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

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Via Electronic Submission: baselcommittee@bis.org
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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 Second 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 on Banking Supervision and the International Organization of Securities Commissions ("**WGMR**") in response to its Second Consultative Document on Margin Requirements for Non-Centrally Cleared Derivatives (the "**Consultation Paper**")[2]. As noted in our response to the original WGMR consultation on margin requirements for non-centrally cleared derivatives[3], MFA strongly supports the WGMR's efforts to provide a global standard framework for margining non-centrally cleared derivative contracts ("**uncleared derivatives**").

In providing our comments and recommendations in respect of the four open issues in the Consultation Paper, MFA seeks to assist the WGMR in developing a final margin requirements framework for uncleared derivatives that ensures that such requirements appropriately reflect and address the potential risks to the financial system presented by such transactions.

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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, issued on February 15, 2013, is available at: http://www.bis.org/publ/bcbs242.pdf.

[3] Our response to the original consultation is available at: https://www.managedfunds.org/wp-content/uploads/2012/09/Basel-IOSCO-Margin-Proposals-MFA-Final-Letter.pdf.

I. Executive Summary

MFA continues to support the efforts of the WGMR to provide for an international framework for bilateral exchange of initial margin ("**IM**") and variation margin ("**VM**"). MFA thanks the WGMR for considering and adopting many of our comments on the original consultation.

In response to the four open issues in the Consultation Paper, and more specifically as set out below, we respectfully urge the WGMR in the final policy framework to continue to take into consideration the importance of certain uncleared derivatives as customized risk management tools.

- Physically-settled FX forwards and swaps. MFA supports the bilateral exchange of VM in respect of these derivatives. We also strongly support a consistent, global application of this requirement by local regulators. However, while MFA does not support these derivatives being exempt from IM requirements, we respectfully urge the WGMR to take a more nuanced approach to IM requirements, as outlined below, to address the highly liquid nature of certain physically-settled FX forwards and swaps.

- Re-hypothecation. MFA supports the segregation and robust physical protection of IM unless a customer has made a deliberate decision to waive such protection, in which case, such customer should be permitted to allow re-hypothecation of its IM by its counterparty without condition or restriction. MFA therefore respectfully urges the WGMR to allow posting counterparties to decide whether or not to allow re-hypothecation of their IM based on their individual risk assessments and the protections afforded by local laws.

- Phase-in arrangements. MFA generally supports the WGMR's phase-in arrangements. In particular, we strongly support the single effective date of 1 January 2015 for all financial firms and systemically-important non-financial entities ("**covered entities**") to comply with the requirement to exchange VM. With respect to the staging of the bilateral exchange of IM, MFA believes that the WGMR should consider applying a test of a covered entity's month-end average notional amount of uncleared derivatives over each of the twelve months in a calendar year, rather than the last three months of such year. We also believe that the thresholds between 2018 and 2019 should be staggered more gradually.

- QIS results. MFA has no specific comments on the accuracy of the results of the WGMR's quantitative impact study ("**QIS**"). In reflecting on the applicability of the results, though, we believe that they highlight the need for IM models to be sufficiently replicable and transparent to enhance their utility by both parties to an uncleared derivative. In addition, the results underscore the importance of ensuring that eligible collateral is employed as efficiently as possible. Toward this end, MFA requests that the WGMR clarify certain language in paragraph 3.4 of the Consultation Paper to reinforce the authority of market participants to use master netting agreements to account for risk offsets among different types of financial instruments within asset classes.

II. MFA Responses to the Consultation Paper Questions

Q1. Given the particular characteristics of physically-settled FX forwards and swaps, should they be exempted from initial margin requirements with variation margin required as a result of either supervisory guidance or national regulation? Should physically-settled FX forwards and swaps with different maturities be subject to different treatments?

MFA believes that VM should be required for all physically-settled FX forwards and swaps regardless of their maturity. Although certain physically-settled FX forwards and swaps do have unique characteristics (*e.g.*, they may be highly liquid), they still carry counterparty credit risk. We believe that such risk should be addressed by the bilateral exchange of VM in the same way that the WGMR would require bilateral VM exchange in respect of all other types of uncleared derivatives, including other FX derivatives.[4] Accordingly, MFA supports universal two-way exchange of VM between covered entities and would not support any local deviation from this standard by either supervisory guidance or national regulation. Such deviations would create opportunities for regulatory arbitrage. Such regulatory arbitrage risk would undermine the efforts and objectives of the WGMR in specifying a final global framework for margining requirements for all uncleared derivatives.

