INVESTMENT COMPANY INSTITUTE

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February 1, 2011

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: *Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy (RIN 3038–AD28)*

Dear Mr. Stawick:

The Investment Company Institute[1] appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("Commission") proposal to: (i) impose requirements on swap dealers and major swap participants with respect to the treatment of collateral posted by their counterparties for uncleared swaps and (ii) amend certain provisions of the Commission's Part 190 rules related to securities held in a portfolio margining account that is a futures account, for purposes of the Bankruptcy Code.[2] The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") mandates that the Commission develop a regulatory structure for swaps that promotes safety and soundness, including the protection of swap customer collateral relating to uncleared swap transactions.[3] Funds use multiple types of derivatives, including swaps, as a means to pursue their stated investment objectives, policies, and strategies, often by hedging their investments from a decline in value, for efficient portfolio management purposes, and for securing at low cost assets they wish to

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding and otherwise advance the interest of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.68 trillion and serve almost 90 million shareholders.

[2] *Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy,* 75 FR 75432 (December 3, 2010), available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2010-29831a.pdf.

[3] *See* Section 724(c) of Title VII of the Dodd-Frank Act (adding Section 4s(l) to the Commodity Exchange Act ("CEA")).

acquire.[4] We therefore have a strong interest in the safety and soundness of the derivatives markets. While we support some aspects of the proposal, we have significant concerns relating to the parties' choice of custodian and the investment of segregated collateral, both of which we believe should remain subject to bilateral negotiations between the parties to the swap transaction, in accordance with current market practice.[5] Other recommendations are discussed below.

I. Segregation of Margin for SD and MSP Counterparties With Respect to Uncleared Swaps

A. Definition of "Initial Margin"

At the outset, to avoid any potential confusion or misunderstanding, we recommend that the Commission modify the proposed definition of the term "initial margin" in proposed Rule 23.600.[6] As proposed, this definition could be construed to include not only initial margin, which is typically referred to as an "Independent Amount" in the swap market, but also variation margin.[7] We believe such an interpretation would be inconsistent with the Commission's intent, as well as Section 724(c) of the Dodd-Frank Act. "Initial margin" (or the "Independent Amount") is margin posted at the outset of a swap transaction in a fixed amount agreed upon by the parties, such as a percentage of the notional amount of the swap transaction. The Independent Amount generally is not affected by, or subject to, future changes in the market value of the swap. The proposed definition of "initial margin" should be modified to reflect current market practices. In other words, the proposal should require segregation of the Independent Amount as agreed to by the parties under the related ISDA/CSA,[8] rather than having any ambiguity as to whether the term "initial margin" means the same thing as "Independent Amount."

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[4] *See* Report of the Task Force on Investment Company Use of Derivatives and Leverage, Committee on Federal Regulation of Securities, ABA Section of Business Law, July 6, 2010. The proposal would affect all registered investment companies, including mutual funds, closed-end funds, and ETFs.

[5] ICI has previously submitted comment letters on a number of Dodd-Frank Act rulemakings. In particular, we have strongly recommended that the Commission and the Securities and Exchange Commission ("SEC") exclude funds from the definition of the term "major swap participant" ("MSP") and the term "major security-based swap participant" ("MSBSP"), respectively. *See* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, and David A. Stawick, Secretary, Commodity Futures Trading Commission, dated September 20, 2010, available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26197&SearchText=Investment. Our comments in this letter with respect to the obligations of swap dealers ("SDs") and MSPs are premised on ICI's view that registered investment companies should not be deemed to be MSPs (or MSBSPs) in the final rules to be promulgated by the Commission and the SEC relating to the definition of those terms.

[6] Initial margin would be defined as an amount calculated based on anticipated exposure to future changes in the value of a swap.

[7] Variation margin would be defined as an amount calculated to cover the current exposure arising from changes in the market value of the position since the trade was executed or the previous time the position was marked to market. A swap counterparty does not have a right to segregation of variation margin under Section 4s(l) of the CEA.

[8] The ISDA/CSA is the standardized contract used by counterparties to enter into a swap transactions.

B. Notification of Right to Segregation

ICI agrees with many of the provisions of proposed Rule 23.601, which are designed to implement the statutory requirement of Section 4s(1)(l)(A) of the CEA, that an SD or an MSP notify each counterparty with respect to an uncleared swap that the counterparty has the right to require that its initial margin be segregated in accordance with the proposal.[9] Specifically, we agree that: (1) confirmation of receipt of the notification and the election to require segregation or not should occur prior to confirming the terms of an uncleared swap; (2) such notification to a particular counterparty by a particular SD or MSP need only be made once in any calendar year; and (3) the counterparty's decision whether or not to require segregation of initial margin may be changed in its discretion upon written notice to the SD or MSP.

We do not believe, however, that notification should be required to be provided to a high-level decision-maker for the counterparty. Notices should go to an authorized person to avoid the disruption that would be associated with a chief risk officer or other "high-level decision-maker" making an election to each SD or MSP before a trade can settle.

