

May 11, 2015

The Honorable Mary Jo White  
Chair  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549

Re: *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers*  
(File No. S7-08-12)

Dear Chair White:

On behalf of the Investment Company Institute (“ICI”),<sup>1</sup> I am writing to urge that the Securities and Exchange Commission (“Commission” or “SEC”) re-propose its capital, margin, and segregation proposal for security-based swap dealers (“SBSDs”) and major security-based swap participants (“MSBSPs”) in a form that is consistent with both international standards and recent proposals of other U.S. regulators.<sup>2</sup> The Proposal currently under consideration by the Commission differs substantially both from the proposals subsequently advanced by other U.S. regulators and from the international standards adopted by the Basel Committee on Banking Supervision (“BCBS”) and the International Organization of Securities Commissions (“IOSCO”). Were the Commission to act on the Proposal now before it, it will be impossible to achieve international harmonization of margin rules for uncleared derivatives,<sup>3</sup> an objective we believe is of vital importance. Lack of harmonization

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<sup>1</sup> 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 interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$17.9 trillion and serve over 90 million shareholders.

<sup>2</sup> Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 FR 70214 (Nov. 23, 2012) (“Proposal”), available at <http://www.gpo.gov/fdsys/pkg/FR-2012-11-23/pdf/2012-26164.pdf>.

<sup>3</sup> Margin Requirements for Non-Centrally-Cleared Derivatives, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, September 2013, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD423.pdf> (“International Margin Framework”).

would undermine one of the important goals of the G-20 countries in reforming the derivatives markets and could result in regulatory arbitrage.

### Background

Our members – investment companies that are registered under the Investment Company Act of 1940 – find uncleared security-based swaps (“covered swaps”), as well as other derivative instruments, particularly useful portfolio management tools that offer considerable flexibility in structuring funds’ investment portfolios. Registered funds employ covered swaps and other derivatives in a variety of ways, including to hedge other investment positions, equitize cash that the fund cannot immediately invest in direct equity holdings, manage a fund’s cash positions more generally, adjust the duration of a fund’s portfolio or manage a fund’s portfolio in accordance with the investment objectives stated in the fund’s prospectus.

ICI members, as market participants representing millions of investors, generally support the goal of providing greater oversight of the swaps markets. Although the margin rules would apply to SBSDs and MSBSPs, our members have a strong interest in these rules, which will have an indirect effect on registered funds as counterparties to SBSDs and MSBSPs. Moreover, given that many swaps transactions are conducted across multiple jurisdictions, we strongly support efforts for meaningful coordination among regulators and international harmonization of margin rules for swaps, including security-based swaps. In this regard, the International Margin Framework is a significant achievement by the international regulators in coordinating an important aspect of derivatives reform agreed to by the G-20 countries.

In response to the adoption of the International Margin Framework, regulators in the United States<sup>4</sup> and in Europe<sup>5</sup> – with the exception of the SEC – have re-proposed or proposed margin rules for uncleared derivatives that are largely consistent with the International Margin Framework.

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<sup>4</sup> Last fall, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency (together, the “prudential regulators”) and the Commodity Futures Trading Commission (“CFTC”) re-proposed their margin requirements for uncleared swaps and security-based swaps. See Margin and Capital Requirements for Covered Swap Entities; Proposed Rule, 79 FR 57348 (Sept. 24, 2014), *available at* <http://www.gpo.gov/fdsys/pkg/FR-2014-09-24/pdf/2014-22001.pdf> (“Prudential Regulators Proposal”); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 FR 59898 (Oct. 2, 2014), *available at* <http://www.gpo.gov/fdsys/pkg/FR-2014-10-03/pdf/2014-22962.pdf> (“CFTC Proposal”).

<sup>5</sup> In April 2014, the European Securities and Markets Authority, the European Banking Authority, and the European Insurance and Occupational Pensions Authority (collectively “European Supervisory Authorities” or “ESAs”) issued their draft regulatory technical standards (“RTS”) for margin requirements for non-centrally cleared OTC derivatives. See Consultation Paper on Draft Regulatory Technical Standards on Risk-Mitigation Techniques for OTC-Derivative Contracts Not Cleared by a CCP under Article 11(15) of Regulation (EU) No. 648/2012, April 14, 2014, *available at* [http://www.esma.europa.eu/system/files/jc\\_cp\\_2014\\_03\\_cp\\_on\\_risk\\_mitigation\\_for\\_otc\\_derivatives.pdf](http://www.esma.europa.eu/system/files/jc_cp_2014_03_cp_on_risk_mitigation_for_otc_derivatives.pdf) (“EMIR Proposal”).

