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

July 11, 2011

Via Electronic Submission: http://www.fdic.gov/regulations/laws/federal/propose.html and http://www.regulations.gov

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Re: Notice of Proposed Rulemaking on Margin and Capital Requirements for Covered Swap Entities RIN 1557-AD43; RIN 7100-AD74; RIN 3064-AD79; RIN 3052-AC69; and RIN 2590-AA45.

Ladies and Gentlemen:

Managed Funds Association ("MFA")[1] appreciates the opportunity to provide comments to the prudential regulators (the "Prudential Regulators")[2] on their proposed rules on "Margin and Capital Requirements for Covered Swap Entities" (the "Proposed Rules")[3] related to Title

1 MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $2 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

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 Notice of Proposed Rulemaking on "Margin and Capital Requirements for Covered Swap Entities", 76 Fed. Reg. 27564 (May 11, 2011) (the "Proposing Release").

VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[4] MFA strongly supports measures to reduce risk in the swap markets and incentivize central clearing, including the imposition of appropriate risk-based margin requirements. In this spirit, we are providing comments on the Proposed Rules that we believe will assist the Prudential Regulators in promulgating final rules that balance the need to minimize risk with maintaining liquidity in the swap markets.

I. Margin and Capital Requirements Affect Buy-side Firms

The Proposed Rules place obligations on swap dealers ("SDs") and major swap participants[5] that are subject to regulation by the Prudential Regulators, referred to in the Proposing Release as "covered swap entities" ("CSEs"). Because the Proposed Rules will affect how CSEs trade uncleared swaps with their customers, they will materially affect buy-side firms when entering into uncleared swap transactions for hedging and investing purposes. As discussed in this comment letter, MFA urges the Prudential Regulators to evaluate and consider the effects of its Proposed Rules on non-CSEs and the broader swap markets.

The Proposed Rules mandate the delivery of margin for uncleared swaps to CSEs.[6] As buy-side firms are often counterparties to CSEs, this mandate will directly affect the cost to buy-side firms when entering into uncleared swaps. Many of the costs associated with the Proposed Rules will be incremental to buy-side firms, which regularly post and collect margin for uncleared swaps; however, they may result in buy-side firms incurring costs beyond higher margin amounts and related operational costs. For example, buy-side firms may incur increased trading costs in the form of adverse pricing as CSEs seek to pass along to their customers costs associated with new capital and margin requirements. In addition, if buy-side firms can no longer use robust netting arrangements, their overall funding costs for delivering margin will increase. In the aggregate, these incremental costs might be quite large. If the additional costs are excessive, they may effectively limit buy-side firms' access to the uncleared swap markets, which will likely adversely affect the swap markets as they lose liquidity and depth. Thus, MFA urges the Prudential Regulators to be mindful of increased costs that margin regulation may impose upon buy-side firms.

In particular, the Prudential Regulators should ensure that the Proposed Rules allow for a well-functioning market for uncleared swaps. Even after central clearing of swaps has become commonplace, market participants will need a market for uncleared swaps to meet their trading needs, including entering into customized transactions. We recognize that regulators expect

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4 Pub. L. 111-203, 124 Stat. 1376 (2010).

5 The Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC") have not yet promulgated final rules defining swap dealer and major swap participant. Therefore, for the remainder of this letter, when reference is made to either swap dealers or major swap participants, it shall mean an entity likely to be included in such category based on the SEC's and the CFTC's current joint proposed definitions. *See* SEC and CFTC joint Notice of Proposed Rulemaking on "Further Definition of 'Swap Dealer,' 'Security-Based Swap Dealer,' 'Major Swap Participant,' 'Major Security-Based Swap Dealer' and 'Eligible Contract Participant'" 75 Fed. Reg. 80174 (Dec. 22, 2010).

6 Proposed Rule 3(a) (for initial margin) and Proposed Rule 4(a) (for variation margin).

margin regulation to reduce unsecured counterparty credit risk and incentivize clearing.[7] The Proposed Rules also have the potential to bring consistency and transparency to margin practices. However, we believe that the Proposed Rules, while promoting such benefits, should not be so punitive with respect to uncleared swaps that the markets for uncleared swaps become destabilized. To allow for a transparent and efficient market for uncleared swaps, the Prudential Regulators should capture the best of existing industry practices, such as the two-way exchange of variation margin and robust netting, while layering on appropriate additional safeguards.

