correlated cleared and non-cleared positions on a portfolio basis, market participants would be unintentionally penalized during the transition to central clearing. Indeed, market participants will be forced to post redundant collateral for their cleared positions and their non-cleared positions. This unintended penalty during the transition to central clearing would act as a disincentive to market participants voluntarily moving more of their portfolios in non-cleared derivatives to be cleared by a central counterparty. The resulting bifurcation of derivatives portfolios between cleared and non-cleared derivatives is likely to have material and adverse liquidity implications in the cleared and non-cleared derivatives markets. Even after the transition of the liquid, standardized portion of the OTC derivatives markets to central clearing, portfolio margining should be available to encourage market participants to use cleared positions to offset the risk of their remaining non-cleared positions. Such cross-product portfolio margining would therefore reduce systemic risk by encouraging customers to maintain balanced and appropriately hedged portfolios as a result of the reduced aggregate margin requirements applicable when the aggregate portfolio is so hedged. Thus, counterparties would be effectively rewarded for maintaining a balanced or hedged portfolio of mutually offsetting transactions taking into account both cleared and non-cleared positions.

Further, initial margin models that account for cross-product master netting agreements are consistent with the proposals set out in the Consultation Paper,[6] as they are not intended to lower margin standards that may already exist, but rather, are intended to produce appropriate risk assessments of counterparties' potential future exposure with a view to promoting robust margin requirements. Allowing for risk offsets across centrally cleared derivatives and non-centrally cleared derivatives within the same cross-product master netting agreement would not alter the amount of, or compromise relevant parties' rights to, the margin posted to a central counterparty in connection with any cleared derivatives. This result is evidenced by the existing market practice of including cleared futures contracts in cross-product master netting agreements that also include non-cleared derivatives. MFA wishes to emphasize that initial margin models that permit cross-product master netting agreements would continue to be subject to the WGMR's additional proposed requirements applicable to quantitative initial margin models, including only accounting for offsets that may be reliably quantified, receiving regulatory

[6] *Id.* at 17.

approval prior to applying the model, and the model being subject to the internal approval and governance process of the counterparty proposing to use the same.

We therefore respectfully request that the WGMR include in the final policy proposals the following statement, or a substantially similar statement: "Quantitative initial margin models that account for risk on a portfolio basis may also take into account all products that are approved for model use and that are subject to a single legally enforceable cross-product master netting agreement." As an additional requirement, the WGMR could also specify that the regulated party intending to use an initial margin model that recognizes a cross-product master netting agreement should obtain a legal opinion verifying the validity and enforceability of the cross-product master netting agreement under the applicable law of each relevant jurisdiction.[7]

Transparency and objectivity of models. MFA urges the WGMR to require that margin models be sufficiently replicable in order to allow both parties to a non-cleared derivative contract to determine independently the applicable margin. The buy-side's ability to access and replicate initial margin models would enable them to anticipate how margin might change over the life of the derivative contract and how much they should hold in reserve. Such replicability is fundamental to conducting capital planning and underlies a buy-side market participant's ability or inability to devote its resources strategically to other investments or obligations. MFA is concerned that, without a requirement for reasonable transparency, sell-side firms may alter their baseline models to produce different initial margin requirements for different counterparties without an objectively justifiable basis. Therefore, MFA respectfully recommends that the WGMR require the basic functionality and baseline assumptions of proprietary initial margin models to be made available to counterparties to allow for model replication of initial margin determinations.

Without a right of access to basic functionality information regarding the margin model, the buy-side will lack adequate transparency into their current and future initial margin requirements. The ability of buy-side firms to replicate initial margin determinations is critical to such firms' capacity to anticipate and adjust to changes in their obligations. In MFA's view, replicability should be a condition to regulatory approval of any initial margin model. Without the information necessary to predict with reasonable certainty potential changes in initial margin requirements, market participants may hold excess capital to account for an unanticipated initial margin change, or may not have sufficient capital reserves, potentially resulting either in inefficient use of capital and reduced market liquidity, or in a series of defaults with potential pro-cyclical effects. Requiring transparency with respect to initial margin requirements would therefore allow customers to model for and anticipate margin changes and to avoid capital inefficiencies and capital shortages.

Further, initial margin models should generally be objective (*i.e.*, a model should arrive at the same initial margin amount for identical swaps regardless of the counterparty's identity) so

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[7] Such requirement would be consistent with the requirement in the definition of "Qualifying cross-product master netting agreement" in the U.S. prudential regulators' proposed "Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule", 77 Fed. Reg. 52978 (Aug. 30, 2012), at §___.101(b) on p. 53004.

that the initial margin requirements are predictable. Therefore, we request that the guidelines prohibit the variation of the initial margin models based solely on the identity of a counterparty, other than to clearly reflect the creditworthiness of its counterparty. We believe such a prohibition is necessary to prevent discriminatory distortions in derivatives markets and eliminate unfair competitive advantages among market participants.

Q15. With respect to the standardised schedule, are the parameters and methodologies appropriate? Are the initial margin levels prescribed in the proposed standardised schedule appropriately calibrated? Are they appropriately risk sensitive? Are there additional dimensions of risk that could be considered for inclusion in the schedule on a systematic basis?

Improving the Initial Margin Schedule. MFA endorses the optionality embedded in the proposals regarding the basis for determining margin requirements and commends the provision of two alternative methods for calculating initial margin. We acknowledge that the wide spectrum of market participants in the non-cleared derivatives markets merits the provision of a standardized approach, such as provided by the initial margin schedule in Appendix A of the Consultation Paper ("**IM Schedule**"). We appreciate the simplicity and predictability of the IM Schedule and its usefulness to some market participants. However, we are concerned that the IM Schedule does not properly account for the diversity and risk characteristics of derivatives products that, in some cases, could create inappropriate market asymmetries. We have included as an annex to this letter a proposed sample of an amended IM Schedule that provides some additional granularity. The amended IM Schedule annexed hereto is not an exhaustive revision and does not propose to address all concerns relating to the IM Schedule, but seeks to enhance the usefulness and reliability of the IM Schedule for non-cleared derivatives with embedded optionality, as described below.

More specifically, where the buyer and seller have asymmetric risk/reward profiles under products with embedded optionality, such as CDS, the margin requirements for those products should be more granular to avoid over-posting or under-posting of initial margin. More granularity would be consistent with existing market practice that reflects differences in the risk profile between the party acquiring protection from the debtor's default under the terms of a CDS, for example, and the party providing protection. In the case of a CDS transaction, the risk profile of the protection buyer is lower than the risk profile of the seller given its contingent payout obligation if a credit event is triggered. The prospective default of a buyer therefore presents a lower systemic risk than the prospective default of a seller, and a buyer should accordingly be subject to lower margin requirements. For example, the buyer of a CDS should be subject to an initial margin requirement which is a lower proportion of the notional exposure compared to the seller, while the seller should be subject to an initial margin requirement that is a higher proportion of the notional exposure.

