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

February 24, 2014

Via Electronic Submission: rule-comments@sec.gov

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers (RIN 3235 – AL12; File No. S7-08-12): Supplemental Comments to Comment Letter dated February 22, 2013 and Meeting with Staff on October 8, 2013 Relating to Proposed Capital Charge for Segregation of Initial Margin

Dear Ms. Murphy:

Managed Funds Association ("**MFA**")[1] is providing the Securities and Exchange Commission ("**Commission**" or "**SEC**") with additional comments to supplement MFA's comment letter dated February 22, 2013 ("**February Letter**"),[2] and MFA's October 8, 2013 meeting with staff of the SEC's Division of Trading and Markets and Division of Investment Management. The February Letter was in respect of the SEC's proposed rules ("**Proposed Rules**") on capital, margin and segregation requirements for security-based swap dealers ("**SBSDs**") and major security-based swap participants.[3]

Our additional comments relate to only one aspect of the Proposed Rules: the proposed imposition of a capital charge on SBSDs when their financial end-user counterparties elect to

[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] *See* MFA's February Letter, available at: http://www.sec.gov/comments/s7-08-12/s70812-28.pdf.

[3] "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. 70214 (Nov. 23, 2012), available at: http://www.gpo.gov/fdsys/pkg/FR-2012-11-23/pdf/2012-26164.pdf .

segregate initial margin for uncleared security-based swaps. We are writing to highlight the protections and safeguards afforded both the SBSDs and the pledgors by tri-party segregation arrangements. In addition, and as discussed in our October meeting with SEC staff, we include in this letter a list of suggested contractual provisions that will be protective of the SBSD, the pledgor and the structure generally.[4]

The Proposed Rules would impose a 100% capital charge on SBSDs for any initial margin held by a third-party custodian in a segregated account. The effect of the proposed capital charge would be the same from a capital perspective as if the counterparty had failed to post any initial margin at all. The SEC has stated that its concern is that tri-party segregation arrangements would likely delay the SBSD from taking possession of the collateral when necessary. Given the structure and safeguards included in typical tri-party segregation arrangements, we believe that this capital charge is unnecessary. Moreover, the capital charge is inconsistent with the goal of customer protection articulated and enacted by Congress through statutory provisions encouraging tri-party segregation of initial margin under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**").[5]

We note that our position on this matter is shared by a wide range of financial market participants, including the International Swaps and Derivatives Association (ISDA), the Securities Industry and Financial Markets Association (SIFMA), the Asset Management Group (AMG) of SIFMA, the Investment Company Institute (ICI) and the Alternative Investment Management Association (AIMA).[6] Each group has a different market perspective, but all agree that collateral held in a tri-party segregated account under current industry-standard arrangements should not attract a capital charge. In addition, we note that other regulators that have proposed swap capital rules have not included a special capital charge for initial margin held in a tri-party segregated account.[7]

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[4] We note that ICI's supplemental comment letter on the Proposed Rules, filed with the SEC on December 5, 2013 (the "**ICI Supplemental Letter**"), available at: http://www.sec.gov/comments/s7-08-12/s70812-54.pdf , includes an excellent discussion of the safeguards and protections of tri-party segregation and also includes recommended terms for inclusion in tri-party collateral arrangements, which MFA supports. *See* ICI Supplemental Letter at p.12.

[5] Pub. L 111 – 203, 124 Stat. 1376 (2010).

[6] *See* ISDA's comments on the Proposed Rules, filed with the SEC on January 23, 2013, available at: http://www.sec.gov/comments/s7-08-12/s70812-17.pdf; SIFMA's comments on the Proposed Rules, filed with the SEC on February 22, 2013, available at: http://www.sec.gov/comments/s7-08-12/s70812-29.pdf; SIFMA AMG's comments on the Proposed Rules, filed with the SEC on February 22, 2013, available at: http://www.sec.gov/comments/s7-08-12/s70812-38.pdf; ICI's comments on the Proposed Rules, filed with the SEC on February 4, 2013, available at: http://www.sec.gov/comments/s7-08-12/s70812-20.pdf; the ICI Supplemental Letter; and AIMA's comments on the Proposed Rules, filed with the SEC on February 22, 2013, available at: http://www.sec.gov/comments/s7-08-12/s70812-31.pdf.

