



June 20, 2019

Via Electronic Submission

To: Board of Governors of the Federal Reserve System
Department of the Treasury/Office of the Comptroller of the Currency
Farm Credit Administration
Federal Deposit Insurance Corporation
Federal Housing Finance Agency

Re: Request for Action by the Prudential Regulators to Facilitate Orderly Initial Margin Phase-in Implementation; Margin and Capital Requirements for Covered Swap Entities, Final Rule

Ladies and Gentlemen:

Managed Funds Association (“MFA”)¹ requests that the U.S. prudential regulators (the “**Prudential Regulators**”)² adopt certain measures this summer to ease resource burdens and avoid trading disruptions for swaps market participants in the final implementation phases of minimum initial margin (“**IM**”) requirements for non-cleared derivatives adopted by the Prudential Regulators³ and many other regulators (commonly referred to as the “**Uncleared Margin Rules**” or “**UMR**”) in accordance with the international margin framework issued by Basel Committee on Banking Supervision (“**BCBS**”) and International Organization of Securities Commissions (“**IOSCO**”)⁴. Specifically, we request that the Prudential Regulators take the following near-term measures to ensure a smooth and orderly implementation of IM requirements in the final phases, especially for the relatively large influx of newly in-scope entities on the September 1, 2020 implementation date for Phase 5:

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 over time. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and many other regions where MFA members are market participants.

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 Final Rule, “Margin and Capital Requirements for Covered Swap Entities”, 80 Fed. Reg. 74840 (Nov. 30, 2015), as amended on Oct. 10, 2018.

⁴ Available at: <https://www.bis.org/bcbs/publ/d317.pdf>.

- Issue guidance that affirms the recent BCBS-IOSCO guidance statement issued on March 5, 2019 (“**BCBS-IOSCO Guidance**”)⁵, an action that is consistent with the recent request of the Commodity Futures Trading Commission (“**CFTC**”).⁶ We acknowledge that UMR does not require an in-scope entity to post regulatory IM until its bilateral IM amount in a counterparty relationship exceeds \$50 million, and therefore an in-scope entity’s bilateral IM amount below such threshold would not need regulatory-compliant documentation and custodial arrangements in place in order to continue trading non-cleared derivatives with its counterparty after UMR implementation.⁷ Nonetheless, the requested guidance would help clarify the obligations of market participants and manage and prioritize their resources.
- Provide a forbearance period of six months after a Phase 5 entity’s counterparty relationship that was initially below the \$50 million regulatory IM exchange threshold later exceeds such exchange threshold in order to put the necessary bilateral collateral documentation and trilateral custodial arrangements in place to both post and receive regulatory IM and avoid trading disruptions. As discussed in more detail below, a reasonable forbearance period is necessary to manage the complexities, compliance expenses and resource constraints facing Phase 5 entities, including with respect to separately managed accounts (“**SMAs**”)⁸ and associated risks.

I. Resource Constraints in Final Phases Need Near-Term Regulatory Measures

Many MFA members regularly enter into non-cleared derivatives as part of their investment strategies and already post agreed amounts of IM as “Independent Amounts” to their swap dealer counterparties. Currently, most MFA members do not collect Independent Amounts from their swap dealer counterparties. Under UMR, they will be required to receive regulatory

⁵ Available at: <https://www.bis.org/press/p190305a.htm>. MFA acknowledges and appreciates that BCBS and IOSCO recognize the significant challenges facing Phase 5 entities by stating in this guidance that they “will continue to monitor the effect of meeting the final stage of phase-in, scheduled for 2020.”

⁶ See CFTC Chairman Giancarlo letter to Randal Quarles, Vice Chair of Supervision, Federal Reserve Board of Governors, dated April 29, 2019 (the “**Giancarlo Phase 5 Letter**”), available at: <https://www.cftc.gov/system/files/2019/05/02/PhaseFiveImplementationLetter043019.pdf>. The Giancarlo Phase 5 Letter calls for U.S. regulators to issue regulatory guidance to clarify that a U.S. regulated entity need not have in place systems and documentation to exchange IM on uncleared swaps with a counterparty if its calculated bilateral IM amount with that counterparty is less than \$50 million.

⁷ See Final Rule, “Margin and Capital Requirements for Covered Swap Entities”, 80 Fed. Reg. 74840 at 74844 (“The final rule permits a covered swap entity to adopt a maximum initial margin threshold amount of \$50 million, below which it need not collect or post initial margin from or to swap entities and financial end users with material swaps exposures.”).

⁸ Large institutional investors, such as pension plans and endowments, typically hire multiple asset managers to exercise investment discretion over a portion of such investor’s assets for management in accounts referred to as “separately managed accounts”. Asset managers do not know the positions of other asset managers trading derivatives for the same underlying investor under multiple SMAs and do not act in coordination.