II. Comments on Proposed Rules

MFA urges the Prudential Regulators to issue margin requirements that promote a fair and stable market for uncleared swaps. As discussed in more detail below, we believe that sound regulation of margin delivered in connection with uncleared swaps includes, at a minimum, the following attributes:

- consistency of margin requirements among regulators;
- coordinated implementation of margin rules with the availability of central clearing;
- parity among market participants in their obligations to deliver variation margin;
- extensive use of netting to both abate counterparty credit risk and lower costs associated with the delivery of margin;
- transparent methods for determining margin amounts that both CSEs and their counterparties can use independently; and
- determination of variation margin in a negotiated manner that need not be formula-based.

A. Uniformity of Regulation

MFA believes, as a general matter, that the swap markets will work most efficiently if one set of margin requirements applies for all uncleared swaps regardless of which regulator oversees a particular CSE. A uniform set of margin requirements will facilitate orderly collateral management practices. In the absence of such uniformity, buy-side firms will have to monitor and comply with multiple margin regimes, which is administratively difficult, costly and burdensome. Also, margin requirements that differ by regulator create advantages for certain

[7] According to Secretary of the U.S. Treasury, Timothy Geithner, "imposing appropriate margin requirements on uncleared swaps will … help create incentives for market participants to use centralized clearing and standardized contracts." Timothy Geithner, Secretary, U.S. Dept. of the Treasury, Address to the International Monetary Conference (Jun. 6, 2011). Available at: http://www.treasury.gov/press-center/press-releases/Pages/tg1202.aspx.

regulated entities over others.[8] Accordingly, we urge the Prudential Regulators to coordinate with the CFTC and the SEC to assure a uniform set of margin requirements in U.S. swap markets.

B. Coordinated Implementation of Margin Rules with the Availability of Central Clearing

MFA recommends that the Prudential Regulators implement capital and margin regulations for uncleared swaps only after the central clearinghouse infrastructure is in place to implement the Dodd-Frank Act's mandatory clearing requirements.[9] This ordering is necessary because the capital and margin requirements for uncleared swaps likely will be significantly higher than those for cleared swaps[10] to encourage swap market participants to move to central clearing.[11] However, until the central clearinghouse infrastructure is established, swaps that might otherwise be deemed clearing-eligible would be given punitively higher capital and margin charges, simply because: (i) clearinghouses are not yet ready to accept them; (ii) regulators have not yet deemed the contracts eligible for clearing; or (iii) participants do not yet have access to clearinghouses. The consequence of temporarily excessive capital and margin requirements could be destabilizing to the swap markets as the higher costs discourage trading and cause the markets to lose depth. Throughout the legislative and regulatory processes, MFA has strongly supported central clearing and rational methods to incentivize its widespread usage. However, despite continued efforts, customers do not yet have sufficient access to clearinghouses. Thus, we respectfully request that the Prudential Regulators coordinate the capital and margin requirements for uncleared swaps with the establishment of central clearing.[12]

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8 For example, under the CFTC's proposed margin rules, SDs that are subject to the CFTC's proposed margin rules can enter into margin arrangements with non-financial end users that allow the non-financial end user to deliver non-cash collateral as margin. CSEs however, cannot accept non-cash collateral as margin under the Proposed Rule. *See*, Proposed Rule 6. This limitation may put CSEs at a competitive disadvantage relative to SD's subject to the CFTC's margin rules when attempting to enter into uncleared swaps with certain non-financial end users.

9 The Prudential Regulators and the CFTC can implement clearing and margin for uncleared swaps in a lockstep manner by asset class. CFTC Chairman Gensler has suggested that the Commission may put the central clearing requirement for swaps in place with certain asset classes and/or participant types coming before others. *See*, Remarks of Chairman Gary Gensler, Implementing the Dodd-Frank Act, FIA's Annual International Futures Industry Conference, Boca Raton, Florida, March 16, 2011. Available at: http://www.cftc.gov/pressroom/speechestestimony/opagensler-73.html.

10 *See e.g.*, CFTC Proposed Rule 23.155(c)(1)(iv) at 76 Fed. Reg. 237322, 23746 (Apr. 28, 2011). The CFTC has proposed an alternative method for determining initial margin in which a factor of 2.0 is applied to the initial margin associated with a referenced cleared swap to calculate initial margin for an uncleared swap.

11 *Infra* at footnote 7.

12 MFA also recommends, if the Prudential Regulators implement capital and margin requirements for swaps of a certain asset class when clearing becomes available for such asset class, that some meaningful transition period is provided so market participants do not incur higher costs associated with uncleared swaps without a meaningful opportunity to negotiate the operational issues of moving uncleared swaps into a cleared paradigm.