[7] *See* Commodity Futures Trading Commission's Notice of Proposed Rulemaking on "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants", 76 Fed. Reg. 23732 (Apr. 28, 2011), and Notice of Proposed Rulemaking on "Capital Requirements of Swap Dealers and Major Swap Participants", 76 Fed. Reg. 27802 (May 12, 2011); and Prudential Regulators' Notice of Proposed Rulemaking on "Margin and Capital Requirements for Covered Swap Entities", 76 Fed. Reg. 27564 (May 11, 2011). The Prudential Regulators are

Protection of Customer Initial Margin and the Proposed Capital Charge

Section 3(E)(f) of the Securities Exchange Act of 1934 (the "**Exchange Act**") grants certain customers of SBSDs the right to elect to have their initial margin segregated in an account with a third-party custodian. Dodd-Frank added this section in large part as a response to the experience of swap counterparties that posted initial margin directly to Lehman Brothers Special Financing, an unregulated swap subsidiary. The initial margin was not segregated and consequently, was swept into the Chapter 11 bankruptcy estate. Those counterparties became unsecured creditors of the bankruptcy estate with respect to any excess collateral they had posted, including in many cases posted initial collateral.

Around the time of Lehman, many buy-side counterparties began the arduous process of negotiating with dealers in order to put tri-party segregation agreements in place that would give the dealers the necessary control over initial margin, and also protect such margin from a dealer credit event. Tri-party segregation is intended to protect customers' initial margin from risk of loss upon a SBSD bankruptcy (although its treatment is untested), while still preserving an SBSD's interests as a secured party (*e.g.*, a perfected security interest in, legal control of, and access to initial collateral). Protection of initial margin in this manner is consistent with the final policy framework issued by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions. The framework includes as a key principle that posted initial margin should be subject to arrangements that protect the pledgor "to the extent possible under applicable law" in the event of the secured party's bankruptcy.[8] Congress made this same determination and chose tri-party segregation as the mechanism to accomplish that end.

The Proposed Rules would impose a 100% capital charge on SBSDs for any initial margin posted by a counterparty to a third-party custodian in a segregated account. In the release accompanying the Proposed Rules, the SEC highlighted two primary concerns with initial margin posted to a third-party custodian in a segregated account: (1) that the collateral would not be in the physical possession and control of the SBSD, and (2) that the initial margin could not be liquidated without the intervention of another party.

In our February Letter and in our meeting with staff, we explained in some detail how initial margin held under a typical tri-party arrangement provides the SBSD with access to and legal control of the initial margin.[9] A summary of the key points discussed follows.

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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.

[8] *See* "Margin Requirements for non-centrally cleared derivatives," issued on September 2, 2013, by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions, at Key principle 5, p. 19, available at: http://www.bis.org/publ/bcbs261.htm.

[9] *See also* the comment letters referenced in note 6, *supra*.

- *SBSD has Legal Control of Collateral*. In the typical OTC derivatives tri-party arrangement the SBSD has a perfected security interest in both the account and the collateral contained therein under Articles 8 and 9 of the Uniform Commercial Code. Legal control is established by the SBSD's power upon the delivery of a notice of exclusive control to instruct the custodian with respect to the collateral without further consent by a pledgor.

- *SBSD has Access to Collateral upon Counterparty Default*. The SBSD, as secured party, will have the right upon a counterparty insolvency or other default to assert exclusive control and gain timely access to the collateral through the delivery of a notice of exclusive control to the custodian. A standard provision in a tri-party custody agreement is that the custodian will comply with all entitlement orders and other instructions from the secured party, without inquiry and without the consent of pledgor, in accordance with any notice of exclusive control.

- *Well-Developed Systems*. OTC tri-party segregation arrangements have become more commonly used post-Lehman bankruptcy, and post-Dodd-Frank. With increasing frequency, OTC tri-party segregation arrangements use sophisticated operational platforms that leverage off existing technology that has been developed through years of use in well-established markets. These platforms can handle matters such as the verification of collateral as eligible collateral, the valuation of collateral, the application of haircuts to collateral values and substitutions of collateral, all in an efficient and systematic manner.

The use of tri-party segregation arrangements not only provides SBSDs with legal control of and access to initial margin, but also mitigates what is otherwise significant credit risk for counterparties because posting initial margin directly to a dealer creates, on a dollar-for-dollar basis, unsecured credit risk and exposure to the dealer. Tri-party segregation of initial collateral should result in counterparties having credit exposure to the dealer that is limited to changes in the daily mark-to-market values. This may make it less likely that counterparties precipitously move their collateral and related positions based on negative news relating to a particular dealer's financial condition.

Documentation for OTC Derivatives Tri-Party Segregation

Documentation reflecting the tri-party segregation arrangements is subject to bilateral negotiation between the SBSD and its counterparty, as well as to negotiation among all three parties. Consequently, agreements will differ and there is no one standard form of agreement. In October 2013, ISDA published its Account Control Agreement form, which reflects increasing market demand for tri-party segregation documentation. The ISDA Account Control Agreement uses a menu-like approach with annexes and schedules providing the parties with rights to make certain elections. The ISDA form will likely lead to more standardization in the market, but it will not lead to a single agreement with a single set of terms for all parties.

