May 10, 2013

The Hon. Mary Jo White
Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

The Hon. Gary Gensler
Chairman
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Re: Request for Action by the SEC and CFTC to Improve Coordination and to Facilitate Portfolio Margining for Customers in the Cleared CDS Market

File No. S7-13-12: Order Granting Conditional Exemptions Under the Securities Exchange Act of 1934 in Connection With Portfolio Margining of Swaps and Security-Based Swaps; and CFTC Order, Treatment of Funds Held in Connection with Clearing by ICE Clear Credit of Credit Default Swaps

Dear Chairmen White and Gensler:

Recent administrative actions requiring buy-side participants to post 150-200% more margin than sell-side participants in centrally cleared credit default swaps ("**CDS**") impose significant, disparate burdens and discourage clearing. We greatly appreciate the opportunity to explain this matter and achieve an appropriate balance of investor protection and efficient markets. Managed Funds Association ("**MFA**"), the American Council of Life Insurers ("**ACLI**"), and the Alternative Investment Management Association ("**AIMA**") (collectively, the "**Associations**"[1]) represent investors that use derivatives to invest and hedge their investment

[1] The Associations represent an extensive range of investors in the derivatives markets, which includes hedge funds and life insurers. A description of the Associations is set forth in the Annex to this letter.

portfolios.[2] The Associations have supported regulatory efforts to allow investors access to central clearing as mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"). Of concern is the SEC Staff's temporary conditional approval ("**Temporary Conditional Approval**") of the margin methodologies of registered broker-dealers and futures commission merchants, as clearing member firms (collectively, "**BD/FCMs**") under the SEC's December 19, 2012 order (the "**Order**").[3]

The Associations support the clearing of eligible single-name CDS and CDS indices and appropriate risk-based margin levels. However, the temporary approvals set margin levels for customers that are unjustifiably high both on an absolute basis and on a relative basis versus the baseline margin levels applied to dealers. Among other adverse consequences, this:

- Creates an economic barrier to customer clearing
- Counters the systemic risk reduction benefits of central clearing
- Undermines investor protection by increasing counterparty credit risk and interconnectedness
- Exacerbates systemic risk by de-coupling economically offsetting portfolios, draining liquid reserves through excess collateral demand, and/or disincentivizing risk-mitigating hedging activity
- Harms market efficiency by creating pricing distortions
- Entrenches competitive inequality

For these and other reasons explained in more detail below, the Associations respectfully suggest that the two commissions work in greater coordination and that the SEC modify its temporary customer margin requirements.

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[2] MFA and ACLI appreciate the opportunity to have met with representatives from both the Securities and Exchange Commission ("**SEC**") and the Commodity Futures Trading Commission ("**CFTC**") on April 8, 2013 to initially discuss our concerns. MFA also submitted a comment letter in response to the Order on February 11, 2013, available at: http://www.sec.gov/comments/s7-13-12/s71312-1.pdf.

[3] SEC "Order Granting Conditional Exemptions Under the Securities Exchange Act of 1934 in Connection With Portfolio Margining of Swaps and Security-Based Swaps", 77 Fed. Reg. 75211 (Dec. 19, 2012), available at http://www.gpo.gov/fdsys/pkg/FR-2012-12-19/pdf/2012-30553.pdf. The Order grants conditional exemptive relief from compliance with certain provisions of the Securities Exchange Act of 1934, as amended (the "**Exchange Act**") for registered clearing agencies and derivatives clearing organizations and BD/FCMs, to offer a program to commingle and portfolio margin customer positions in cleared CDS, which include both swaps and security-based swaps, in a segregated account established and maintained in accordance with Section 4d(f) of the Commodity Exchange Act, as amended ("**CEA**").

I. Legal Background

The Dodd-Frank Act divided jurisdiction over the CDS market between the CFTC and the SEC. The CFTC has jurisdiction over broad-based CDS indices, while the SEC has jurisdiction over narrow-based CDS indices and single-name CDS. Nevertheless, the Dodd-Frank Act specifically instructed the CFTC and the SEC to cooperate to facilitate portfolio margining.[4] Portfolio margining is a risk-based approach for setting initial margin requirements that takes into account correlations among positions within a portfolio, where losses on certain positions are offset by gains on others. Registered clearing agencies and derivatives clearing organizations (collectively, "**Clearinghouses**") offer regulator-approved portfolio margining arrangements to optimize the use of capital while ensuring that if a clearing participant fails, the Clearinghouse (or, in the case of participant clearing through a clearing member, that clearing member) has sufficient collateral. In short, portfolio margining maximizes investors' use of capital while minimizing risks.