C. Mandatory Bilateral Exchange of Variation Margin

The Proposed Rules require CSEs to collect (but not post) variation margin when they enter into swaps with counterparties that are financial entities.[13] The Prudential Regulators requested comment as to whether they should include additional language in the Proposed Rules requiring CSEs to both post and collect variation margin with regard to swaps entered into with financial entity counterparties.[14] As we explain further below, MFA strongly encourages the Prudential Regulators to require CSEs to post and collect variation margin with non-CSE financial entities because such bilateral exchange of variation margin is crucial to the proper functioning of the swap markets and abatement of counterparty and systemic risk therein.

1. Current Widespread Best Practice

The Proposed Rules do not prevent CSEs from posting variation margin to their financial entity counterparties. However, because the Proposed Rules do not include an express requirement that CSEs post variation margin, they create a presumption that it may not be either necessary or important for a CSE to do so. MFA is concerned that CSEs may use this presumption created by the Proposed Rules to retreat from the current market "best practice" of posting variation margin to their counterparties.

A wide range of market participants currently exchange variation margin bilaterally for uncleared swaps,[15] and buy-side firms largely have adopted this sound market practice as "best practice" for collateral management. Bilateral margin arrangements among buy-side firms and CSEs reflect that buy-side firms trade with CSEs most often as peers, with comparable expertise, technical proficiency and understanding of the risks inherent in trading swaps. Bilateral margin arrangements also reflect that both parties have counterparty credit risk when trading swaps. The collection of margin, together with netting, are effective means for any market participant to reduce counterparty credit risk. Just as banks are responsible for protecting the interests of depositors, so too are buy-side firms responsible for the interests of their investors, which include pension plans and university endowments. Thus, shielding assets invested with buy-side firms from financial contagion is important to the U.S. and global economy. Recognizing the immense protections that the collection of variation margin offers, swap market participants have historically delivered variation margin on a bilateral basis. To support this practice, market participants have efficient contractual arrangements and extensive operational infrastructure for bilateral variation margin exchange. Thus, the Prudential Regulators would not be imposing a material incremental burden or a change from "best practice" for CSEs if they require CSEs to deliver variation margin to their counterparties.

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13 *Infra* at footnote 6.

14 Proposing Release at 27575 and 27577.

15 MFA understands that one-sided variation margin arrangements are an exception to established market practices for collateral arrangements.

2. *Reduction of Systemic Risk*

The bilateral exchange of variation margin prevents either party to a swap from accumulating substantial unsecured exposures, thus limiting both counterparty and systemic risk. The ability of market participants to accumulate an unlimited amount of unsecured obligations to counterparties was one of the primary causes of the recent financial crisis and, in part, was why entities such as AIG were "too interconnected to fail" and "too big to fail."[16] As a result, the failure to mitigate current counterparty credit exposures through the daily bilateral exchange of variation margin could exacerbate system-wide losses in the event of a CSE default. Such losses could cause serious harm to the financial system.

Given the potential systemic benefits, the Prudential Regulators should further their mission to ensure the soundness of all market participants,[17] including CSEs, by requiring CSEs to deliver variation margin to their customers. In the absence of CSEs delivering variation margin, if a CSE were to default, the uncollateralized swap positions might result in other market participants suffering losses, which could potentially be significant for an individual firm or in the aggregate across market participants. In turn, these market participants might become less stable and may experience difficulty fulfilling their obligations to other financial institutions for swaps and other financial products. Thus, by requiring CSEs to deliver variation margin to all their customers for uncleared swap transactions, the Prudential Regulators prevent the possibility of a CSE's financial contagion spreading among other market participants, not by direct firm-to-firm relationships among financial institutions, but through indirect transmission through the swap markets.

Given the asymmetry that exists currently in swap markets with respect to the delivery of initial margin (*i.e.*, dealers collect initial margin from their customer counterparties but do not concomitantly post initial margin to them), and the higher degree of interconnectedness and systemic risk that such asymmetry engenders, it is even more imperative that the Prudential Regulators require the "best practice" of bilateral exchange of variation margin.

3. *Increased Transparency*

Bilateral exchange of variation margin will increase the transparency of the swap markets, which is a key goal of the Dodd-Frank Act.[18] As a general matter, margin exchange is an observable measure of a CSE's gains and losses with respect to its swaps. A CSE's ability to

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16 Oversight of the Federal Government's Intervention at American International Group, House Committee on Financial Services, 111th Cong. (Mar. 24, 2010) (statement of Hon. Ben S. Bernanke, Chairman, Federal Reserve Board of Governors), in which he addresses "why supporting AIG was a difficult but necessary step to protect our economy and stabilize our financial system".