Similarly, the IM Schedule currently sets out a single category for equity derivatives, which would place a call option on a highly liquid equity security in the same category as a total return swap on an illiquid security. In this example, the equity option and the total return swap would each be subject to an initial margin requirement of at least 15% of notional exposure, which would be a high initial margin requirement for the equity option (given the payment of premium and lack of continuing credit exposure), but a potentially appropriate initial margin requirement for the total return swap.

MFA therefore recommends that, where appropriate, the IM Schedule should differentiate between the risk profiles of parties buying protection under a derivative contract (lower risk) and parties selling such protection (higher risk). Further, the IM Schedule should reflect the differences in the risks presented by a derivative transaction where the underlying is, for example, a currency of, or equity issued by, an issuer established in one of the G7 or G20 countries (lower risk), and where the underlying is currency of, or equity issued by, an issuer established in a country with an unstable or a new currency (higher risk). Accordingly, we request that the WGMR revise the IM Schedule to properly account for the variety of derivatives and the risk profiles of the parties by: (i) increasing the number of subcategories in the asset classes and assigning appropriate initial margin ranges and alternative initial margin calculation bases to such subcategories; and (ii) considering the asymmetric risk profiles of a buying/selling party in each relevant asset class or subcategory and appropriately reflecting risk profile differences in the initial margin amounts.

Element 4: Eligible Collateral

Q21. Should concrete diversification requirements, such as concentration limits, be included as a condition of collateral eligibility? If so, what types of specific requirements would be effective? Are the standardised haircuts prescribed in the proposed standardised haircut schedule sufficiently conservative? Are they appropriately risk sensitive? Are they appropriate in light of their potential liquidity impact? Are there additional assets that should be considered in the schedule of standardised haircuts?

While MFA appreciates the simplicity of the proposed standardized haircut schedule set out in Appendix B of the Consultation Paper ("**Haircut Schedule**"), we are concerned that the proposed haircuts in the Haircut Schedule are static and there is no adjustment mechanism to reflect changes in market conditions. We respectfully suggest that the standardized haircuts in the Haircut Schedule more dynamically reflect current collateral financing markets of such assets, as necessary, and that the standardized haircuts are revised periodically to ensure that the Haircut Schedule does not significantly deviate from observable market levels. Accordingly, MFA recommends that the WGMR consider using the haircut levels available in the repurchase market for the relevant collateral asset as the basis for the standardized haircuts. Haircuts should also be subject to regular review and, where appropriate, revision and adjustment. We believe these recommendations would allow the parties to a non-cleared derivative trade to agree and apply more objective, current and accurate haircuts reflecting actual market values of the collateral assets at the relevant time.

Element 5: Treatment of Provided Margin

Q22. Are the proposed requirements with respect to the treatment of provided margin appropriate? If not, what alternative approach would be preferable, and why? Should the margin requirements provide greater specificity with respect to how margin must be protected? Is the proposed key principle and proposed requirement adequate to protect and preserve the utility of margin as a loss mitigants in all cases?

Q23. Is the requirement that initial margin be exchanged on a gross, rather than net basis, appropriate? Would the requirement result in large amounts of initial margin being held by a potentially small number of custodian banks and thus creating concentration risk?

Q24. Should collateral be allowed to be re-hypothecated or re-used by the collecting party? Are there circumstances and conditions, such as requiring the pledgee to segregate the re-hypothecated assets from its proprietary assets and treating the assets as customer assets, and/or ensuring that the insolvency regime provides the pledger with a first priority claim on the assets that are re-hypothecated in the event of a pledgee's bankruptcy, under which re-hypothecation could be permitted without in any way compromising the full integrity and purpose of the key principle? What would be the systemic risk consequences of allowing re-hypothecation or re-use?

MFA respectfully requests that the WGMR consider the requirements under the Dodd-Frank Act regarding the segregation of collateral.[8] Under the Dodd-Frank Act, regulated entities[9] must offer their counterparties the opportunity to segregate with an independent third-party custodian any collateral that does not constitute variation margin that is posted in connection with non-cleared derivative transactions. The counterparty therefore has the option to elect full third-party segregation of its initial margin, but is not mandated to do so. We respectfully urge the WGMR to provide for such similar optionality by a counterparty regarding the segregation of its posted initial margin in the final margining requirements. In addition, we further suggest that collateral providers should have the option to permit the collateral recipient to re-hypothecate all or a proportion of the posted initial margin. We believe that such optionality would allow for necessary cost mitigation to avoid excessive disruption in the non-cleared derivatives markets without compromising the overall benefits of the enhanced margining requirements set out in the Consultation Paper.

Element 7: Interaction of National Regimes in Cross-Border Transactions

Q27. Is the proposed approach with respect to the interaction of national regimes in cross-border transactions appropriate? If not, what alternative approach would be preferable, and why?

MFA supports the clarification of the jurisdiction over market participants proposed in the Consultation Paper, *i.e.,* that the margin requirements in a particular jurisdiction should generally be applied to legal entities established in that local jurisdiction. We also agree with the

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8 *See* Dodd-Frank Act, Section 724(c), available at: http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf. Section 724(c) of the Dodd-Frank Act, enacting Section 4s(l) of the CEA, provides that "at the request of a counterparty to a swap that provides funds ... to a swap dealer or major swap participant to margin … the obligations of the counterparty, the swap dealer or major swap participant shall segregate the funds … for the benefit of the counterparty" and shall do so with an "independent third-party custodian."

9 Under Section 724(c) of the Dodd-Frank Act and the proposed rulemaking by the U.S. Commodity Futures Trading Commission on protection of collateral for uncleared swaps, the obligation to offer initial margin segregation to counterparties applies to "swap dealers" and "major swap participants". *See* 75 Fed. Reg. 75432.

limited exception to this principle as set out in the Consultation Paper. In order to achieve a more stable and effectively regulated market environment for non-centrally cleared derivatives, maximum harmonization of regulatory requirements is necessary and desirable. Given the close integration of the non-centrally cleared derivatives markets across geographies and jurisdictions, we are conscious of the potentially serious impact that even a relatively minor divergence in substantive regulatory requirements could have in the operation of the non-centrally cleared derivatives markets and on the business of the market participants. Inability to ensure that both parties to transactions are able to meet their respective regulatory obligations at all times could result in disruption of business and inadvertent or unavoidable breach of regulatory requirements. Given the potentially significant consequences of divergent regulatory requirements in the non-cleared derivatives markets, to the extent that maximum harmonization is not possible, we respectfully urge the WGMR to propose a fallback mechanism to reconcile conflicts in regulatory requirements of different jurisdictions.