IM from their swap dealers and segregate it with a third-party custodian bank under trilateral custodial account control agreements (“ACAs”). Based on our members’ experience, the negotiation of ACAs is a time-consuming and costly process, which is compounded by the need for two ACAs for each counterparty relationship for bilateral IM exchange under UMR. In addition, in-scope entities will need to modify or replace their existing bilateral collateral arrangements for posting IM to their swap dealer counterparties, which is an expensive and resource-intensive undertaking for each trading relationship. Many MFA members have trading relationships with 10 to 30 swap dealers per each fund managed by an MFA member, which number is often multiplied by three to account for separate trading relationships with affiliates of their swap dealers. The formidable resource demands associated with putting regulatory-compliant documentation and custodial arrangements and associated systems in place may result in a significant reduction in negotiation power for many Phase 5 buy-side entities. Phase 5 entities will be competing for the attention of swap dealers and custodians and thus may either rush the negotiation process, or forgo negotiations altogether if faced with a “take it or leave it” ultimatum, and agree to less favorable terms in order to meet the September 1, 2020 implementation deadline and continue their non-cleared derivatives trading without disruption. We note that although MFA members are ready and willing to begin the negotiation process, swap dealers have advised some buy-side entities that they are still working on Phase 4 implementation and will not be ready for months to engage in Phase 5 discussions.

MFA members are also expending significant resources to determine the applicability of the new regulatory IM regime to the funds and SMAs they manage and whether they will exceed the 8 billion US\$/Euro threshold for Phase 5 implementation under U.S. and EU UMR. If so, they must make self-disclosures to their swap dealers and undertake additional calculations with their swap dealers to determine whether or not their counterparty relationships will exceed the 50 million US\$/Euro regulatory IM exchange threshold. The cliff-edge effect of the phase-in threshold dropping from the 750 billion US\$/Euro for Phase 4 to the 8 billion US\$/Euro threshold for Phase 5 is expected to bring into scope a relatively large number of buy-side counterparties, including many MFA members, with the resulting resource constraints facing them to prepare and negotiate the necessary documentation and custodial arrangements to facilitate their swap dealers’ regulatory obligations for UMR compliance. In October 2018, MFA submitted a letter to BCBS-IOSCO with constructive and targeted recommendations to implement in advance of these final stages of IM phase-in to help Phase 5 entities, swap dealers, and custodians prepare for timely implementation of IM requirements and efficiently allocate limited resources.⁹

II. Adopt BCBS-IOSCO Guidance Statement

In a meeting of the CFTC’s Global Markets Advisory Committee (“GMAC”) on April 15, 2019, participants engaged in an extensive discussion of UMR IM implementation challenges and the recent BCBS-IOSCO Guidance. This guidance clarifies that the BCBS-IOSCO

⁹ See MFA letter to BCBS-IOSCO, submitted on October 25, 2018, available at: <https://www.managedfunds.org/wp-content/uploads/2018/11/MFA-Letter-UMR-Implementation-Challenges-for-Final-Stages-of-IM-Phase-in.pdf>.

international margin framework does not specify documentation, custodial or operational requirements if the bilateral regulatory IM amount does not exceed the framework's 50 million US\$/Euro IM exchange threshold. MFA recommended this guidance as one of several recommendations to decrease the resource-intensive challenges facing market participants for the final phases of IM implementation.¹⁰ The BCBS-IOSCO Guidance also states an expectation that "covered entities will act diligently when their exposures approach the threshold to ensure that the relevant arrangements needed are in place if the threshold is exceeded".¹¹ Although the BCBS-IOSCO Guidance is a good first step in providing helpful clarity to market participants, MFA urges the Prudential Regulators, the CFTC and other regulators to adopt expressly the BSBS-IOSCO Guidance this summer to help Phase 5 entities, swap dealers, and custodians manage the resource-intensive documentation process and ensure they have operational systems that are tested and ready for bilateral IM exchange under UMR.