17 Section 731 of the Dodd-Frank Act provides a new Section 4s(e)(3) to the Commodity Exchange Act, which section instructs regulators, including the Prudential Regulators, to set capital and margin requirements "[t]o offset the greater risk to the swap dealer or major swap participant *and the financial system* arising from the use of swaps that are not cleared" (emphasis added).

18 S. Rep. No. 111-176 at 32 (2010). Available at: http://www.gpo.gov/fdsys/pkg/CRPT-111srpt176/pdf/CRPT-111srpt176.pdf.

conceal losses associated with its swap portfolio is difficult if that CSE must deliver variation margin to its counterparties on a frequent basis. Such transparency could enhance reporting to regulators and the ability of regulators to gauge counterparty credit quality. Critically, such transparency would be advantageous to regulators evaluating and monitoring systemic risk as the CFTC and the Prudential Regulators will be notified when substantial collateral disputes occur.[19] We believe that requiring CSEs to post variation margin would ensure that they engage in proper risk management and alert regulators to an impending failure, which would enable them to intervene promptly and thus limit the degree to which a default by a CSE could impact the U.S. financial system.

4. *Facilitation of Central Clearing*

One of the key goals of the Dodd-Frank Act is to move the swap markets towards greater central clearing.[20] When CSEs enter into cleared swap transactions, the relevant clearinghouses require them to post variation margin on such swaps.[21] Requiring CSEs to also post variation margin on uncleared swaps would create symmetry between the cleared and uncleared swap markets. In addition, the bilateral exchange of variation margin would make the transition to central clearing less burdensome and operationally easier to integrate. If CSEs are required to deliver variation margin on uncleared swaps, then they will have to adapt their working capital and collateral management systems and policies to account for such obligations across their entire portfolio. Because these systems would then already be in place when the central clearing mandate becomes effective, they will reduce the financial and operational burden of progressively moving eligible portions of swap portfolios to central clearing.

D. Netting Under the Proposed Rules

MFA appreciates that the Proposed Rules clearly permit the netting of variation margin and, to a more limited extent, initial margin.[22] Effective netting agreements lower systemic risk by reducing both the aggregate requirement to deliver margin and trading costs for market participants. In addition, by allowing counterparties to net margin when they have an enforceable netting agreement in place, the Proposed Rules allow swap market participants to continue current "best practices" with regard to the collateralization of uncleared swaps. However, the Proposed Rules appear to limit the efficacy of netting as a risk reduction tool, expressly placing restrictions in certain places while remaining silent or vague in others, as we

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19 The CFTC has proposed rules with respect to the documentation of swap transactions that would require CSEs to report any valuation dispute with another CSE that is not resolved within one business day and any valuation dispute with a non-CSE counterparty that is not resolved within five business days to the Commission (or SEC if the transaction in question is a security-based swap) and any applicable Prudential Regulator. *See*, CFTC proposed rule 23.504(e) at "Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants" 76 Fed. Reg. 6715, 6726 (Feb. 8. 2011) (the "CFTC Proposed Documentation Rules")

20 S. Rep. No. 111-176 at 32.

21 The CFTC has proposed rules that require DCOs to settle margin payments and collections of initial and variation margin. *See*, CFTC proposed rule 39.14(b) at "Risk Management Requirements for Derivatives Clearing Organizations", 76 Fed. Reg. 3698, 3722 (Jan. 20, 2011) (the "CFTC Proposed Risk Management Rules").

22 Proposed Rule 4(d) (for variation margin) and Proposed Rule 8(b) (for initial margin).

discuss further below. MFA urges the Prudential Regulators to explicitly permit robust netting practices with respect to both initial and variation margin when crafting final rules.

Many market participants currently have netting agreements that allow them to net initial and variation margin amounts across many different exposures and assets. We urge the Prudential Regulators, when adopting final margin rules, to allow for such broad netting arrangements. For example, the margin requirements might provide for netting among, but not limited to, the following items:

- margin for swaps of the same or similar asset classes (*e.g.*, interest rate swaps, commodity swaps, equity swaps, etc.), but cleared by one FCM through different clearinghouses;
- margin for swaps with highly correlated assets or other financial products (*e.g.*, a credit default swap with referenced bond or a interest rate swap and Eurodollar futures);
- margin for swap exposures of one asset class with margin for swaps of another asset class (*e.g.*, interest rate swaps and commodity swaps);
- margin between swaps and security-based swaps;
- margin for cleared swaps with margin for uncleared swaps;
- margin for swap exposures with margin for other financial product types (*e.g.*, physically-settling forwards, repurchase agreements, security lending agreements); and
- margin for swap exposures with other financial or liened account assets (*e.g.*, securities in a securities account).