In addition, we believe that the Commission should distinguish between the types of fees associated with a segregated account. There are two costs to consider: (1) fees charged by the custodian for holding collateral segregated; and (2) fees embedded in the SD's swaps pricing for not having access to the customer's collateral for rehypothecation or other purposes. We do not believe that it is necessary for the Commission to mandate that the SD or MSP disclose the cost of custodial fees to the counterparty, because such information is normally provided by the custodian to the counterparties to the transaction in a schedule to the custody agreement or is available upon request from the SD.[10] We do, however, believe that the Commission should require an SD to disclose any embedded fees it will impose if a customer elects to establish a segregated account and thereby restrict the SD's rehypothecation rights.

C. Requirements for Segregated Margin

In proposed Rule 23.602(a)(l), the proposal would provide that initial margin that is to be segregated pursuant to an election under proposed Rule 23.601 must be segregated with a custodian that is "independent" of both the SD or the MSP and the counterparty. We believe that, consistent with longstanding market practice, the choice of custodian should be left to the agreement of the

[9] In a situation in which both parties are either an SD or an MSP, we recommend that the parties would mutually agree on who has the requirement to post initial margin as part of the negotiation of the swap trade, and whichever party has to post margin has the right to have their initial margin segregated.

[10] At the same time, a customer should always be able to request and receive from the SD disclosure of the difference in pricing for a segregated account versus a non-segregated account.

parties.[11] Subject to such agreement, a fund typically prefers to use its custodian for holding collateral for swap transactions posted to secure its obligations to a dealer in an individual segregated account. Additionally, there are so few custodians offering this service to market participants, especially those that would qualify as "independent," that we cannot support placing restrictions on the parties' choice of custodian. In view of the limited number of custodians, it also should not be difficult for the parties to reach an agreement on which custodian to select.[12]

Similarly, while we agree that the custody agreement should be in writing and must include the custodian as a party, we do not believe that the Commission should adopt a prescriptive approach to the terms of the custody agreement. In particular, we oppose requiring that a written statement for turnover of control of initial margin from an SD, an MSP or the counterparty to the custodian be signed under oath or under penalty of perjury as specified in 28 U.S.C. 1746. It is true that such a statement should not be made lightly, but we believe that it is unnecessary to introduce the specter of criminal prosecution into custodial account documentation for this purpose and that requiring that such a provision be included in the custody agreement is not constructive. We believe that demands for the return of initial margin prior to the scheduled termination of a swap occur only infrequently and inadvertent errors relating to demands for return of initial margin occur even more infrequently. Further, any such inadvertent error is typically corrected promptly by the parties.

We agree, however, that notification of any withdrawal of initial margin, other than pursuant to agreement of the parties to the swap transaction, should be given immediately to the non-withdrawing party. In addition, the Commission should clarify that objective evidence must be provided to the custodian concerning the notice to confirm the accrual of the counterparties' rights as to the delivery of collateral from the custodian (both with respect to any control notice from the secured party and any final return notice from the pledgor, in each case following the other party's default).

D. Investment of Segregated Collateral

In proposed Rule 22.603(a), the proposal would provide that segregated initial margin for uncleared swap transactions could only be invested in a manner consistent with the restrictions in Rule 1.25, rather than pursuant to the agreement of the parties as is consistent with current swaps market practice. Swap customers should be afforded the flexibility to agree with an SD or an MSP as to the

[11] Significantly, while this would mean that an affiliate of an SD or an MSP could serve as the custodian, if agreed upon, counterparties should always have the ability to choose a custodian who is completely independent of the SD or MSP. Neither an SD nor an MSP should be permitted to say that it would agree only to a custodian that is an affiliate.

[12] If the Commission chooses not to adopt our recommendation regarding selection of a custodian by mutual agreement of the parties to a swap transaction, we recommend that it deem a fund's custodian "independent" provided the custodian is unaffiliated with the fund.

appropriate custodial arrangements for a particular swap transaction.[13] We therefore do not support extending Rule 1.25's limitations to the investment of initial margin for uncleared swap transactions.

Rule 1.25 governs investment of segregated customer funds for exchange-traded futures and options on futures contracts.[14] Under the rule, permitted investments for customer funds include only government sponsored enterprise ("GSE") securities, bank certificates of deposit, commercial paper, corporate notes, general obligations of a sovereign nation, and shares of money market funds, subject to certain terms and conditions. Recently, the Commission proposed to shrink even further the universe of permissible investments by, among other things, (1) removing from the list GSE securities not backed by the full faith and credit of the United States, corporate debt obligations not guaranteed by the FDIC, foreign sovereign debt, and in-house transactions; and (2) reducing the amount of permissible investment in money market funds.[15]

We believe that swap counterparties are best positioned to weigh market, credit and other risks to evaluate the proper categories of securities for investment of initial margin collateral for swap transactions. In fact, in negotiating custodial arrangements and agreeing upon acceptable forms of non-cash collateral, counterparties often agree on appropriate haircuts for securities after evaluating numerous risk factors. Limiting the type of securities that may be posted is therefore unnecessary and would not serve any useful purpose. Also, in the case of a fund, Section 17(f) of the Investment Company Act of 1940 and the SEC's rules thereunder, which are designed to assure that fund assets are safely maintained and adequately protected, impose additional restrictions on the contractual relationship between the fund, its custodian and the swap counterparty, which further lessens the need for prescriptive regulation by the Commission in this area.