Asset managers of SMAs would also benefit from helpful staff guidance to clarify their ongoing monitoring obligations. After Phase 5 implementation, MFA notes that many MFA members and other asset managers will face unique and serious challenges in determining and monitoring UMR IM requirements for SMAs of an underlying investor, such as a pension plan, with multiple asset managers. For derivatives trading purposes, a dealer counterparty will face the same SMA client through multiple SMAs of multiple asset managers. An asset manager of an SMA for its underlying investor has no visibility into the non-cleared derivatives positions of SMAs managed by other asset managers for the same underlying investor. This lack of visibility renders impossible the ability of asset managers to monitor daily the SMA's bilateral IM amounts with dealer counterparties. For in-scope SMAs in one or more counterparty relationships below the applicable 50 million US\$/Euro regulatory IM exchange threshold, the asset manager will not know how close an in-scope SMA is to approaching the IM exchange threshold for a given dealer counterparty relationship, or even if the SMA has exceeded the IM exchange threshold for that counterparty relationship, until the underlying investor or its swap dealer notifies the asset manager. For SMAs that are not initially in-scope of UMR IM requirements, an asset manager will also not know when the SMA has exceeded the 8 billion US\$/Euro threshold that will trigger UMR IM requirements until the underlying investor notifies the asset manager. Asset managers need regulatory clarification of their obligations after receiving such notifications.

III. Provide Forbearance Period for Phase 5 Counterparty Relationships Below \$50M IM Exchange Threshold

Given the complexity of managing the UMR IM requirements of SMAs, the formidable resource constraints facing Phase 5 entities, and the associated risks of trading disruptions without regulatory-compliant documentation and systems to operationalize IM exchange, MFA requests that the Prudential Regulators coordinate with the CFTC and other regulators to provide a six-month forbearance period for counterparty relationships involving those Phase 5 entities, including SMAs, that will not exceed the applicable 50 million US\$/Euro regulatory IM

¹⁰ *See id.*

¹¹ *See supra* note 5.

exchange threshold at the outset of the new regulatory IM regime (such entities, the “**Below \$50M Subgroup**”). MFA expects that the Below \$50M Subgroup will likely be placed relatively low in the priority queue due to the resource constraints of swap dealers and custodians. Such resource constraints would require that swap dealers and custodians prioritize those Phase 5 entities that will exceed the applicable regulatory IM exchange threshold to ensure their regulatory-compliant documentation and custodial arrangements are in place by September 1, 2020. To address such expected resource prioritization, MFA believes that a forbearance period of six months after a Phase 5 entity exceeds the applicable 50 million US\$/Euro regulatory IM exchange threshold would be a reasonable phase-in period for the Below \$50M Subgroup to put the necessary documentation and systems in place.

IV. Consider Broader Solutions for Targeted UMR Recalibration

In addition to issuing timely clarifying guidance and providing a general forbearance period for the Below \$50M Subgroup as near-term regulatory measures, MFA urges the Prudential Regulators to coordinate with the CFTC and other regulators through the BCBS-IOSCO Working Group on Margining Requirements (“**WGMR**”) to implement broader regulatory solutions that would involve targeted recalibration of UMR IM requirements. As the WGMR continues to monitor Phase 5 IM implementation, MFA reiterates the following recommendations in its letter to BCBS-IOSCO¹² for the Prudential Regulators and other members of the WGMR to consider:

- Excluding physically settled foreign exchange swaps and forwards in calculations of aggregate average notional amount thresholds for determining whether counterparties are in-scope of the UMR IM requirements. This recalibration is logical and would smooth implementation by avoiding the inclusion of products that should not otherwise be affected by the rules into the process.
- Adopting another phase-in threshold between 750 billion US\$/Euro and 8 billion US\$/Euro; specifically, MFA recommended a Phase 5.a. threshold of 100 billion US\$/Euro in 2020, with 8 billion US\$/Euro pushed back to 2021 as Phase 5.b. A more gradual and orderly staging would ensure that there is market infrastructure in place to support the final stages of IM phase-in and avoid market disruption. Such a further phase-in would also be preferable to a blanket delay of Phase 5, which would simply defer the cliff-edge effect of the threshold dropping from 750 billion US\$/Euro to 8 billion US\$/Euro without further facilitating the industry’s transition.
- Enhancing the use and risk-sensitivity of approved IM models, including the ISDA SIMMTM, by:
 - exempting Phase 4-5 non-dealer counterparties from prudential-style governance of IM models designed for bank capital standards;
 - enhancing portfolio margining in IM models;

¹² See *supra* note 9.

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- accelerating regulatory approvals of business-specific IM models to avoid model herding to a single standard initial margin model; and
 - authorizing opt-in margining of non-regulated products to enhance portfolio offsets in IM models.
- Requiring robust data security protections by third-party software vendors that provide functionality for regulatory IM calculations, reconciliation, and margin workflows.

MFA respectfully submits this letter for the Prudential Regulators' consideration. If the Prudential Regulators or their respective staffs have any questions, please do not hesitate to call the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Laura Harper Powell

Laura Harper Powell
Associate General Counsel

cc: Mr. Michael Gibson, Board of Governors of the Federal Reserve System
Ms. Heather Pilley, Financial Conduct Authority
Bank of England
European Banking Authority
European Central Bank
European Commission
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