Moreover, we understand that these other regulators, recognizing the importance of coordination, are working diligently to further harmonize their margin rules before final adoption.<sup>6</sup> With this backdrop, we are perplexed and deeply concerned that the Commission has not issued a re-proposal of its margin rules and does not appear to have plans to re-propose its margin rules to be consistent with the International Margin Framework.<sup>7</sup> As described below, the Commission's overall framework is vastly different from those of the other regulators and key elements of the Proposal are inconsistent with those of other regulators and the International Margin Framework.

#### SEC's Broker-Dealer Framework is Inconsistent with U.S. and International Margin Framework

As noted in the Proposal, the Commission has modeled its margin rules on existing broker-dealer financial responsibility requirements because of its familiarity with these requirements and because some of the rationales or objectives underlying the broker-dealer requirements may have relevance in the context of dealers and major participants that engage in security-based swaps. This model, unless changed significantly, is not consistent with the International Margin Framework. The International Margin Framework, for example, imposes strict restrictions on rehypothecation of margin, which may be a common practice among broker-dealers. We support restrictions on rehypothecation, which are consistent with the restrictions to which registered funds are subject

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<sup>6</sup>Testimony of Commissioner Mark Wetjen before the U.S. House Committee on Agriculture Subcommittee on Commodity Exchanges, Energy, and Credit Subcommittee (Apr. 14, 2015) ("In finalizing this rule, the commission must continue to coordinate with regulators both in the United States and abroad. The importance of global harmonization cannot be overstated given the risk of regulatory arbitrage if material differences in margin requirements exist among major financial markets"); Keynote Address by Chairman Timothy G. Massad before the Institute of International Bankers (Mar. 2, 2015) ("In addition to harmonizing with the U.S. bank regulators, it is very important that we try to make our rules as similar as possible with the rules that Europe and Japan are looking to adopt, and so we have spent considerable time in discussions with our international counterparts"); Testimony of Chairman Timothy G. Massad before the U.S. House Committee on Agriculture, Washington, DC (Feb. 12, 2015) ("In formulating our approach, we coordinated closely with the relevant bank regulators, because Congress mandated that margin requirements be set by different regulatory agencies for the respective entities under their jurisdiction. . . . We have also been working with our international counterparts to harmonize our proposed margin rule for uncleared swaps with corresponding rules in other jurisdictions. Europe, Japan and the United States have each proposed rules which are largely consistent, and which reflect a set of standards agreed to by a broader international consensus. . . . While there were some differences in the proposals, we are working closely with our counterparts in Europe and Japan, as well as the U.S. banking regulators, to try to further harmonize these rules").

<sup>7</sup>Section 712(a)(2) of the Dodd-Frank Wall Street Reform and Customer Protection Act ("Dodd-Frank Act") requires the SEC to "consult and coordinate to the extent possible with the Commodity Futures Trading Commission and the prudential regulators for the purposes of assuring regulatory consistency and comparability, to the extent possible." Section 752(a) of the Dodd-Frank Act also provides that "[i]n order to promote effective and consistent global regulation of swaps and security-based swaps, the Commodity Futures Trading Commission, the Securities and Exchange Commission, and the prudential regulators . . . as appropriate, shall consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to the regulation (including fees) of swaps."

under the Investment Company Act. We urge the Commission to reconsider imposing a broker-dealer framework on SBSs and MSBSs without adequately tailoring the requirements to the realities of the swap and security-based swap markets.<sup>8</sup>

#### SEC's Unilateral Margining Requirement Is Inconsistent with U.S. and International Standards

The Proposal would require SBSs to collect collateral from their counterparties to non-cleared security-based swaps to cover both current exposure and potential future exposure to the counterparty subject to certain exceptions. Proposed SEC Rule 18a-3(c)(2) would require an MSBS to collect collateral from counterparties to which the MSBS has current exposure and deliver collateral to counterparties that have current exposure to the MSBS subject to certain exceptions. The Proposal would not require bilateral exchange of collateral to cover potential future exposure for MSBSs. This aspect of the Proposal is inconsistent with the International Margin Framework and with the re-proposals by the prudential regulators and the CFTC.