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MFA thanks the WGMR for the opportunity to provide comments regarding the proposals in the Consultation Paper and we would welcome the opportunity to discuss our views in greater detail. Please do not hesitate to contact Laura Harper or the undersigned at +1 (202) 730-2600 with any questions the WGMR or any member of the WGMR might have regarding this letter.

Respectfully submitted,

/s/ Stuart J. Kaswell

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

cc: Mr. Michael Gibson, Board of Governors of the Federal Reserve System
Mr. Bobby Bean, Federal Deposit Insurance Corporation
Mr. Sean Campbell, Federal Reserve Board
Mr. Nicolas Gauthier, European Commission
Mr. John Lawton, U.S. Commodity Futures Trading Commission
Mr. Thomas McGowan, U.S. Securities and Exchange Commission
Ms. Heather Pilley, UK Financial Services Authority
Ms. Roopa Sharma, UK Financial Services Authority
Mr. Graham Young, Bank of England
Mr. Kurt Wilhelm, Office of the Comptroller of the Currency

The Hon. Gary Gensler, Chairman, U.S. Commodity Futures Trading Commission
The Hon. Jill E. Sommers, Commissioner
The Hon. Bart Chilton, Commissioner
The Hon. Scott D. O'Malia, Commissioner
The Hon. Mark P. Wetjen, Commissioner

The Hon. Mary L. Schapiro, Chairman, U.S. Securities and Exchange Commission
The Hon. Elisse B. Walter, Commissioner
The Hon. Luis A. Aguilar, Commissioner
The Hon. Troy A. Paredes, Commissioner
The Hon. Daniel M. Gallagher, Commissioner

Annex

SAMPLE INITIAL MARGIN SCHEDULE

Product Category	**Initial Margin Calculation Basis**
Equities	Options: • X% of the premium paid on the derivative contract; or • X% of the notional value of the derivative contract; or • X% of the premium premium paid on the derivative contract *multiplied by* delta Swaps: • X% of the notional value of the derivative contract Other Factors: • Higher % where the underlier is an equity security by a non-G7 issuer
Interest Rates	Options: • X% of the premium paid on the derivative contract; or • X% of the notional value of the derivative contract; or • X% of the premium premium paid on the derivative contract *multiplied by* delta Swaps: • X% of the notional value of the derivative contract Other Factors: • Higher % where the underlier relates to non-G7 countries • Higher % where the underlier relates to emerging markets
Credit Default Swaps	For Buyer of Protection: Nil, or, if agreed between the parties, X% of the notional value of the derivative contract, graduated % possibly reflecting CDS spreads (*i.e.*, lower % for tighter spreads), for example, on the basis of the following spread tiers: • 0 – 250 bps • 251 – 500 bps • 500 – 1050 bps / 0 – 20 points upfront • 1050 – 2500 bps / 21 – 50 points upfront • 2500 bps / > 50 points upfront For sold protection:

Product Category	**Initial Margin Calculation Basis**
	• X% of the notional value of the derivative contract
FX	Options: • X% of the premium paid on the derivative contract; or • X% of the notional value of the derivative contract; or • X% of the premium paid on the derivative contract *multiplied by* delta Swaps: • X% of the notional value of the derivative contract Other Factors: • Higher % where the underlier is a currency of a non-G7 country Higher % where the underlier is a currency of a non-G21 country • Higher % where the underlier is a currency of an emerging markets country
Commodities	Options: • X% of the premium paid on the derivative contract; or • X% of the notional value of the derivative contract; or • X% of the premium paid on the derivative contract *multiplied by* delta; or • standardized portfolio of risk (SPAN) margin for the nearest futures or options contract + X% Swaps: • X% of the notional value of the derivative contract

Annex B
MFA Accompanying Letter on Cross-Product Portfolio Margining

November 26, 2012

Via Electronic Submission: regs.comments@occ.treas.gov; regs.comments@federalreserve.gov; Comments@FDIC.gov; reg-comm@fca.gov; and RegComments@fhfa.gov

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Ms. Jennifer J. Johnson
Secretary
Board of Governors of the
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Executive Secretary
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Mr. Alfred M. Pollard
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Fourth Floor
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Mr. Gary K. Van Meter
Acting Director, Office of Regulatory
Policy
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102–5090

Re: **Reopening of Comment Period for Notice of Proposed Rulemaking on Margin and Capital Requirements for Covered Swap Entities RIN 1557-AD43; RIN 7100-AD74; RIN 3064-AD79; RIN 3052-AC69; and RIN 2590-AA45.**

Ladies and Gentlemen:

Managed Funds Association ("MFA")[1] respectfully submits this letter regarding the proposing release entitled "Margin and Capital Requirements for Covered Swap Entities" (the "***Proposing***

[1] MFA represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia, and all other regions where MFA members are market participants.

Release") issued by 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 (collectively, the "***Prudential Regulators***"), whereby the Prudential Regulators have proposed margin requirements for certain swap dealers ("***SDs***"), major swap participants ("***MSPs***"), security-based swaps dealers ("***SBSDs***") and major security-based swap participants ("***MSBSPs***", and together with SDs, MSPs and SBSDs, "***covered swap entities***") pursuant to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("***Dodd-Frank***"). The purpose of this letter is to seek clarification and confirmation that the final version of the margin requirements proposed in the Proposing Release (the "***Proposed Rules***") will preserve the benefits of portfolio margining arrangements that provide for the cross-margining of cleared futures, options and swaps and security-based swaps ("***Cleared Products***") and uncleared swaps and security-based swaps ("***Uncleared Swaps***").[2] MFA has previously commented on the Proposed Rules as well as the proposed rules issued by the Commodity Futures Trading Commission (the "***CFTC***") on this same subject.[3] MFA is also concurrently filing a supplemental comment letter on the Proposed Rules.[4]

I. Executive Summary

Portfolio margining is an established, widely-used and highly beneficial practice in the derivatives marketplace. Portfolio margining allows a futures commission merchant (an "***FCM***") with respect to cleared swaps, options and futures, or a broker-dealer with respect to cleared security-based swaps, and an affiliated covered swap entity to calculate jointly the margin required to collateralize the risk exposure to a single customer with respect to its Cleared Products and Uncleared Swaps. Utilizing cross-margining, the customer is not required to post redundant initial margin to secure its Cleared Products and Uncleared Swaps, but each of the FCM or broker-dealer and covered swap entity remain adequately margined and secured with respect to such positions and each entity receives full variation margin payments with respect to those positions. This letter addresses the need to continue such current portfolio margining

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2 MFA believes that broad portfolio margining across all product types would further benefit the market while maintaining appropriate collateral levels.

3 *See* MFA's comments on the Prudential Regulators' Notice of Proposed Rulemaking on "Margin and Capital Requirements for Covered Swap Entities", 76 Fed. 27564 (May 11, 2011) filed with the Prudential Regulators on July 11, 2011, and on the CFTC's Notice of Proposed Rulemakings on "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants", 76 Fed. Reg. 23732 (Apr. 28, 2011) and on "Capital Requirements of Swap Dealers and Major Swap Participants", 76 Fed. Reg. 27802 (May 12, 2011) filed with the CFTC on July 11, 2011.

