MEMORANDUM

TO: File Number S7-08-12

FROM: Teen Sheng
Special Counsel
Office of Financial Responsibility, Division of Trading and Markets
U.S. Securities and Exchange Commission

DATE: October 8, 2013

RE: Meeting with the Managed Funds Assocation

On October 8, 2013, Commission staff met in-person and by telephone with representatives of the Managed Funds Assocation ("MFA") to discuss the proposed rules and rule amendments on capital, margin, and segregation requirements for security-based swap dealers and major security-based swap participants and capital requirements for broker-dealers (release number 34-68071). Representatives of the Financial Industry Regulatory Authority ("FINRA") were also present via telephone.

Commission representatives included John Ramsay, Christian Sabella, Michael Macchiaroli, Tom McGowan, Randall Roy, Wenchi Hu, Gena Lai, Sheila Swartz, Valentina Deng, and Teen Sheng from the Division of Trading and Markets; and Douglas Scheidt, David Joire, Richard Rodgers, and Steve Packs from the Division of Investment Management.

The MFA representatives at the meeting were Stuart Kaswell (MFA), Kenneth Kopelman (Sidley Austin LLP), Chris Ramsay (Citadel LLC), Laura Harper (MFA), Debbie Coleman (Convexity Capital Management), Kim Rosman (HBK Capital Management), and David Holmes (King Street Capital Management).

The FINRA representatives at the meeting were Grace Vogel, Marshall Levinson, Kris Dailey, Mohit Dayal, and Amr El-Sabbagh.

Managed Funds Association

October 8, 2013

Tri-Party Segregation of Initial Margin for OTC Derivatives

Introduction

- Dodd-Frank added customer protection rules encouraging tri-party segregation of OTC derivatives initial margin posted to dealers – also reflected in the final Basel-IOSCO margin requirements
- Swap dealers maintain legal control of, and a perfected security interest in, the tri-party account – reflected in ISDA form of Account Control Agreement
- SEC proposed rule that would impose a 100% capital charge on swap dealers for these arrangements is unnecessary
- This presentation covers the following topics:
  - Tri-Party Segregation, Generally
  - Why Use Tri-Party Segregation for OTC Derivatives Initial Margin?
  - Tri-Party Segregation of OTC Derivatives Initial Margin
  - Tri-Party Segregation Arrangements Give SBSDs Legal Control
  - Tri-Party Segregation Arrangements Give SBSDs Access to Collateral
  - Pledgor Access to Segregated Collateral is Limited
  - Proposed Capital Charge for Segregated Customer Initial Margin is Unnecessary

Tri-Party Segregation of Initial Margin for OTC Derivatives

Tri-Party Segregation, Generally

- Section 3E of the '34 Act, added by Dodd-Frank, gives OTC derivatives customers the right to require segregation of initial margin with a third-party custodian
- Tri-party custody and control arrangements are commonly used and relied on in various areas of the financial markets
  - For registered investment companies – to post collateral for various transactions
  - Tri-party repo market – for broker-dealers to post securities against cash
  - The OTC derivatives market – for posting initial margin, the topic of this discussion
- OTC tri-party segregation arrangements use operational and legal methods that are similar to those used in the tri-party repo market, which is a large and significant market

Tri-Party Segregation of Initial Margin for OTC Derivatives

Why Use Tri-Party Segregation for OTC Derivatives Initial Margin?

- Tri-party segregation protects customers from risk of loss of their initial margin to an insolvent security-based swap dealer (SBSD)
  - Initial margin posted by customer directly to SBSD = customer credit exposure to SBSD
  - Tri-party segregation could reduce customer flight from credit-threatened SBSDs
- Key principle of Basel-IOSCO final margin requirements is that posted initial margin be subject to arrangements that fully protect pledgor if the secured party enters bankruptcy
- Tri-party segregation accomplishes this important customer protection goal in a way that maintains the SBSD's control of and legal access to the account