ICI strongly urges the Commission to re-propose its margin rules to include the fundamental requirement of bilateral margining consistent with the International Margin Framework. The prudential regulators and the CFTC properly have recognized the importance of achieving consistency with the internationally agreed standards: doing so is critical to protecting counterparties (such as registered funds); promoting financial stability by reducing a build-up of risk at institutions that engage in a significant amount of swap transactions; and preventing regulatory arbitrage. The prudential regulators and the CFTC therefore re-proposed their margin rules last fall to reflect this internationally agreed upon element of the margin framework. In proposing the bilateral margining requirement, the prudential regulators and the CFTC acknowledged the critical role that bilateral margining plays in the protection of counterparties and the swaps markets more generally.<sup>9</sup>

#### SEC's Lack of an Initial Margin Threshold is Inconsistent with International Standards

The Proposal also does not permit the application of thresholds for initial margin (the amount under which an entity would have the option of not collecting initial margin). The

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<sup>8</sup> We expressed our concerns with the Proposal in a detailed comment letter to the Commission. See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated February 4, 2013, available at <http://www.ici.org/pdf/26967.pdf>. We also submitted a supplemental comment letter to respond to the SEC staff's request for additional information about tri-party custodial arrangements. See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated December 5, 2013, available at <http://www.ici.org/pdf/27742.pdf>.

<sup>9</sup> Prudential Regulators Proposal, *supra* note 4, at 57354 ("the Agencies also believe that requiring a covered swap entity to post margin to other financial entities could forestall a build-up of potentially destabilizing exposures in the financial system"); CFTC Proposal, *supra* note 4, at 59907 ("daily posting of initial margin also helps to ensure the safety and soundness of a [covered swap entity] by making it more difficult for the CSE to build up exposures that it cannot fulfill").

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International Margin Framework established a threshold of €8 billion in gross notional outstanding amounts, below which entities would not be subject to initial margin requirements. Although the prudential regulators and the CFTC re-proposed a different amount than the level established by the International Margin Framework, the European regulators have proposed the €8 billion threshold in their margin requirements for OTC derivatives contracts not cleared by a central counterparty pursuant to the European Market Infrastructure Regulation (“EMIR”) to determine whether particular counterparties would be subject to the margin requirements under the EMIR Proposal. We understand that the prudential regulators and the CFTC are working to further harmonize their margin proposals and there are indications that they may raise the threshold to be consistent with the international standards.<sup>10</sup> We strongly recommend that the Commission re-propose its margin rules and incorporate the use of an €8 billion equivalent initial margin threshold.

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The Proposal issued in 2012 differs fundamentally, in a number of critical respects, from the International Margin Framework, and from the EU proposal and the re-proposals of the prudential regulators and the CFTC that were issued in response thereto. We do not believe that it is possible to harmonize the Proposal, as issued by the SEC, with the regulatory regime upon which these other regulators are converging in line with the International Margin Framework. We, therefore,

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<sup>10</sup> Keynote Address by Chairman Timothy G. Massad before the Institute of International Bankers (Mar. 2, 2015) (“I am willing to be flexible regarding some aspects of our proposed rule in order to ensure greater consistency. For example, the threshold for when margin is required is currently lower in our proposed rule than in the proposals in Europe and Japan. I believe we should harmonize the threshold, even if it means increasing ours”).



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respectfully urge the Commission to re-propose its margin rules in line with the International Margin Framework and incorporate the key elements discussed above. If you have any questions on our comment letter, please feel free to contact me at (202) 326-5901, Jennifer Choi at (202) 326-5876, or Sarah Bessin at (202) 326-5835.

Sincerely,



Paul Schott Stevens  
President and CEO  
Investment Company Institute

cc: The Honorable Luis A. Aguilar  
The Honorable Daniel M. Gallagher  
The Honorable Kara M. Stein  
The Honorable Michael S. Piwowar

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