We note that, on October 17, 2012, the Securities and Exchange Commission (the "***SEC***") proposed rules for the margin requirements for uncleared security-based swaps held at SBSDs and MSBSPs. *See* SEC, "Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers", 77 Fed. Reg. 70213 (Nov. 23, 2012) (the "***SEC Proposed Rules***"). MFA has not, as of yet, commented on these proposed rules.

4 *See* MFA's supplemental comment letter concerning the Proposed Rules, "Reopening of Comment Period for Notice of Proposed Rulemaking on Margin and Capital Requirements for Covered Swap Entities RIN 1557-AD43; RIN 7100-AD74; RIN 3064-AD79; RIN 3052-AC69; and RIN 2590-AA45", dated November 26, 2012.

practices between Cleared Products and Uncleared Swaps. We note that, in its recently proposed rules for the margin requirements for uncleared security-based swaps held by SBSDs and MSBSPs, the SEC generally approved of portfolio margining between different product types.[5] These practices are consistent with newly adopted regulations for cleared swaps,[6] do not impair or interfere with the effect or purpose of the Dodd-Frank regulatory regime, and will support the transition to clearing.

Portfolio margining between Cleared Products and Uncleared Swaps has been permitted by the CFTC and the SEC for a number of years without adverse effects on the market or its participants, despite the recent market crisis.[7] These practices continue to be broadly employed by market participants today. Negatively affecting these practices would require significant changes to market structures and a substantial aggregate increase in margin that clients and banks would be required to post to secure these transactions. By contrast, continued use of portfolio margining would facilitate a smooth transition to the mandatory clearing regime for swaps while motivating market participants both to clear where possible and to maintain balanced portfolios that include both Cleared Products and Uncleared Swaps. The absence of portfolio margining would, counter to the objectives of Dodd-Frank, lead participants to prefer Uncleared Swaps as a means to realize the benefits of portfolio risk reduction. Because portfolio margining enables market participants to use capital more efficiently, its continued availability would also help counteract excessive demand for the more limited range of assets that will be eligible for use as collateral, thereby reducing market distortions with respect to a more limited supply of collateral. For these reasons, we respectfully request that the Prudential Regulators confirm that the final version of the Proposed Rules will take into account current portfolio margining practices with respect to Cleared Products and Uncleared Swaps in such a way as to preserve the benefits of these arrangements.[8]

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5 *See* SEC Proposed Rules, 77 Fed. Reg. at 70259 ("The goal of modeling proposed new Rule 18a-3 on the broker-dealer margin rules is to promote consistency with existing rules and to facilitate the portfolio margining of security-based swaps with other types of securities.").

6 Although the SEC has proposed rules relating to the segregation of customer margin posted to SBSDs and MSBSPs to secure and guarantee security-based swaps, the SEC has not, as of the date of this letter, proposed rules relating to the segregation of customer margin held by clearing agencies and broker-dealers to secure or to guarantee cleared security-based swaps. As a result, we cannot address the treatment of cleared security-based swaps in the same level of detail in which we address other swaps in this letter. However, we anticipate that the SEC's approach will be broadly similar to that of the CFTC, at least with respect to the issues relevant to the requests made in this letter.

7 Portfolio margining has been broadly accepted under various regulatory regimes. FINRA permits portfolio margining for certain products pursuant to NASD Rule 2520(g) and NYSE Rule 431(g). The Options Clearing Corporation, Chicago Mercantile Exchange, Inc., New York Portfolio Clearing, LLC and LCH.Clearnet, Ltd. also permit portfolio margining between certain products.

8 MFA recognizes that portfolio margining arrangements may involve covered swap entities that are subject to several different regulatory regimes, including bank regulatory regimes (which would include regulation pursuant to Sections 23A and 23B of the Federal Reserve Act). As a representative of customers of FCMs and dealer institutions, MFA members are not among those entities subject to these various regulatory regimes, and therefore this letter is not intended to address such subjects. Nevertheless, MFA believes that portfolio margining has been found beneficial by all parties involved, and would urge that its use be continued as a method of satisfying collateral requirements.

II. Background

Portfolio margining is grounded in the application of a risk-based margin methodology that computes margin requirements based on the overall risk of a portfolio. To the extent that market risks of positions are correlated so as to hedge one another, portfolio margining frees up excess margin while continuing to account adequately for the market risks relating to these positions. As a result, current portfolio margining practices provide liquidity necessary for sound, properly functioning capital markets.

Market participants are currently able to use portfolio margining with respect to cleared futures, options and over-the-counter ("***OTC***") derivatives positions cleared through FCMs and uncleared OTC derivatives positions entered into with FCMs' affiliated, but separate, dealers through the use of master netting agreements. Under such arrangements, two affiliated entities that serve an individual customer as both a swap counterparty through the dealer entity and clearing agent through an affiliated FCM assess their total exposure to the customer and assess the value of the liens on affiliate-held collateral (described below) and on the potential for excess collateral and liquidation value to be held within the affiliated group. The dealer and the FCM then determine the necessary initial margin or upfront collateral required across both entities for protection in the event of default by the relevant customer.[9] Pursuant to a master netting agreement, the customer grants to the dealer a second priority lien on the customer's cleared positions account (*i.e.*, on the liquidation rights to the positions and on the collateral posted to secure its cleared positions). The customer reciprocally grants to the FCM a second priority lien on its transactions with, and any initial margin or upfront collateral posted to, the dealer. In addition, the dealer and the FCM have cross-termination rights pursuant to the master netting agreement in the event that the customer defaults on its obligations to either the FCM or the dealer. If the customer defaults with respect to positions at the FCM and the FCM liquidates the customer's cleared positions account, the dealer will be able to terminate the uncleared positions which it holds. Conversely, if the customer defaults and the dealer terminates the uncleared positions, the FCM will be entitled to liquidate the customer's cleared positions. After taking into account any proceeds from liquidated or terminated positions, the FCM will use the customer's initial margin or upfront collateral posted to the FCM to satisfy any remaining customer obligations to the FCM, while the dealer will concurrently use the customer's initial margin or upfront collateral posted to the dealer to satisfy any remaining customer obligations to the dealer. In the event that either the FCM or dealer have a shortfall, the dealer may apply excess initial margin or upfront collateral held at the FCM, or the FCM may apply excess initial margin or upfront collateral held at the dealer, after the customer's obligations to each are met individually.