MFA also believes that physically-settled FX forwards and swaps should not be exempted from IM requirements. However, we strongly believe that it would be inappropriate to apply rigidly the same IM baseline considerations for physically-settled FX forwards and swaps as would apply to other types of uncleared derivatives. Our rationale for this position is based on the highly liquid nature of certain physically-settled FX swaps and forwards – particularly, for example, those which are based on the currencies of the G7 countries. As the WGMR notes at paragraph 3(d) of the Consultation Paper, "[i]nitial margin protects the transacting parties from the potential future exposure that could arise from future changes in the mark-to-market value of the contract during the time it takes to close out the position".[5]

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[4] Consultation Paper, §3.13, at 14 ("For variation margin, the full amount necessary to fully collateralise the mark-to-mark exposure of the non-centrally derivative must be exchanged".) MFA also notes the recent publication of the Basel Committee on Banking Supervision's "Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions", issued in February 2013 (the "**Basel Supervisory Guidance**"), available at: http://www.bis.org/publ/bcbs241.pdf. The Basel Supervisory Guidance, which is directed to banks and their supervisors, echoes the WGMR's VM requirements in the Consultation Paper that would apply to all covered entities, stating at 16 that: "A bank should exchange (ie both receive and deliver) the full amount of variation margin necessary to fully collateralize the mark-to-market exposure on physically settling FX swaps and forwards with counterparties that are financial institutions and systemically important non-financial entities".

[5] Consultation Paper at 10.

We submit that this close-out period will likely be shorter in the case of a highly liquid, physically-settled FX forward or swap than it would be in the case of a less liquid uncleared derivative. For this reason, the WGMR should allow quantitative models to take account of the shorter close-out periods that are regularly observed in the FX market. For example, the 10-day liquidation horizon/close-out period which the WGMR envisages for setting the IM baseline for an uncleared derivative for which VM is exchanged on a daily basis would be manifestly inappropriate in the case of short-term (*e.g.* 30-day tenor) U.S. dollar or Euro FX forwards. For such liquid, physically-settled FX forwards and swaps, we respectfully urge the WGMR to apply the same, or a lower, time horizon as is applicable to cleared derivatives.

For the standardised IM schedule at Appendix A to the Consultation Paper, we respectfully recommend that the WGMR consider making the "Foreign Exchange/Currency" asset class more risk-specific. For example, we believe this asset class should be segmented by tenor, and also by currency (*e.g.* with lower requirements applying to G7 and G20 currencies, and higher requirements applying to emerging market currencies).[6] Our recommendation is informed by the extensive trading experience of MFA members in these transactions, and also by noting the more risk-specific construction of the Credit asset class, which is segmented into different durations, with the lowest IM requirements applying to those credit derivatives which have the shortest tenor.

For the standardised haircut schedule in Appendix B to the Consultation Paper, we are particularly concerned that the 8% "additive" haircut on assets in which the currency of the derivative obligation differs from that of the collateral asset does not clearly or directly correspond to actual FX risk among different currencies. We respectfully submit that an 8% haircut is unwarranted for cash in U.S. dollars or any other creditworthy sovereign currency.

Q2. Should re-hypothecation be allowed to finance/hedge customer positions if re-hypothecated customer assets are protected in a manner consistent with the key principle? Specifically, should re-hypothecation be allowed under strict conditions such as (i) collateral can only be re-hypothecated to finance/hedge customer, non-proprietary positions; (ii) the pledgee treats re-hypothecated collateral as customer assets; and (iii) the applicable insolvency regime allows customer first priority claim over the pledged collateral.

[6] We refer you in this respect to the "Sample Initial Margin Schedule" annexed to our original consultation response, which provides an example of how further specificity in such sub-categories could work in practice.

MFA notes that the WGMR's current position is that re-hypothecation of IM should not be allowed, given the risk that third parties could gain legal or beneficial title over the posting counterparty's IM, or that IM is pooled with assets belonging to others, resulting in a lack of protective insulation and attendant complications in an insolvency situation. Under the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"), customers have the option to elect segregation protection, but this election comes at a cost as it would disable the right of the receiving counterparty to re-hypothecate its customer's IM.[7] Customers who elect not to have segregation protection should have the ability to permit re-hypothecation of their IM. MFA submits that whether or not to allow IM re-hypothecation should be a function of customer choice based on the robustness of the protections afforded to its posted IM in different legal regimes.

