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
wgmr@iosco.org

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

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

Re: Margin Requirements for Non-Centrally-Cleared Derivatives – Final Stages of Initial Margin Phase-in

Dear Sir or Madam:

Managed Funds Association ("**MFA**")[1] appreciates the opportunity to provide comments to the Working Group on Margining Requirements ("**WGMR**") of the Basel Committee on Banking Supervision ("**BCBS**") and the International Organization of Securities Commissions ("**IOSCO**"). MFA is writing this letter to provide recommendations to facilitate the smooth and efficient implementation of minimum initial margin ("**IM**") requirements for non-centrally cleared derivatives adopted by many global regulators (commonly referred to as the "**Uncleared Margin Rules**" or "**UMR**") in accordance with the international margin framework issued by BCBS-IOSCO.[2] The final phases of these IM requirements will come into effect on September 1, 2019 (Phase 4) and September 1, 2020 (Phase 5). In these final phases, a large number of buy-side counterparties, including MFA members, will come into scope. To better prepare for timely implementation of IM requirements, and efficiently allocate limited resources, MFA offers constructive and targeted recommendations to refine UMR in a coordinated fashion in advance of these final stages of IM phase-in.

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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 many other regions where MFA members are market participants.

[2] Available at: https://www.bis.org/bcbs/publ/d317.pdf.

MFA supports broadening the bilateral posting of initial margin to other relevant market participants under UMR, provided that the IM requirements are calibrated to address the risks to the financial system presented by the relevant non-cleared derivative transactions and/or the counterparties. MFA members already post IM, commonly referred to as Independent Amounts, for their non-centrally cleared derivatives. Our primary concern in the upcoming expansion of the IM regime is maintaining reasonable costs and sufficient market liquidity for this important part of the swaps market. We are concerned that if the cost of trading non-cleared derivatives is disproportionately increased by UMR implementation, this could reduce liquidity and adversely impact market participants' ability to invest and properly hedge their portfolios using these instruments. Moreover, for products where no central clearing offering is available and/or where central clearing is not appropriate, calibrating UMR to incentivize such clearing is unrealistic and accordingly may need to be revisited. UMR should be designed to properly mitigate the risks associated with non-centrally cleared derivatives, not to penalize market participants for using non-centrally cleared derivatives to meet their trading needs for prudent risk management, including entering into customized transactions where warranted. This is particularly the case for certain non-cleared and non-clearable derivative products, such as total return swaps[3] on equities and other equity derivatives that are commonly used to provide exposure to physical equities, among other products for which there is no viable cleared market. MFA therefore offers the following recommendations for modifying UMR to ease implementation challenges for many MFA members and other buy-side market participants. Given the global nature of non-cleared derivatives markets, we urge the WGMR and global regulators to coordinate with each other to realize the benefits of our recommendations and the efficiencies of an orderly phase-in of a uniform set of IM requirements.

A. Recalibrate IM requirements to more appropriately address systemic risk

1. *Re-consider gross notional phase-in thresholds for Phase 5*

MFA previously noted to the WGMR in response to its second consultative document on margin requirements for non-centrally cleared derivatives that under the proposed phase-in arrangements there would be a particularly sharp increase in the scope of IM requirements between Phase 4 (with a threshold of more than EUR 0.75 trillion), and Phase 5 (with a threshold of at least EUR 8 billion).[4] In MFA's prior letter, we asked the WGMR to consider making the thresholds more staggered towards the end of the staging such that the scope of IM requirements would increase more gradually. As a result, the WGMR and global regulators should consider inserting another phase-in threshold to ease implementation challenges and to ensure that the required market infrastructure is in place to support the final stages of IM phase-in. MFA supports an interim phase-in threshold of EUR/USD 100 billion in 2020 (a new "**Phase 5.a.**") to manage the industry's logistical challenges and to ensure market infrastructure readiness to

[3] Portfolio swaps or total return swaps are a common type of non-cleared swap used by the hedge fund industry.

[4] *See* MFA Letter to BCBS-IOSO, dated March 15, 2013, at p. 6, available at: https://www.managedfunds.org/wp-content/uploads/2013/03/Basel-IOSCO-Second-Consultative-Document-on-Margin-Requirements-MFA-Final-Letter.pdf.

facilitate and support an orderly phase-in process for the large-scale influx of newly in-scope counterparties in these final stages. The ultimate EUR/USD 8 billion threshold (now "**Phase 5.b**") could still proceed in 2021; however, the lessons learned from Phase 5.a. would provide the WGMR and global regulators with further data to better inform any further decisions about modifying requirements with respect to "Phase 5.b." firms.

If the WGMR and global regulators determine that the insertion of Phase 5.a. is not a viable option, MFA suggests a coordinated re-assessment by regulators and industry participants to consider whether an adjustment is warranted to the current Phase 5 threshold of EUR/USD 8 billion. MFA cautions the WGMR and global regulators that if the Phase 5 phase-in threshold is set too high, regulators may introduce competitive and market structure distortions with disparate impacts based on the type of buy-side entity that enters into non-cleared trades with in-scope dealers. Within non-cleared derivatives markets, these distortions could result in substantial non-uniformity in IM requirements between two distinct tiers of buy-side counterparties, with a larger group of out-of-scope counterparties having a competitive advantage over a smaller group of in-scope counterparties by virtue of not having to post, collect and segregate regulatory IM.