In light of the security arrangements described above, the FCM and dealer, as a group, are able to offer the customer margin relief in respect of the amount of margin posted with the dealer, to the extent that the sum of the margin calculated on a standalone basis for the dealer and FCM would exceed the margin required to protect the FCM and the dealer taken together. Accordingly, in

[9] In no event is the amount of initial margin or upfront collateral less than the minimum amount required to cover the customer's cleared portfolio held by the FCM, as calculated by the relevant derivatives clearing organization ("***DCO***") on a standalone basis (*i.e.*, without reference to offsetting positions held by the affiliated dealer entity).

the event of a customer default, both the FCM and dealer have concluded that they are adequately collateralized, but at the same time the customer is not required to post initial margin or upfront collateral to each entity in excess of the amount required to collateralize adequately both the FCM and dealer taken together subject to any cleared position minimum margin requirements required at any entity.[10] As discussed above, this reduction in collected margin is possible because, in the event of a customer default, subject to the FCM's priority in the cleared margin and subject to the dealer's priority in margin posted to it, each of the FCM and dealer may access excess customer initial margin or upfront collateral held by the other prior to its return to the customer's estate.

Many dealers and FCMs currently offer portfolio margining arrangements to their buy-side counterparties whose portfolios include certain Cleared Products and Uncleared Swaps, conferring margin optimization benefits to those customers while maintaining appropriate standards of collateralization in the event of customer default. The migration of OTC derivatives to clearing pursuant to Dodd-Frank will divide portfolios that today benefit from portfolio margining into separate cleared and uncleared segments. If these segments were then subject to separate, independent margining regimes, this segmentation would reverse the benefits of current portfolio margining practices. If Cleared Products were independently margined based on the margining rules of DCOs while Uncleared Swaps were subject to separate margin requirements, without either the dealer or the FCM being able to take into account the potential liquidation value or the potential for excess margin in the transactions that the other holds with the customer, the total margin would exceed suitable portfolio margin levels. The Prudential Regulators have acknowledged the viability of portfolio margining models[11] in the Proposed Rules. We ask the Prudential Regulators expressly to confirm allowance for the continued practice of portfolio margining between Cleared Products and Uncleared Swaps when adopting the final version of the Proposed Rules so as to provide certainty to the market that it will be able to continue to realize the risk-reducing benefits of portfolio margining under the new regulatory regime.

III. Portfolio Margining Across Cleared and Uncleared Swaps Is Beneficial to the Market as a Whole and Promotes Clearing

We respectfully submit that current portfolio margining practices could effectively be applied in the post-Dodd-Frank swaps regulatory regime through continued use of master netting agreements or similar arrangements that implement portfolio margining across Cleared Products and Uncleared Swaps. As clarified above, portfolio margining enables market participants to avoid posting redundant initial margin or upfront collateral while ensuring that the FCM or broker-dealer and covered swap entity both have access to sufficient collateral in the event of a customer default and still requiring full variation margin payments to be made to each entity. Therefore, portfolio margining eliminates excess initial margin or upfront collateral and avoids a

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[10] *See* Section V.B for a further discussion of how the security interest on the customer account at the FCM is consistent with the CFTC Regulations.

[11] That is, cross-product margining between uncleared swaps and security-based swaps entered into with a covered swap entity. *See* Proposed Rule §__.8(b).

reduction in market liquidity resulting from segregated Cleared Products and Uncleared Swaps regimes. Without portfolio margining, these increased costs of trading would be passed on to swaps end-users and thereby would reduce liquidity and competitiveness in the markets as well as raise the costs of hedging. Furthermore, portfolio margining allows capital to be invested more effectively (*i.e.*, not tied up as redundant initial margin securing swaps positions) without compromising the safety of individual covered swap entities or the system as a whole.

The market benefits of portfolio margining between Cleared Products and Uncleared Swaps would ease the market transition to the mandatory clearing requirements of Dodd-Frank. Initially, during the transition to mandatory clearing, only certain swaps will be cleared. While the cohort of cleared swaps is expected to expand over time, market participants will necessarily continue to hold positions in Uncleared Swaps (with many of these positions held at covered swap entities affiliated with FCMs or broker-dealers that hold their Cleared Products accounts). With respect to those remaining swaps that cannot be cleared, portfolio margining will encourage market participants to use Cleared Products to offset the risk of their remaining Uncleared Swaps positions. If not allowed to engage in portfolio margining between these positions, a market participant will be forced to post redundant initial margin or upfront collateral for its Cleared Products and its Uncleared Swaps, even when such transactions offset one another.

There are numerous examples of swaps contracts that market participants will not be required or able to clear. For example, single-name credit default swaps ("***CDS***") are regulated by the SEC and index CDS are regulated by the CFTC. It appears that the CFTC will require index CDS to be cleared before the SEC requires single-name CDS to be cleared. Moreover, an extensive range of sovereign CDS is not currently offered for clearing. Without portfolio margining, market participants who hold positions in cleared and uncleared CDS will be required to post redundant margin to secure their uncleared portfolios of CDS, especially as the full universe of CDS are not offered for clearing despite the fact that some of the Uncleared Swaps may otherwise offset some of the cleared ones.[12] Similarly, there are many types of rates swaps that are currently used in portfolio margining, but that are not presently clearable and for which there is no certain timeline for these products to become eligible for clearing. These rates products include swaptions, caps, floors, cross-currency swaps and inflation swaps.

Also, consistent with a primary objective of Dodd-Frank, portfolio margining will encourage market participants to use Cleared Products. If a customer's market risk with respect to a

[12] As of the date of this letter, only CDS on the components of the major indexes have been offered for clearing, whereas single-name CDS that are not components of the indexes are not yet eligible for clearing. ICE Clear Credit currently clears 59 index CDS, 152 corporate single-name CDS, and 4 sovereign single-name CDS and ICE Clear Europe currently clears 44 index CDS and 121 single-name CDS. The CME Group (through CME Clearport) does not offer clearing for as many swaps. Currently, the CME Group offers clearing for a few index credit swaps and is considering adding single-name CDS that are index constituents later this year. The CME Group may offer clearing for additional single-name CDS in the future. By contrast, DTCC tracks data on over a thousand reference entities, including 922 corporate single-name CDS. Therefore, during the initial transition to clearing, a large number of CDS will not be available for clearing at the time the mandatory clearing requirement becomes effective and may not be available to be cleared for some time after that date. Further, clearing with respect to other potentially highly correlated CDS asset classes such as CDS on asset-backed securities may not be in place for a long time to come.

particular Uncleared Swap position can be hedged (from the market participant's perspective) by either a Cleared Product or an Uncleared Swap, without the benefits of portfolio margining across Cleared Products and Uncleared Swaps, the market participant would need to enter into an Uncleared Swap to realize margin efficiencies. Even if Uncleared Swaps carry higher initial margin requirements, if a market participant has a large portfolio of Uncleared Swaps,[13] that market participant would be motivated to take advantage of portfolio margining across its Uncleared Swaps and, therefore, may enter into Uncleared Swaps to hedge this specific risk. If, by contrast, portfolio margining across Cleared Products and Uncleared Swaps were available, market participants would have an incentive[14] to use Cleared Products to hedge this risk and to promote ongoing expansion by central counterparties (including DCOs and clearing agencies) of the products available to be cleared.