Permitting CSEs to net across a wide variety of offsetting exposures with their financial entity counterparties, in addition to reducing aggregate counterparty credit risk and lowering trading costs, would: (i) allow entities to make efficient use of their capital; (ii) provide market participants and regulators with better transparency as to the overall amount of counterparty risk between two parties, which is informative of risk in the swap markets; and (iii) reduce complexity and settlement risk.[23] In contrast, without adequate allowances for netting, the Proposed Rules would drain liquidity from the swap markets as participants seek other execution strategies to prevent the over-collateralization of otherwise offsetting positions.

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[23] Conversely, placing an artificial prohibition on offsetting margin requirements for cleared and uncleared swaps will impede a voluntary transition to the use of central clearing.

1. Modifications of the Grid-Based Method to Facilitate Netting

The Prudential Regulators requested comment as to whether they should amend the alternative grid-based method for initial margin set forth in Proposed Rule 8(a) (the "Grid-Based Method") to allow CSEs to offset initial margin requirements.[24] Under the Grid-Based Method, CSEs cannot net initial margin requirements and the Prudential Regulators acknowledge that the Grid-Based Method "may not accurately reflect the size or riskiness of the actual position in many circumstances."[25] MFA requests that the Prudential Regulators allow CSEs and financial entities, when transacting with each other, to offset initial margin requirements to the fullest extent possible where the counterparties have determined (based on basic parameters set forth by the Prudential Regulators) that there is a sound theoretical basis and significant empirical support for such offset. We support the use of netting arrangements, particularly where positions offset each other from a risk perspective.

2. Netting of Initial Margin Requirements between Cleared and Uncleared Swaps

It is unclear whether the Proposed Rules permit CSEs and their counterparties to net initial margin requirements between cleared and uncleared swaps.[26] Currently, master netting agreements allow counterparties to net exposures between cleared and uncleared swaps with the same counterparty or affiliated counterparties. For example, if a market participant enters into a cleared swap through a futures commission merchant (an "FCM") and then hedges that cleared swap with an uncleared swap with the FCM (or an affiliate of the FCM), the FCM or its affiliate might allow the market participant to reduce any initial margin required to be posted on the uncleared swap to the degree that the exposure under the uncleared swap was offset by the liquidation value of the cleared swap account.

> *Example*: A customer trades both cleared and uncleared swaps with an SD that is a registered FCM. The customer's cleared swap collateral account has a balance of $10,000. However, the aggregate requirement for initial margin with respect to the cleared swaps is $3,000, so the account holds $7,000 in excess margin. The

[24] Proposing Release at 27573. The Grid-Based Method for initial margin requires CSEs to determine initial margin amounts based on the characteristics of a swap such as duration and the underlying asset. The relevant characteristics are set forth in Appendix A to the Proposed Rules.

[25] *Id.* The Proposing Release illustrates this issue through the following example: "Appendix A's standardized table is based upon gross notional amounts and recognizes no offsetting exposures, diversification, or other hedging benefits ... For example, with respect to a swap portfolio containing (i) a one year pay fixed and receive floating interest rate swap with a notional value of $10 million and (ii) a two year pay floating and receive fixed interest rate swap with a notional value of $10 million, an initial margin model would recognize that much of the risk of the one year swap is offset by the risk of the two year swap—changes in the level of interest rates that increase the value of the one year swap will simultaneously decrease the value of the two year swap. Under Appendix A, however, the gross notional interest rate swap position would be $20 million and the initial margin on the portfolio would be twice the initial margin of either $10 million swap even though the trades are, in fact, risk reducing."

[26] Both the requirements for initial margin models and the Grid-Based Method set forth in Proposed Rule 8 do not expressly address whether parties may net initial margin requirements for cleared and uncleared swaps.

SD estimates that, if it were to terminate the cleared swaps and liquidate the account assets to satisfy obligations to the derivatives clearing organization ("DCO"), the SD would return $5,000 to the customer as the "liquidation value" of the cleared swap account.