As a practical matter, we believe that imposing these limitations could result in significant additional costs and economic risks to swap counterparties which the Commission may not have evaluated fully in the context of the swaps markets. Extending Rule 1.25's limitations to the investment of initial margin for uncleared swaps transactions would likely result in counterparties taking on

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[13] In support of this position, it is important to recognize that SDs did not have any difficulties during the financial crisis accessing segregated swap customer assets set aside at custodians through bilateral agreements to meet their obligations.

[14] Section 4d(a)(2) of the CEA limits the investment of customer segregated margin collateral to obligations of the United States, obligations fully guaranteed as to principal and interest by the United States, and general obligations of any State or any political subdivision thereof. Rule 1.25 expands the list of permitted investments as listed above.

[15] *See Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions*, 75 FR 67642 (November 3, 2010), available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2010-27657a.pdf. ICI submitted a comment letter opposing certain aspects of the proposed amendments to the use of money market funds. *See* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to David A. Stawick, Secretary, Commodity Futures Trading Commission, dated December 3, 2010.

additional exposure to their custodians.[16] As noted above, given the limited number of custodians offering this service to market participants, such exposure could result in increased systemic risk, which would be inconsistent with the intent of the Dodd-Frank Act. Accordingly, we urge the Commission to revisit its approach on this issue and make clear that the parties to a swap transaction may continue to enter into any commercial arrangement they agree upon regarding the investment of segregated initial margin and similar business issues.[17]

On a related point, we note that Section 4s(l) of the CEA does not address a situation in which an SD or an MSP posts collateral with its swap counterparty for uncleared swap transactions, including whether such collateral is held in a segregated account at a third-party custodian or directly by the swap counterparty. We believe that it would be helpful for the Commission to confirm our understanding that, whether the collateral is held in a segregated account at a third-party custodian or directly by the swap counterparty, it remains subject to bilateral negotiations between the parties.

E. Effective Date

The Commission is requesting comment on the appropriate timing of effectiveness for the proposal. Given the number of issues posed by the proposal, the possibility that existing custody arrangements may need to be renegotiated and redocumented in order to comply with the provisions of the proposed rules, and the limited number of third-party custodians, we do not believe that six months after adoption of the proposal would be sufficient. Instead, we recommend the Commission provide at least one year to provide market participants adequate time to make the necessary contractual, systems, and internal policy changes to comply with the proposal. Moreover, the Commission should ensure that counterparties are required to put forth a good faith effort in negotiating or renegotiating agreements. Counterparties should not be faced with the dilemma of either acquiescing to an SD or an MSP's proposed conditions for a custody arrangement or having to forego trades to comply with the proposal.

II. **Portfolio Margining Accounts**

We support the Commission's proposal to amend Rules 190.01(k) and 190.08(a)(l)(i)(F), to ensure that securities held in a portfolio margining account carried as a futures account are customer property and the owners of those accounts are customers for the purposes of subchapter IV of chapter 7

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[16] Most custodians hold cash collateral in demand deposit accounts which are commingled across all clients. Consequently, the custodians are not allowed to pay interest on the amounts and, in the case of insolvency, the cash is likely to be trapped in the custodian's bankruptcy estate. It is critical, therefore, for swap customers when instructing their custodians on how to invest their cash collateral in non-cash instruments to have sufficient options and alternatives. This ability would be restricted, and the risk of exposure to their custodian magnified, however, if customer investment options were limited by the imposition of Rule 1.25, particularly if the Commission's proposed amendments to Rule 1.25 were adopted. *Id.*

[17] If the Commission determines to apply Rule 1.25 to the investment of segregated collateral for uncleared swaps, we recommend that the counterparty posting the initial margin be able to narrow the universe of eligible investments if it is not comfortable with all of the categories available under Rule 1.25.

of the Bankruptcy Code. We agree that the proposal would merely implement Section 713(c) of the Dodd-Frank Act.

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If you have any questions on our comment letter, please feel free to contact me directly at (202) 326-5815, Heather Traeger at (202) 326-5920, or Ari Burstein at (202) 371-5408.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel

cc: Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott D. O' Malia, Commissioner
Ananda Radhakrishnan, Director, Division of Clearing and Intermediary Oversight
Robert B. Wasserman, Associate Director, Division of Clearing and Intermediary Oversight