As noted above, in the present marketplace, swap dealers provide portfolio margining to their customers utilizing Uncleared Swaps and cleared futures products. If similar portfolio margining is not available across Cleared Products and Uncleared Swaps, customers that currently rely on portfolio margining will face substantially higher initial margin requirements for an otherwise equivalent portfolio, without a risk-based justification. The unavailability of portfolio margining across these products would have the following adverse unintended consequences: (i) customers would be discouraged from transacting in Cleared Products on a voluntary basis; (ii) once clearing is mandatory, customers could find participating in the swaps market to be cost prohibitive; and (iii) returns that buy-side firms would otherwise be able to deliver to their investors would be diminished due to posting excessive initial margin or upfront collateral. These adverse consequences would jeopardize the transition to mandatory central clearing, impair liquidity, and constitute a material impediment to buy-side support for, and access to, clearing.

Pursuant to Section 39.13(g)(10) of the CFTC Regulations, a DCO "shall limit the assets it accepts as initial margin to those that have minimal credit, market, and liquidity risks" but shall not accept letters of credit as initial margin for swaps. Under Proposed Rules §__.6(a), a covered swap entity would be permitted to collect as initial margin for Uncleared Swaps only cash and certain debt obligations guaranteed by the Federal government or certain Federal agencies. Hence, both the Proposed Rules and the CFTC Regulations would place limits on what may

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[13] Market participants will be more likely to have a large portfolio of Uncleared Swaps during the transition to mandatory clearing.

[14] There are higher costs associated with Uncleared Swaps. First, the margin requirements for Uncleared Swaps are mandated to be as high or higher than the margin requirements for cleared swaps. Second, there are more risks associated with Uncleared Swaps than there are with cleared swaps and, therefore, a market participant will be subject to higher potential costs associated with Uncleared Swaps than the potential costs associated with Cleared Products. Therefore, to the extent that a market participant is able to rely on portfolio margining between Uncleared Swaps and Cleared Products, a market participant will already be incentivized to take advantage of the reduced costs associated with Cleared Products. However, without the benefits of portfolio margining between Cleared Products and Uncleared Swaps, so long as many products are not available for clearing and portfolios effectively must continue to include some Uncleared Swaps, the market participant will be more likely to take advantage of the portfolio margining benefits that would be available if the entire portfolio is limited to Uncleared Swaps, because the costs of having to post redundant collateral for Uncleared Swap positions and Cleared Product positions in the absence of portfolio margining would likely exceed the additional cost of dealing in Uncleared Swaps.

constitute initial margin for swaps. Due to the limited universe of acceptable collateral, after the effective date for the mandatory clearing requirement, there is a material risk that there will be a scarcity of collateral acceptable for use as initial margin for both cleared and uncleared derivatives. The high demand from market participants for acceptable collateral will increase its price and the increased costs will be passed on to all market participants, including end-users. By contrast, portfolio margining mitigates the demand for acceptable collateral, thereby reducing its cost and decreasing the cost of swaps trading for all market participants.

Allowing portfolio margining practices between Cleared Products and Uncleared Swaps under the final version of the Proposed Rules also encourages customers to maintain balanced portfolios, because customers are rewarded for entering into transactions that mitigate the risks of other transactions in the customer's portfolio through a reduction in the aggregate amount of margin posted that results when the aggregate portfolio contains opposing positions. Encouraging each customer to maintain a balanced, or hedged, portfolio, taking into account both Cleared Products and Uncleared Swaps, reduces systemic risk.

IV. Portfolio Margining is Consistent with the Proposed Rules

Proposed Rules §__.8(b) would allow market participants to submit initial margin models that differ from the initial margin calculations set forth in Appendix A of the Proposed Rules so long as the submitted initial margin model conforms to the requirements of Proposed Rules §__.8 and is approved by the relevant Prudential Regulator. Proposed Rules §__.8(b)(1) further provides that "[t]o the extent that a qualifying master netting agreement between a covered swap entity and its counterparty governs swaps or security-based swaps that were entered into before, on, and after the effective date, the covered swap entity may use its initial margin model to calculate the amount of initial margin to be collected pursuant to §__.3 … with respect to all swaps and/or security-based swaps transactions governed by such qualifying master netting agreement, regardless of whether they were entered into before, on, or after the effective date." These provisions demonstrate recognition by the Prudential Regulators of the utility of portfolio margining as among Uncleared Swaps held with the covered swap entity. Portfolio margining between Cleared Products and Uncleared Swaps should, by logical extension, be similarly consistent with these provisions, since portfolio margining would result in posted margin at least equal to the aggregate margin that would have been assessed if all Cleared Products and Uncleared Swaps had been subject to the same margining regime. Portfolio margining between Cleared Products and Uncleared Swaps thus provides market participants with an equitable means to calculate their initial margin requirements across Cleared Products and Uncleared Swaps. Permitting such portfolio margining in an initial margin model provides the flexibility that the nature of the swaps market necessitates. Without this flexibility, overall market liquidity will be reduced and transaction costs (which are borne by end-users) will be greater because of the higher initial margin costs imposed on market participants.

V. Legal Authority for Portfolio Margining

A. Portfolio Margining Is Consistent with the CFTC Regulations Relating to Cleared Futures and Options

Currently, market participants are able to enter into valid master netting agreements between accounts holding cleared futures and options and accounts holding Uncleared Swaps. They are therefore able to establish a valid lien on the account at the FCM holding the cleared futures and options. Dodd-Frank has not imposed any new requirements that affect the segregation of cleared futures and options accounts (*i.e.*, accounts subject to section 4d(a) of the Commodity Exchange Act). Therefore, the adoption of Dodd-Frank and the regulations thereunder has not affected the validity of a covered swap entity's second lien on an account containing cleared futures and options held at an affiliated FCM.

B. Portfolio Margining Is Consistent with the Requirements of Part 22 of the CFTC Regulations

We understand that a portfolio margining regime is fully consistent with the "legally segregated, operationally commingled" model set forth in the recently adopted Part 22 of the CFTC Regulations.[15] In entering into a valid master netting agreement among the customer, the FCM and the affiliated covered swap entity, the customer would grant a valid lien on its account at the FCM and the covered swap entity must be able to establish a valid security interest therein as well. Although an FCM is prohibited from granting a lien on its Cleared Swaps Customer Account,[16] a Cleared Swaps Customer itself "may grant a lien on the Cleared Swaps Customer's individual cleared swaps account (an 'FCM customer account') that is held and maintained at the Cleared Swaps Customer's FCM" that is subordinate to the lien of the FCM.[17] Moreover, the staff of the CFTC's Division of Clearing and Risk has expressly acknowledged that Part 22 of the CFTC Regulations does not prohibit a customer from granting a lien on its FCM customer account.[18] The FCM customer account consists of the rights to proceeds from the cleared swaps positions that are cleared through the DCO on behalf of the customer, and as a result, would also include the customer's rights relating to those cleared swaps positions to receive the return of initial margin posted to the FCM in support of those positions. Further, the CFTC confirmed that

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[15] *See* "Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions," 77 Fed. Reg. 6336 (February 7, 2012).