The customer seeks to execute an uncleared swap with the SD that has an associated initial margin of $2,000. In lieu of the customer delivering $2,000 (and having an aggregate of $12,000 on deposit with the SD), the SD might offset the initial margin amount due from the customer on the uncleared swap to the extent of the liquidation value of the cleared swap account. To accomplish this offset, the customer and the SD may enter into a netting agreement in which the customer grants to the SD a second-priority lien on the cleared swap account and the assets in that account. This lien provides the SD with recourse to the liquidation value should the customer default.[27]

It is important to note that under such an arrangement the FCM and, consequently, the DCO that clears the initial swap will always receive the entire initial margin amount[28] required under the DCO's margin rules.[29] In fact, because a substantial portion of the swap market remains uncleared, we believe that allowing market participants to net cleared and uncleared margin requirements in the manner described above will lower the effective cost of, and promote a transition to, central clearing, because it will allow market participants to net naturally offsetting

27 MFA is concerned that the Proposed Rule might make netting of cleared and uncleared swaps extremely difficult, if not impossible, if applied in conjunction with certain of the CFTC's proposed rules. In the CFTC's proposed rule on the "Protection of Cleared Swaps Customer Contracts and Collateral: Confirming Amendments to the Commodity Broker Bankruptcy Provisions" (76 Fed. Reg. 33818 (Jun. 9, 2011)), the CFTC proposed to prohibit an FCM from imposing, or permitting the imposition of, a lien on collateral delivered by a counterparty to support a cleared swap. (*Id.* at 33833). Moreover, the FCM cannot use such collateral to margin, guarantee or secure the non-cleared swap contracts. (*Id.*, describing proposed CFTC Rule 22.2(d)). The problem this restriction creates is that it frustrates many cross-product netting agreements and many multi-lateral netting agreements. In these arrangements, a party might agree to netting on the basis that, if there were losses in one asset class (*e.g.*, non-cleared commodity options), it could have recourse to collateral for another asset class (*e.g.*, cleared interest rate swaps). Without this lien, it is very difficult, if not impossible, to allow either party recourse to collateral in a default situation.

The ability to net across cleared and uncleared swap positions depends on both (i) the FCM's ability to lien the cleared swap account and (ii) the margin regulations permitting a reduction in the delivery requirements because of such lien. If the margin requirements mandate a counterparty deliver margin regardless of the lien, then netting across cleared and uncleared swap position is frustrated. Thus, the Prudential Regulators' final margin rules should contain an explicit provision that netting (against the assets in a cleared swap account) obviates a party's obligation to deliver initial margin with respect to uncleared swaps.

Should the FCM become insolvent, the lien on cleared swap account might impair an efficient porting of the cleared swap positions and related collateral. Buy-side firms understand this risk and often accept it for the immediate benefits afforded by netting cleared and uncleared positions.

28 The relevant DCO would set the initial margin requirement for the cleared swap.

29 The netting arrangements never reduce a party's obligations with respect to cleared swaps; rather only that party's obligations with respect to its uncleared swaps are affected.

exposures.[30] In addition, it will facilitate efficient margin practices when paired products (*e.g.*, single-name credit default swaps and index credit default swaps) migrate to central clearing at different times. Therefore, we suggest that the Prudential Regulators permit CSEs to consider both cleared and uncleared positions when determining the initial margin requirement for an uncleared swap.

3. Customer Consent to Netting of Pre-effective Date Swaps

The Proposed Rules provide that a CSE, at its option, may net initial and variation margin for uncleared swaps it has with a financial entity so long as it applies the Prudential Regulators' margin regulations with respect to all uncleared swaps, regardless when such swaps were executed.[31] This option, if exercised, would result in the retroactive application of the Prudential Regulators' requirements to swaps entered into before the effective date of the Prudential Regulators' margin rules, which would cause the partial frustration of the economic terms of private contractual arrangements. This retroactive application, therefore, is a limitation on the use of netting, the benefits of which we have discussed above. To preserve the benefits of netting, the Prudential Regulators, as they have for initial margin,[32] should allow a CSE to elect to net variation margin associated only with uncleared swaps entered into after the effective date of the Prudential Regulators' final margin rules. In the alternative, if the retroactive application of the Prudential Regulators' new margin rules is a necessary condition for the netting variation margin for uncleared swaps, then all stakeholders subject to the economic consequences of that retroactive application should have to consent to the election to net variation margin. Accordingly, the Prudential Regulators' final rules should explicitly require the consent of a CSE's counterparty should the CSE wish to net margin at the cost of retroactive application of the Prudential Regulators' margin rules. Otherwise, the Proposed Rules will empower CSEs with the ability to make unilateral decisions that could materially and adversely affect buy-side firms.[33]

E. Calculation of Initial and Variation Margin

The Prudential Regulators should promote margin practices that are fair and understood by all market participants. Initial margin should be determined in a transparent way that allows both parties to a swap to determine independently the applicable margin. The ability of customers to replicate initial margin models enables them to anticipate how margin might change over the life of the swap and how much they should hold in reserve. Such replicability is

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30 Netting of cleared and uncleared swaps also saves both the FCM and the counterparty costs of supporting separate collateral arrangements. Under such an arrangement, the counterparty would be obligated to post full initial margin amounts on all cleared swaps as well as initial margin amounts on uncleared swaps to the extent that cleared swaps do not offset them.