As noted above, MFA members are already posting IM to their dealer counterparties and have been for decades. MFA fears that if other large buy-side market participants are exempted by adjusting the Phase 5 threshold too high, regulators would inadvertently create an unlevel playing field that would harm the underlying investors of MFA members. More specifically, a higher Phase 5 threshold would confer advantages to a larger group of out-of-scope counterparties by virtue of not having to expend significant resources to enter into regulatory-compliant IM documentation and custodial arrangements for bilateral IM exchange. In addition to avoiding the legal and transaction costs associated with custodial arrangements, dealers would likely charge their out-of-scope clients less than in-scope counterparties for non-cleared trades, because dealers can use and rehypothecate client IM posted to them directly versus having to segregate posted regulatory IM for in-scope clients. On the other hand, a higher Phase 5 threshold would lessen the competition for dealer resources to negotiate and enter into regulatory-compliant IM documentation and custodian resources to negotiate and enter into new custodial arrangements for bilateral IM exchange.

In addition to competitive concerns, a significant potential disparity in IM exchange requirements among market participants for certain derivatives products would also raise market structure concerns. In our view, to the extent that certain derivative products are clearable and not yet subject to a clearing mandate, regulators may create an unlevel playing field between cleared derivatives markets, where bilateral exchange of IM (and variation margin) is required, and non-cleared derivatives markets, where bilateral exchange of IM may not be required if regulators adjust the Phase 5 threshold too high. This market structure distortion may have the unintended consequence of creating disincentives for market participants to clear such products, which would undermine systemic risk reduction.

2. *Remove physically settled foreign exchange swaps and forwards from aggregate average notional amount calculations for Phase 5*

MFA believes that counterparties should not be required to include physically settled foreign exchange ("**FX**") swaps and forwards in calculations of aggregate average notional

amount ("**AANA**") thresholds for determining whether they are in-scope of the IM requirements under UMR given that these instruments are not subject to UMR in the first place. Resolving this incongruity is logical and would smooth implementation by avoiding the inclusion of products that should not otherwise be affected by the rules into the process.

In our view, the inclusion of all physically settled FX swaps and forwards in AANA thresholds for Phase 5 could discourage prudent FX hedging. Given that physically settled FX transactions are relatively short-term instruments with low volatility, regulators in both the U.S. and Europe have fully exempted such transactions from IM requirements. Excluding such instruments would both reduce logistical burdens for Phase 5 and result in more consistent regulatory treatment without adversely affecting their use as important hedging tools.

B. Clarify timing for regulatory IM-compliant documentation

MFA believes that regulators could decrease the resource-intensive challenges facing market participants for the final phases of IM implementation by clarifying through coordinated guidance that regulatory-compliant documentation and custodial arrangements are not required until a counterparty's regulatory IM calculation exceeds the applicable IM exchange threshold.[5] We believe such clear guidance from regulators would reduce competition for scarce dealer and custodian resources and relieve many Phase 5 counterparties from expending significant resources. This is particularly the case if a large number of Phase 5 counterparties never breach the applicable IM exchange threshold.[6]

C. Remove Burdens to Use, and Enhance the Use of, Globally Approved IM Models, including the ISDA SIMM

1. Exempt Phase 4-5 non-dealer counterparties from prudential-style governance of IM models designed for bank capital standards

Many MFA members who will face EU dealers subject to EU UMR may need to develop and manage costly monitoring and margin remediation capabilities when using an internal IM model, including the ISDA SIMM, to calculate regulatory IM.[7] For such MFA members, we

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[5] Under U.S. UMR, for example, in-scope counterparties may agree to an IM exchange threshold up to USD 50 million, and if agreed, the counterparties need not exchange IM until the applicable threshold is exceeded.

[6] *See* Letter from the International Swaps and Derivatives Association (ISDA), the Securities Industry and Financial Markets Association (SIFMA), the American Bankers Association, the Global Foreign Exchange Division, GFMA, and the Institute of International Bankers to BCBS-IOSCO, dated Sept. 12, 2018 (reporting a quantitative analysis finding that approximately three-quarters of counterparty relationships that are estimated to become subject to UMR in Phase 5 will not exceed applicable IM exchange thresholds).

[7] *See* Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty, Article 14 (*General requirements)*, Article 16 (*Calibration of the parameters of the model*), and Article 18 (*Qualitative requirements)* (requiring counterparties using an IM model to undertake internal initial validation of the model's conceptual soundness, demonstrate required risk factor inputs, monitor performance, undertake back-testing, and implement an internal governance process that involves regular auditing and documentation of risk management procedures).

recommend exempting Phase 4-5 non-dealer counterparties from prudential-style governance burdens. Hundreds of customers should not be required to independently verify and monitor standard models that have already been reviewed and approved by regulators for use by our bank counterparties.