[16] "Cleared Swaps Customer Account" means "any account for the Cleared Swaps of Cleared Swaps Customers and associated Cleared Swaps Customer Collateral that: (1) a futures commission merchant maintains on behalf of Cleared Swaps Customers (including, in the case of a Collecting Futures Commission Merchant, the Cleared Swaps Customers of a Depositing Futures Commission Merchant) or (2) a derivatives clearing organization maintains for futures commission merchants on behalf of Cleared Swaps Customers thereof." CFTC Regulation §22.1.

[17] 77 Fed. Reg. 6352.

[18] *See* CFTC Staff Letter No. 12-28 (Oct. 17, 2012) ("Regulation 22.2(d) does not prohibit a Cleared Swaps Customer from granting security interests in, rights of setoff against, or other rights in its own Cleared Swaps Customer Collateral, regardless of whether those assets are held in the Cleared Swaps Customer's FCM customer account. Furthermore, nothing in the rule is intended to inhibit this right of the Cleared Swaps Customer.").

CFTC Regulation §22.2(d) permits "other entities (including affiliates of FCMs) to take a security interest in a Cleared Swaps Customer's FCM customer account in support of financing the Cleared Swaps Customer's margin obligations."[19] It follows that a covered swap entity affiliate of the FCM could establish a valid security interest in the FCM customer account of a Cleared Swaps Customer to secure a Cleared Swaps Customer's obligations in respect of Uncleared Swaps with the affiliated covered swap entity on behalf of such Cleared Swaps Customer. We respectfully submit that a covered swap entity would be able to establish a valid security interest under Part 22 in an FCM customer account and could therefore enter into a valid master netting agreement with an affiliated FCM and a customer.

C. Portfolio Margining is Expected to be Consistent with the Requirements for Segregation of Accounts for Cleared Security-Based Swaps

Although the SEC has proposed rules relating to the segregation of customer margin posted to SBSDs and MSBSPs to secure and guarantee security-based swaps, the SEC has not, as of the date of this letter, proposed rules relating to the segregation of customer margin held by clearing agencies and broker-dealers to secure or to guarantee cleared security-based swaps. We expect that the SEC will propose and adopt rules that are harmonized with the account segregation rules recently adopted by the CFTC. Because we believe the lien on the FCM customer account holding cleared swaps to be valid, we believe that a lien on the individual customer account at a broker-dealer holding cleared security-based swaps similarly should also be valid.

D. Portfolio Margining Does Not Raise Concerns Similar to Those in *In re Lehman*

In prior discussions of cross-margining arrangements with representatives of regulators, concerns have been raised that cross-margining arrangements may be rendered ineffective by the decisions in the *Lehman*[20] and *SemCrude*[21] cases relating to the enforceability of "triangular setoff". In those cases, the bankruptcy courts evaluated the enforceability of cross-affiliate setoff arrangements pursuant to separate agreements between one counterparty and two or more counterparties that are affiliates of each other. However, no lien was granted with respect to the obligations subject to set-off. Finding that such arrangements failed to satisfy the requirement of "mutuality" that is a condition to the exercise of an unsecured right of setoff under the Bankruptcy Code, the courts found these arrangements to be unenforceable against a bankrupt defaulting party.

Portfolio margining referred to herein differs fundamentally from the unsecured cross-affiliate set-off arrangements that were at issue in the *Lehman* and *SemCrude* cases. Unlike the arrangements in those cases, portfolio margining arrangements pursuant to master netting agreements include the grant of a perfected security interest in assets that the customer maintains, such as posted collateral, receivables and the liquidation value of its portfolio. In

[19] 77 Fed. Reg. 6352.

[20] *In re Lehman Brothers Inc.*, 458 B.R. 134 (Bankr. S.D.N.Y. Oct. 4, 2011).

[21] *Chevron Products Co. v. SemCrude, L.P. (In re SemCrude, L.P.)*, 428 B.R. 590 (D. Del. 2010).

other words, there is a direct link between the dealer or FCM, the amounts owed to it, and the lien granted to it directly by the customer.

MFA recognizes that the security interest in an FCM customer account or an individual customer account at a broker-dealer, used to secure Uncleared Swaps at an affiliated covered swap entity, may become subject to the provisions of Chapter 7 of the Bankruptcy Code in the event of the bankruptcy of a broker-dealer (*i.e.*, a securities broker), an FCM (*i.e.*, a commodity broker), or the provisions of the Securities Investor Protection Act of 1970. However, we believe that the security interest of a covered swap entity in a customer's FCM customer account or individual customer account at a broker-dealer would be valid even in such a bankruptcy.[22] We believe that these arrangements would be enforceable as perfected security interests securing "safe harbor" transactions under the Bankruptcy Code and other major insolvency regimes, notwithstanding the commencement of an insolvency proceeding against the customer. Thus, the validity and enforceability of the lien should not be affected by the issues of mutuality discussed in these decisions.

VI. Request for Confirmation and Clarification on Certain Provisions within the Proposed Rules

As noted, we understand that the second lien on an individual customer's cleared swaps account at the FCM created by a master netting agreement is valid under Part 22 of the CFTC Regulations. Because the SEC's regulations on segregation of accounts at the clearing agencies or broker-dealers holding cleared security-based swap positions and related initial margin should be harmonized with the related CFTC rules, we believe that the second lien granted to the covered swap entity in the cleared security-based swaps account should also be valid. Furthermore, the validity of a lien on the customer's cleared futures account at an FCM is unaffected by Dodd-Frank. Therefore, initial margin models of a covered swap entity should be able to account for collateral posted with an affiliated FCM in respect to cleared futures, options and swaps (or a broker-dealer in respect to cleared security-based swaps) subject to a master netting agreement to avoid requiring customers to post redundant collateral as initial margin with the covered swap entity in respect of Uncleared Swaps.

Accordingly, we respectfully request that the Prudential Regulators confirm that the final version of the Proposed Rules would preserve the benefits of portfolio margining by not prohibiting:

1. an initial margin model that accounts for portfolio margining between Cleared Products and Uncleared Swaps (pursuant to a master netting agreement under which the customer grants the Covered Swap Entity a security interest in its FCM customer account or individual customer account with a broker-dealer); and

[22] As noted above, the staff of the CFTC has confirmed the authority of the customer to grant the security interest.