The covered entities to which the WGMR's final margining requirements would apply are well-informed of the risks of allowing re-hypothecation without segregation and physical protection of the IM, as starkly demonstrated by recent events highlighting the risk that re-hypothecation can delay, or even prevent, the recovery of posted collateral in an insolvency, resulting in material losses for customers.[8] MFA believes that it is important, in the interest of customer choice and individual risk assessment, to let a customer decide whether to allow for re-hypothecation of its posted IM if the customer were to waive its right to elect segregation. Without any provision for customer choice, we are concerned that an outright regulatory prohibition on IM re-hypothecation, or a limited right of IM re-hypothecation subject to the WGMR's suggested conditions, could result in destabilising liquidity pressures caused by the regulatory imposition of higher collateral requirements for uncleared derivatives. As such, it is in the interests of the global markets to give covered entities the option to allow re-hypothecation of their IM without condition or limitation, as is the case with VM. We support the WGMR's decision not to place any condition or limitation on the re-hypothecation of VM.

Q.3 Are the proposed phase-in arrangements appropriate? Do they appropriately trade off the systemic risk reduction and the incentive benefits with the liquidity, operational and transition costs associated with implementing the requirements? Are the proposed triggers and dates that provide for the phase-in of the requirements appropriately calibrated so that (i) the largest and most systemically-risky covered entities would be subject to the margining requirements at an earlier stage so as to reduce the systemic risk of non-centrally cleared derivatives and create incentive for central clearing, and (ii) the smaller and less systemically

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[7] Under the Dodd-Frank Act, regulated entities (*i.e.*, "swap dealers" and "major swap participants") must offer their counterparties the opportunity to segregate with an independent third-party custodian any collateral that does not constitute VM that is posted in connection with non-cleared derivative transactions. The counterparty therefore has the option to elect full third-party segregation of its IM, but is not mandated to do so. *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 U.S. Commodity Exchange Act, 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."

[8] *See, e.g.*, recent events surrounding the insolvency of MF Global. *See also Report of the Trustee's Investigation and Recommendations, In re MF Global Inc.*, No. 11– 2790 (MG) SIPA (Bankr. S.D.N.Y. Jun. 4, 2012), available at: http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/mfglobaliinvestreport060412.pdf.

risky covered entities would be allowed more time to implement the new requirements? Should the phase-in arrangements apply to the exchange of variation margin, in addition to the exchange of initial margin as currently suggested? Or, given that variation margin is already a widely-adopted market practice, should variation margin be required as soon as the margin framework becomes effective (on 1 January 2015 as currently proposed) so as to remove existing gaps and reduce systemic risk? Do differences of market circumstances such as readiness of market participants and relatively small volumes of derivatives trading in emerging markets require flexibility with phase-in treatment, even for variation margin?

In general, MFA supports the proposed phase-in periods. However, MFA is concerned that the requirement to exchange VM between covered entities, which only applies to new contracts entered into after 1 January 2015, should not create a presumption that bilateral VM exchange should not continue under existing contracts. We believe it would be helpful for the WGMR to provide such clarification in the final margining requirements, particularly given the WGMR's express statement that applying such IM requirements to existing contracts is not required.[9]

With respect to the staging of the bilateral exchange of IM, MFA notes that the application of the phase-in periods is dependent on a covered entity's month-end average notional amount of uncleared derivatives over the last three months of the previous year. Although limiting the calculation to a period of three months would capture the most recent risk profile of the relevant entity, we wish to point out that this limitation could give entities an incentive to manage their derivatives activity during the final three months of the year so that they stay beneath the relevant threshold, thus delaying their need to comply with the mandatory IM requirements. To prevent such unintended consequences, MFA respectfully requests that the WGMR should consider whether a twelve-month average would be more appropriate.

As a general observation, MFA notes that under the proposed phase-in arrangements there would be a particularly sharp increase in the scope of IM requirements between 2018 (with a threshold of more than EUR 0.75 trillion), and 2019 (with a threshold of at least EUR 8 billion). We respectfully urge the WGMR to consider that the market for uncleared derivatives is likely to contract dramatically during the next two years as clearing requirements are phased in for more liquid and standardised derivatives. In addition, any covered entity which is above the phase-in threshold in a particular year will only have to exchange IM with those counterparties which are also above the threshold. Therefore, under the proposed phase-in periods, the application of IM requirements to covered entities will be relatively limited until 2019, when the requirements would then apply to a much broader range of covered entities. The WGMR may therefore wish to consider making the thresholds slightly more staggered towards the end of the staging such that the scope of IM requirements would increase more gradually.