MFA's view is that parties should be able to negotiate the terms of their tri-party segregation documentation without the results of that negotiation giving rise to a capital charge. SBSDs are capable of negotiating agreements that are protective of their rights as a secured party. Nevertheless, we understand that the SEC may wish to ensure that certain contractual terms be included in each agreement to protect the SBSD's rights to take possession of the collateral when required. In addition, we believe the SEC should allow for certain provisions protective of the pledgor to be included in an agreement without attracting a 100% capital charge.

We propose the following as contractual provisions that should be required:

- *Insolvency of Pledgor*. We recognize that management of collateral following a pledgor insolvency is critical to the effectiveness of the tri-party arrangement. Upon the occurrence of a pledgor insolvency, the secured party will be entitled to deliver to the custodian a notice of exclusive control, and the custodian will be obligated to follow the secured party's instructions immediately.

- *Account Naming*. The tri-party custodial account should reflect accurately the ownership of the collateral and the relationship among the parties. An appropriate naming convention would be to list the account in the name of the pledgor, for the benefit of the secured party, pursuant to the governing agreement.

- *Secured Party Consent*. The consent, or deemed consent, of the secured party should be required for the pledgor to withdraw excess collateral from the tri-party account. Similarly, the consent, or deemed consent, of the secured party should be required for the pledgor to substitute collateral in the account. The specific provisions under which the pledgor may withdraw or substitute collateral should otherwise, however, be open to negotiation by the parties. A standard provision that is customary in the market permits substitution of collateral of equal value on an intra-daily basis, but again only with the consent or deemed consent of the secured party. Deemed consent will be most applicable in situations where a third-party valuation agent is responsible for monitoring the account.[10] In those situations, the secured party may consent in advance to the third-party

[10] Deemed consent would be applicable, for example, in the context of the more automated custodian-operated platforms where (1) the custodian is responsible for determining the amount of excess collateral, if any, in the

valuation agent moving collateral from the account, provided that there is excess collateral and the movement of collateral will not create a margin deficit.

- *Limitation on Custodian Liens.* The custodian cannot have a general lien against the account, but may retain a limited lien in respect of fees and amounts related directly to the custodial account. The rights of the custodian should be subordinated to the lien held by the secured party.

In addition, we propose the following as contractual provisions that should be permitted:

- *Insolvency of Secured Party*. The parties should be entitled to negotiate provisions under which the pledgor may gain access to the collateral in the event of a secured party insolvency – the situation for which the tri-party arrangement is designed. The trigger event should be commencement of a formal insolvency or similar proceeding with respect to the secured party or its guarantor (if the swap obligations are guaranteed). Following the commencement of such proceedings, and upon delivery of appropriate notice to the custodian, the pledgor should be afforded access to its collateral in accordance with the terms agreed by the parties and consistent with their rights and obligations pursuant to the underlying bilateral agreement.

- *Other Termination Events, Events of Default, or Specified Conditions.* The parties should be permitted to negotiate provisions under which the secured party may deliver a notice of exclusive control, and the pledgor a notice of pledgor access, upon the occurrence of termination events, events of default, or certain specified conditions. The parties should be entitled to provide for a delay in effectiveness of the notice in order for a determination to be made as to whether the event has in fact occurred.

MFA believes these provisions would strike the balance advocated by Congress and various regulators, including the Basel Committee on Banking Supervision and the International Organization of Securities Commissions, by both providing SBSDs with legal control of and access to initial margin when necessary and providing an appropriate degree of protection to counterparties with respect to their initial margin.

A final point to note is that our members with tri-party segregation arrangements in place typically do not pay additional amounts to their counterparties when entering into these arrangements. The proposed 100% capital charge on SBSDs for any initial margin posted by a counterparty to a third-party custodian in a segregated account would cause our members to incur additional costs. These additional costs would discourage the use of such arrangements and undermine the purpose of Section 3(E)(f) and other customer protection goals.

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account by taking the difference between the (a) required initial margin and (b) the value (as haircut) of the collateral in the account, and (2) the custodian will not permit the withdrawal by the pledgor of any amount greater than the amount of excess collateral.

We thank the Commission for the opportunity to provide these additional comments. Please contact the undersigned or Laura Harper, MFA's Assistant General Counsel, at (202) 730-2600 with any questions the Commission or staff might have regarding this letter.

Respectfully submitted,

/s/ Stuart J. Kaswell

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Executive Vice President, Managing Director & General Counsel

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