2. a security interest granted in the FCM customer account or the individual customer account at a broker-dealer and the collateral contained therein to qualify as "eligible collateral" under the Proposed Rules and to be used as initial margin for Uncleared Swaps.

We further submit that the interest in the FCM customer account or the individual customer account at a broker-dealer does not conflict with the Prudential Regulators' overriding policy concerns regarding collateral quality. We respectfully request that the Prudential Regulators confirm the requests in (1) and (2) above by adding text similar to the following to the preamble of the final version of the Proposed Rules:

> An approved initial margin model that accounts for risk on a portfolio basis may also take into account all products (including cleared swaps and security-based swaps) that are approved for model use and that are subject to a single legally enforceable cross-product master netting agreement.

The lien on the FCM customer account represents an interest in the initial margin posted with an FCM and, in turn, with a DCO. As discussed above, under Section 39.13(g)(10) of the CFTC Regulations, a DCO may only accept as initial margin with respect to Cleared Products assets "that have minimal credit, market and liquidity risks." On the other hand, the Proposed Rules permit a covered swap entity to collect initial margin that consists of immediately available cash funds, any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by the United States and senior debt obligations of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Federal Home Loan Banks and the Federal Agricultural Mortgage Corporation and any "insured obligation" of a Farm Credit System bank.[23] Although the types of collateral which an FCM or DCO may collect are not identical to the types of collateral that constitute "eligible collateral" under the Proposed Rules, an approved initial margin model should be able to account, through haircuts or otherwise, for any perceived increased risk associated with the permissible forms of collateral under Section 39.13(g)(10) of the CFTC Regulations. In addition, because the FCM customer account subject to the master netting agreement (and the positions and collateral within said account) is held by an FCM which is affiliated with the covered swap entity, the covered swap entity would be able to monitor, and even potentially limit, the types of collateral posted as initial margin to secure cleared swaps in the FCM customer account.[24] In this manner, the covered swap entity could ensure that the FCM or broker-dealer only accepts "eligible collateral" to secure cleared futures, options and swap positions in the relevant FCM customer account. Therefore, we believe that collateral posted with the FCM and a DCO (or a broker-dealer and a registered clearing agency) subject to a master netting agreement can be fully aligned with the Prudential Regulators' policy concerns regarding collateral quality.

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[23] Proposed Rules §__.6(a).

[24] A similar arrangement would exist between the covered swap entity and its affiliated broker-dealer that holds the customer's cleared security-based swap positions and related collateral.

VII. Conclusion

In conclusion, we respectfully request that the Prudential Regulators consider the issues discussed above and provide the requested clarifications and confirmations. We ask that the Prudential Regulators confirm that an initial margin model that allows portfolio margining between Cleared Products and Uncleared Swaps can satisfy the margin requirements under the final version of the Proposed Rules. In addition, we ask that the Prudential Regulators confirm that entry into a lien on an account holding Cleared Products and related margin would be equivalent to the collection of "eligible collateral" by a covered swap entity for purposes of the Proposed Rules. We believe, as discussed above, that the continued practice of portfolio margining between Cleared Products and Uncleared Swaps will preserve and provide benefits to the entire swaps market by promoting liquidity and reducing the costs of entering into swaps, while supporting Dodd-Frank's systemic risk management objectives. Furthermore, we believe that a portfolio margining structure that allows cross-margining between Cleared Products and Uncleared Swaps will encourage swaps participants to enter into cleared swaps and cleared security-based swaps rather than Uncleared Swaps, especially during the transition period to mandatory clearing as more swaps become available to be cleared.[25] We respectfully request that the Prudential Regulators provide guidance on these issues at their earliest possible convenience, but, in any event, no later than the effective date of the mandatory clearing requirements under Section 2(h) of the Commodity Exchange Act and Section 3C of the Securities Exchange Act. Without guidance by such time, swaps and security-based swaps customers, including those that are today clearing voluntarily in advance of the mandate, will face uncertainty as to whether they are required to post significant amounts of redundant capital with covered swap entities, thereby hindering clearing and reducing liquidity in the marketplace to the detriment of all market participants. Furthermore, because portfolio margining is currently extensively practiced between cleared and uncleared derivatives, we respectfully request that the Prudential Regulators refrain from taking any regulatory action that would disrupt these arrangements as the mandatory clearing requirement is implemented.

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[25] For a discussion of this incentive, please see n.14.

MFA thanks the Prudential Regulators for the opportunity to provide comments on the Proposed Rules. Please do not hesitate to contact Laura Harper, Assistant General Counsel, or the undersigned at (202) 730-2600 with any questions the Prudential Regulators or their respective staffs might have regarding this letter.

Respectfully submitted,

/s/ Stuart J. Kaswell

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

Annex C
Sample Initial Margin Grid

<u>**Product Category**</u>	<u>**Initial Margin Calculation Basis**</u>
Equities	<u>Options</u>: • X% of the premium paid on the derivative contract; or • X% of the notional value of the derivative contract; or • X% of the premium premium paid on the derivative contract *multiplied by* delta <u>Swaps</u>: • X% of the notional value of the derivative contract <u>Other Factors</u>: • Higher % where the underlier is an equity security by a non-G7 issuer
Interest Rates	<u>Options</u>: • X% of the premium paid on the derivative contract; or • X% of the notional value of the derivative contract; or • X% of the premium premium paid on the derivative contract *multiplied by* delta <u>Swaps</u>: • X% of the notional value of the derivative contract <u>Other Factors</u>: • Higher % where the underlier relates to non-G7 countries • Higher % where the underlier relates to emerging markets
Credit Default Swaps	<u>For Buyer of Protection</u>: Nil, or, if agreed between the parties, X% of the notional value of the derivative contract, graduated % possibly reflecting CDS spreads (*i.e.*, lower % for tighter spreads), for example, on the basis of the following spread tiers: • 0 – 250 bps • 251 – 500 bps • 500 – 1050 bps / 0 – 20 points upfront • 1050 – 2500 bps / 21 – 50 points upfront • 2500 bps / > 50 points upfront <u>For sold protection</u>: • X% of the notional value of the derivative contract

Product Category	**Initial Margin Calculation Basis**
FX	Options: • X% of the premium paid on the derivative contract; or • X% of the notional value of the derivative contract; or • X% of the premium paid on the derivative contract *multiplied by* delta Swaps: • X% of the notional value of the derivative contract Other Factors: • Higher % where the underlier is a currency of a non-G7 country Higher % where the underlier is a currency of a non-G21 country • Higher % where the underlier is a currency of an emerging markets country
Commodities	Options: • X% of the premium paid on the derivative contract; or • X% of the notional value of the derivative contract; or • X% of the premium paid on the derivative contract *multiplied by* delta; or • standardized portfolio of risk (SPAN) margin for the nearest futures or options contract + X% Swaps: • X% of the notional value of the derivative contract