31 Proposed Rule 4(d) (for variation margin) and Proposed Rule 8(b) (for initial margin).

32 Proposed Rule 8(b).

33 Typically, counterparties will negotiate heavily for unilateral legal rights with respect to trading contracts. Unlike a negotiation where a party might grant a concession in return for benefit, if the Prudential Regulators' margin rules require retroactive application of margin rules when a CSE elects to net margin, CSEs will have gained unilateral right without their counterparties receiving any consideration for such right.

fundamental to conducting capital planning and underlies a customer's ability or inability to devote its resources strategically to other investments or obligations.

The Proposed Rules contemplate the use of models or reference methods of determining initial margin amounts; however, they do not mandate the use of one method or another. MFA believes that a CSE and its counterparty should negotiate the selection of a calculation tool that is best suited to them. We support the Prudential Regulators in setting minimum standards for all tools for determining margin that promote fairness and transparency.

1. Equitable Treatment Under Initial Margin Models

Allowing CSEs to use proprietary models to determine initial margin requirements introduces a potential impediment to transparency because the counterparties of CSEs will not have insight into how a CSE establishes the initial margin requirements. Transparency in the use of a model to establish initial margin directly correlates to a buy-side firm's ability to replicate any determination of an amount of initial margin. The ability of a buy-side firm to replicate initial margin determination is critical to that firm's capacity to anticipate and adjust to changes in its obligations. If swap market participants do not have the information necessary to predict with reasonable certainty potential changes in initial margin requirements, there are two possible outcomes. Under the first possible outcome, swap market participants would hold excess capital to account for an unanticipated initial margin change, which would necessarily limit swap market participants' ability to invest capital elsewhere or meet other cash flow needs. Under the second possible outcome, swap market participants would not hold additional capital in reserve and then an unanticipated change in an initial margin requirement could result in a series of defaults, which could have pro-cyclical effects if a class or multiple classes of participants have the same undisclosed margin models and are forced into closing or covering their positions all at the same time. Requiring transparency with respect to initial margin will allow a CSE's counterparties to model for and anticipate margin changes and to avoid these two outcomes.

Generally, initial margin models should be objective (*i.e.*, a model should arrive at the same initial margin amount for identical swaps regardless of the counterparty's identity or creditworthiness). CSEs might use a multiplier that is distinct from the base initial margin model to address any concerns about a counterparty's creditworthiness. We are concerned that, without legally required transparency: (i) CSEs will potentially alter their models to produce a more favorable output when determining initial margin requirements for a particular counterparty or class of counterparties; and (ii) counterparties to CSEs will not have the information necessary to anticipate potential changes in initial margin requirements. Neither potential outcome is desirable. Therefore, MFA recommends that the Prudential Regulators continue to allow CSEs to use their proprietary models to determine initial margin amounts, but require CSEs to make the basic functionality of their initial margin models available to and replicable by their counterparties.

In addition, we request that the Prudential Regulators prohibit CSEs from varying their initial margin models based solely on the identity of their counterparties. For example, the Prudential Regulators should not permit a CSE to use different initial margin models for swaps with other CSEs and swaps with financial entities. As mentioned above, CSEs might use a multiplier that is distinct from the base initial margin model to address any concerns about a counterparty's creditworthiness. We believe such a prohibition is necessary to prevent discriminatory distortions in the swap markets and eliminate unfair competitive advantages among market participants.

2. *Improving the Grid-Based Method*

As proposed, the Grid-Based Method set forth in Proposed Rule 8(a) is a non-granular approach to the determination of initial margin. While we appreciate the simplicity and predictability provided by the Grid-Based Method, we are concerned that the Grid-Based Method does not properly account for the diversity of products in the swap markets and the risk characteristics of such products. For example, the proposed Grid-Based Method has a single category for equity swaps, which would place a call option on a highly liquid equity security in the same category as a total return swap on an illiquid security. In this example, the equity option and the total return swap would each be subject to an initial margin requirement of at least 10% of notional exposure, a high initial margin requirement for the equity option (given the payment of premium and lack of continuing credit exposure), but a potentially appropriate initial margin requirement for the total return swap. As a result, we request that the Prudential Regulators revise the Grid-Based Method to properly account for the variety of swaps by: (i) increasing the number of subcategories in the asset classes and assigning appropriate initial margin ranges to such subcategories; (ii) lowering the initial margin floor on the broader asset classes to allow counterparties to account for lower risk positions;[34] or (iii) a combination of (i) and (ii).