Tri-Party Segregation of Initial Margin for OTC Derivatives

Tri-Party Segregation of OTC Derivatives Initial Margin

- In an OTC derivatives tri-party arrangement:
  - Initial margin is posted by customer and maintained in an account held by a third-party custodian bank for the benefit of the SBSD
  - Account is typically in the name of customer (as Pledgor), with SBSD as secured party
  - The SBSD has a perfected security interest in the account and collateral under Articles 8 and 9 of the UCC
  - The Pledgor maintains day-to-day rights and obligations regarding posting, substituting and receiving back collateral from the account
- The right to tri-party segregation under Section 3E covers initial margin only
  - Collateral cushion for SBSD's Potential Future Exposure
  - Mark-to-market collateral is posted directly to the SBSD

Tri-Party Segregation of Initial Margin for OTC Derivatives

Tri-Party Segregation Arrangements Give SBSDs Legal Control

- Legal control is established by the SBSD's power to instruct the Custodian with respect to the collateral without further consent by a defaulting Pledgor
- The Secured Party SBSD has the power under a tri-party agreement to deliver to the custodian a "Notice of Exclusive Control" (NOEC)
- Upon receipt of a NOEC, Pledgor has no right to consent to any movement of collateral in the account, and the securities intermediary (Custodian) is required to act without further consent from Pledgor

Tri-Party Segregation of Initial Margin for OTC Derivatives

Tri-Party Segregation Arrangements Give SBSDs Legal Control

- Tri-party agreements are subject to negotiation, but certain provisions are standard
- Basic provision in a tri-party custody agreement:

  Securities Intermediary will comply with all entitlement orders and other instructions originated by Secured Party with respect to the collateral in accordance with the Notice of Exclusive Control provisions without further consent of Pledgor.

Tri-Party Segregation of Initial Margin for OTC Derivatives

Tri-Party Segregation Arrangements Give SBSDs Access to Collateral

- Key to the analysis is what happens in a Pledgor insolvency, the situation with highest risk of loss to the SBSD
- SBSD has immediate right upon Pledgor insolvency to deliver a NOEC – typically with no verification required
- Upon receipt of a NOEC after Pledgor insolvency, Custodian must refuse to honor any instructions from Pledgor
- Following delivery of the NOEC, the SBSD controls the account
- Pledgor insolvency should not affect or delay the right of the SBSD to direct Custodian to deliver collateral as instructed by the SBSD, or the requirement of Custodian to do so
  - Custodian acts on behalf of SBSD
  - Safe harbor protection under Bankruptcy Code for creditors
  - Other bankruptcy regimes (in the US and other jurisdictions) do not typically impose a stay (exceptions are typically regulated entity counterparties)

Tri-Party Segregation of Initial Margin for OTC Derivatives

Pledgor Access to Segregated Collateral is Limited

- Upon SBSD default, Pledgor may have the right to deliver a notice giving it full access to the collateral in the account
  - Notice must include a certified statement that swap agreement has been terminated due to SBSD default
  - In an insolvency default, evidence of insolvency is typically required
- If Pledgor access is permitted for non-insolvency defaults, the SBSD may be given a right to contest
- These pledgor access rights are consistent with the purpose of Section 3E of the '34 Act and preserve the necessary control of the account by the SBSD

Tri-Party Segregation of Initial Margin for OTC Derivatives

Soon-to-be-Published ISDA Form of Account Control Agreement

- An ISDA working group comprised of market leading swap dealers, custodians and buy-side firms, together with their counsel, have almost completed work on a form of Account Control Agreement
- The Account Control Agreement uses a menu-like approach, with annexes and schedules providing the parties with rights to make certain elections
- The Account Control Agreement reflects the importance and increasing use of tri-party segregation in the market
- The ISDA form is expected to be published this month

Tri-Party Segregation of Initial Margin for OTC Derivatives

Proposed Capital Charge for Segregated Customer Initial Margin Is Unnecessary

- In a segregated tri-party arrangement the SBSD has legal access to and control of the initial margin
  - SBSD may deliver a NOEC at any time
  - Secured Party has a perfected security interest in the account and collateral under the UCC
- An additional capital charge is unnecessary for initial margin held under the SBSD's control
- An additional capital charge is also contrary to the customer protection goal of Section 3E of the '34 Act added by Dodd-Frank, a view shared by a wide range of market participants (see comment letters from ISDA, SIFMA and Investment Company Institute)