2. *Enhance portfolio margining in IM models*

The current UMR authorize netting of non-cleared swaps and non-cleared security-based swaps under the same eligible master netting agreement for model-based calculations of required IM.[8] To enhance the recognition of mutually offsetting transactions, MFA believes that global regulators should authorize IM models to account for risk offsets across suitably correlated cleared and non-cleared swap products and non-swap products within the same broad risk category pursuant to a single cross-product master netting agreement. For example, a cross-product master netting agreement might include different products in the FX/interest rate category, including U.S. Treasury futures, Eurodollar futures, cleared interest rate swaps, non-cleared FX options, and repurchase agreements. Such cross-product portfolio margining arrangements account adequately for risks of a portfolio, while avoiding the capital inefficiencies of over-collateralization by reducing both the aggregate requirement to deliver IM and trading costs for market participants. It bears emphasizing that any IM model that permits cross-product master netting agreements would continue to be subject to all other regulatory requirements for IM models.[9]

3. *Accelerate regulatory approvals of business-specific IM models to avoid model herding to a single standard initial margin model*

MFA shares the concerns raised in the Giancarlo-Tuckman White Paper regarding the use of a single, global model for calculating IM for non-cleared derivatives between bank dealers and their customers.[10] In response to the IM model requirements in UMR, ISDA developed the ISDA SIMM to facilitate calculations of required IM for non-cleared interdealer trades during the initial phases of the phase-in schedule. With the upcoming last two phases, MFA believes that regulators should facilitate the development of bank dealers' own business-specific IM models by streamlining and accelerating the regulatory approval process. Such approved, business-specific models would calculate more risk-refined IM amounts for non-cleared dealer-to-customer trades with enhanced netting and risk-sensitive liquidation periods.

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[8] *See, e.g.,* Final Rule, "Margin and Capital Requirements for Covered Swap Entities", 80 Fed. Reg. 74,840 (Nov. 30, 2015), 74,903 at sec. __.5, and 74,906 at sec.__.8(d)(5).

[9] *Id.* at sec. __.8.

[10] *See* White Paper, "Swaps Regulation Version 2.0: An Assessment of the Current Implementation of Reform and Proposals for Next Steps," co-authored by J. Christopher Giancarlo, CFTC Chairman, and Bruce Tuckman, CFTC Chief Economist, dated April 26, 2018 (the "**Giancarlo-Tuckman White Paper**"), at pp. 85-87; available at: Swaps Regulation Version 2.0: An Assessment of the Current Implementation of Reform and Proposals for Next Steps (noting that firms have less incentive to develop better models and other risks resulting from widespread adoption of a single, imperfect model).

4. *Authorize opt-in margining of non-regulated products to enhance portfolio offsets in IM models*

MFA believes another area that needs additional regulatory flexibility and calibration to ease implementation challenges and achieve enhanced risk sensitivity in regulatory IM calculations relates to the ability of IM models to recognize offsetting hedging sets between swaps and non-swaps in a portfolio. MFA understands from our members that there are numerous instances where non-cleared swaps that will be subject to the new IM requirements are held in a portfolio with other products that are not subject to the new IM requirements. For example, MFA members with FX options (*i.e.*, swaps) in their portfolios typically have FX forwards (*i.e.*, exempted as swaps[11]) to hedge their FX options. Unfortunately, the new rules do not authorize IM models to recognize the hedging sets between swaps and non-swaps. The resulting inability of IM models to recognize risk-reducing hedges in market participants' portfolios will generate needlessly over-sized IM levels for many non-cleared swaps.

5. *Ensure Robust Data Security Protections by Third-Party Vendors*

It has come to MFA's attention that many in-scope dealers are using third-party software vendors to provide functionality for regulatory IM calculations, reconciliation and margin workflows. With the surge in sensitive transaction data from newly in-scope client counterparties in Phases 4 and 5, MFA strongly believes that third-party vendor systems must have adequate and robust data security protections in place before receiving and storing such transaction data. Given recent evidence of a tendency towards increasingly detrimental and recurrent large-scale attacks conducted against information systems, MFA recommends that regulators work with dealers, their clients and critical third-party vendors sufficiently in advance of the IM phase-in dates for Phases 4 and 5. It is critical that such solutions ensure that there are robust systems safeguards and effective controls in place to guard against cyberattacks and data breaches. Regulatory deadlines should not be used by critical third-party vendors to force the marketplace to adopt workflows that undermine data security.

We look forward to an ongoing dialogue to discuss pragmatic solutions to the various implementation challenges that will arise for MFA members and other buy-side market participants.

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[11] *See* U.S. Department of the Treasury, "Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act", 77 Fed. Reg. 69,694 (Nov. 20, 2012), available at: https://www.gpo.gov/fdsys/pkg/FR-2012-11-20/pdf/2012-28319.pdf.

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MFA thanks the WGMR for the opportunity to provide comments and recommendations. We would welcome the opportunity for a meeting to discuss our views in greater detail. Please do not hesitate to contact 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,

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Laura Harper Powell
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cc: Mr. Michael Gibson, Board of Governors of the Federal Reserve System
Ms. Heather Pilley, Financial Conduct Authority
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National Futures Association
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U.S. Commodity Futures Trading Commission
U.S. Department of the Treasury
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