Q4. The BCBS and IOSCO seek comment on the accuracy and applicability of the QIS results discussed in the Consultation Paper.

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[9] Consultation Paper, §8.9 at 22. We also acknowledge the WGMR's statement in §8.1 at 22 that "[e]xchange of variation margin on other contracts is subject to bilateral agreement". However, we respectfully suggest that the phrase "other contracts" could be clarified to include existing contracts and other contracts that covered entities may enter into prior to 1 January 2015.

MFA has no specific comments on the accuracy of the QIS results. However, in relation to the applicability of the QIS results, we note that the WGMR concludes that use of the standardised schedule would result in IM requirements that are 6 to 11 times higher than those resulting from the use of a model.[10] We also note that the Consultation Paper states that "[b]ilateral margining requirements would increase significantly if the standardised schedule is used by a significant number of firms", but that "[i]t is difficult to put a precise number on this estimate since the scope of model approvals cannot be anticipated at this time".[11] In light of the WGMR's proposal that market participants should be given the option of using regulator-approved models or of using the standardised schedule set out in Appendix A to the Consultation Paper to calculate IM requirements, we believe it would be desirable for the WGMR to enhance the use of quantitative models that yield more risk-sensitive IM amounts in the interests of reducing the potential liquidity impact of the IM requirements.[12] To this end, MFA respectfully urges the WGMR to consider including a requirement that the basic functionality of IM models should be sufficiently replicable and transparent to allow both parties to an uncleared derivative contract to determine independently the applicable margin. In MFA's view, such replicability and transparency should be conditions to regulatory approval of any IM model.

As a final observation, the results of the QIS study clearly demonstrate the significant liquidity impact which the proposed IM requirements will have on the global derivatives market. In this respect, MFA strongly supports the WGMR's decision to include a wider range of assets in the list of assets which may be used as eligible collateral. However, we question the extent to which brokers will accept the full range of assets proposed by WGMR as collateral. Given this concern, the WGMR should aim to ensure that existing collateral is employed as efficiently as possible. Accordingly, MFA respectfully urges the WGMR to include in its final rules a specific statement that IM models may account for risk offsets across cleared and uncleared derivatives as well as across correlated non-derivative instruments, provided such instruments are within the same asset class (*i.e.* currency/rates, equity, credit, or commodities) and are covered by the same legally enforceable master netting agreement. As discussed in our response to the WGMR's first consultation paper, such master netting agreements account for risk offsets among different types of financial instruments within asset classes, rather than merely among uncleared derivatives across asset classes. Portfolio margining under such master netting agreements is permitted under existing regulatory regimes and is consistent with current market practice in the derivatives markets.

MFA notes with appreciation that the Consultation Paper now states at paragraph 3.4 that "[i]nitial margin models may account for diversification, hedging and risk offsets **within** well-defined asset classes . . . but not **across** such asset classes and provided these <u>instruments</u> are covered by the same legally enforceable netting agreement" (*underscored emphasis added).*[13]

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[10] *Id*. at 26, App. C, §1(e).

[11] *Id.*

[12] We note the WGMR's compelling conclusion from the QIS results that use of the standardised margin schedule could raise the amount of available liquid assets required to be used as margin from 8% to 86%. *Id*. at 27, App. C, §1(g).

[13] *Id*. at 12.

We submit that the continued use of such intra-asset class master netting agreements would substantially mitigate the risk of a potential shortfall in eligible collateral assets to satisfy the final IM requirements. We respectfully request that the WGMR clarify the issue by adding "or master netting agreement" after "netting agreement" in the language quoted above.

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We would welcome the opportunity to discuss our responses and 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,

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, Board of Governors of the Federal Reserve System
Mr. Nicolas Gauthier, European Commission
Mr. John Lawton, U.S. Commodity Futures Trading Commission
Mr. Thomas McGowan, U.S. Securities and Exchange Commission
Mr. Matthew Osborne, UK Financial Services Authority
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Mr. Graham Young, Bank of England
Mr. Kurt Wilhelm, U.S. Office of the Comptroller of the Currency

The Hon. Gary Gensler, Chairman, U.S. Commodity Futures Trading Commission
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