3. *Ten-Day Liquidation Time Horizon for Initial Margin Determinations*

Under the Proposed Rules, a CSE's initial margin model is required to set initial margin at a level that covers at least 99% of price changes over at least a ten-day liquidation time horizon.[35] We understand that such requirements arguably must be equal to or greater than margin requirements for comparable cleared swaps,[36] and that proposed DCO margin requirements would require a five-day time horizon.[37] However, the Prudential Regulators provide little explanation as to why a ten-day time horizon (*i.e.,* double the time horizon for cleared swaps) is appropriate. In part, the Prudential Regulators may assume that an uncleared swap will be substantially less liquid than a comparable cleared swap, which, as discussed above, will likely not be the case prior to the implementation of the Dodd-Frank Act's mandatory clearing requirement, and may not be the case after the mandatory clearing requirement's implementation. Consequently, MFA requests that the Prudential Regulators clarify why they selected a ten-day time horizon as the basis for their initial margin requirements.

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34 MFA believes that the upper limits of the proposed initial margin ranges under the Grid-Based Method are appropriate, but the lower limits do not allow CSEs to assign appropriate initial margin requirements for certain lower risk positions.

35 Proposed Rule 8(d)(1).

36 Section 4s(e)(3)(A) of the Commodity Exchange Act states: "to offset the greater risk ...arising from swaps that are not cleared, the [margin and capital] requirements imposed under paragraph (2) shall..."

37 *See* the proposing release for the CFTC Proposed Risk Management Rules at 3704–05.

4. *Determination of Variation Margin*

MFA recommends that the Prudential Regulators not follow the CFTC's proposal to include valuation formulas in swap documents. The CFTC Proposed Documentation Rules set a standard for determining variation margin that likely can only be met using a valuation formula.[38] The CFTC Proposed Documentation Rules require the parties to set forth those valuation methods, procedures, rules and inputs with enough specificity for the parties, the CFTC or any applicable prudential regulator to determine the value of the swap,[39] essentially requiring the inclusion of a valuation formula in the documentation. This requirement is burdensome because parties will need to spend additional time negotiating the formula (which is not currently negotiated) and trying to agree on matters that do not require advance agreement. This extended negotiation will impose substantial additional transaction costs and provide little or no obvious benefit.

The Proposed Rules, while similar to the CFTC Proposed Documentation Rules, lack the requirement that the valuation formula allow regulators to replicate the variation margin amounts."[40] Therefore, we believe that the language in the Proposed Rules is more appropriate than the CFTC Proposed Documentation Rules.

III. Capital Relief for Cleared Swaps

The Proposed Rules do not require firms to maintain capital for cleared swaps. Central clearing reduces counterparty credit risk associated with swaps because, with regard to CSEs, it is likely that their DCO counterparty will be more creditworthy than their current counterparties.[41] We believe that the Prudential Regulators should reflect the lower risk associated with central clearing by ensuring that the capital charge for a CSE's cleared swap exposures is lower than any capital charge for equivalent uncleared swap exposures. A lower capital charge would appropriately lower the cost of central clearing for CSEs and, ultimately, their customers. We believe that creating such incentives to clear swaps will reduce systemic risk in swap markets.

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[38] CFTC Proposed Documentation Rule §23.504(b)(4) provides that "the swap trading relationship documentation shall include written documentation in which the parties agree on the methods, procedures, rules, and inputs for determining the value of each swap at any time from execution to the termination, maturity, or expiration of such swap. To the maximum extent practicable, the valuation of each swap shall be based on objective criteria, such as recently-executed transactions or valuations provided by independent third parties such as derivatives clearing organizations."

[39] *Id.*

[40] Proposed Rule 5(b). This Proposed Rule only requires that swap documents contain "the methods, procedures, rules, and inputs for determining the value of each swap or security-based swap for purposes of calculating variation margin requirements."

[41] *See,* Darrell Duffie et al. *Policy Perspectives on OTC Derivatives Market Infrastructure*, Federal Reserve Bank of New York Staff Reports No. 424 (January 2010) at 4-5. Available at: https://gsbapps.stanford.edu/researchpapers/library/RP2046.pdf.

MFA appreciates the opportunity to comment on the Proposed Rules and respectfully submits these comments for the Prudential Regulators' consideration. If the Prudential Regulators or their staffs have any questions, please do not hesitate to call Carlotta King or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

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