However, portfolio margining of products that are subject to regulation by both the SEC and the CFTC requires close cooperation of the two commissions. As the SEC explained in its Order, Section 724 of the Dodd-Frank Act added provisions to Section 4d of CEA that perform functions similar to those in Section 3E of the Exchange Act in creating a segregation framework for swap customers. Accordingly, in order to permit collateral related to cleared security-based swaps to be commingled with that related to cleared swaps for purposes of portfolio margining and to operate under the segregation framework for swaps, a broker-dealer would need relief from the applicable provisions of Section 3E and Section 15(c)(3) of the Exchange Act as well as Rule 15c3-3 thereunder. Similarly, a clearing agency would need relief from applicable provisions of Section 3E of the Exchange Act. The CFTC would also need to provide relief to allow security-based swaps to be commingled with swaps in an account maintained in accordance with Section 4d(f) of the CEA.

ICE Clear Credit, LLC ("**ICC**") has developed an offering to clear both CDS indices and single-name CDS. ICC further developed a portfolio margining methodology that takes into account risk offsets between these products. ICC launched its CDS portfolio margining regime for the proprietary positions of its self-clearing members ("**Dealers**") in January 2012 after receiving approval from the SEC and submitting its self-certification to the CFTC.[5] We

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[4] The Order notes that Section 713(a) of the Dodd-Frank Act provides explicit authority for such exemptive relief to facilitate portfolio margining programs. *Id*. at 75212, n. 6.

[5] The SEC approved ICC's proposed rule change SR-ICC-2011-03 on December 16, 2011. *See* SEC "Order Approving Proposed Rule Change to Adopt ICC's Enhanced Margin Methodology", Release No. 34-66001; File No. SR-ICC-2011-03 (Dec. 16, 2011) at p. 5 (hereinafter "**ICC Margin Order**"). The ICC Margin Order authorizes ICC to provide portfolio margining offsets to its clearing members that maintain proprietary portfolios that hedge CDS index products against single-name CDS products. On November 28, 2011, the CFTC received ICC's self-certification of the implementation of its enhanced margin methodology to provide appropriate portfolio margining relief between CDS indices and offsetting single-name CDS positions for its clearing members' proprietary positions.

understand from ICC and also from discussions with both CFTC and SEC officials that there have been no difficulties in the use of such portfolio margining by Dealers, and we are not aware of any regulatory concerns in connection with its use.

ICC planned to offer the same CDS portfolio margining program implemented for Dealers to customers using a CFTC-regulated Section 4d(f) segregated account.[6] In October and November 2011, ICC submitted its petitions to the CFTC and the SEC, respectively, for exemptive relief under Section 713(a) of the Dodd-Frank Act[7] to permit ICC's portfolio margining regime for customers. Industry participants, including Dealers, FCMs, Clearinghouses and the buy-side, broadly supported ICC's petitions so that clearing members would be approved to offer portfolio margining to cleared CDS customers.[8] On December 19, 2012 and January 14, 2013, respectively, the SEC issued the Order[9] and the CFTC issued its companion final exemptive order[10] approving ICC's portfolio margining regime for customers in response to ICC's petitions for exemptive relief under Section 713(a) of the Dodd-Frank Act. Among other requirements, the CFTC's order requires ICC's clearing members to collect initial margin from customers at a minimum level determined by ICC. In contrast, among other conditions, the SEC's Order requires that clearing members must set initial margin levels for customers at least equal to the amount determined using a margin methodology established and maintained by the clearing member that has been approved in writing, individually, BD/FCM by BD/FCM, by the SEC or SEC Staff.[11] During our recent meeting, the SEC Staff expressed the view that it was not sufficient for BD/FCMs to adopt the ICC margin methodology. The SEC Staff requires that each BD/FCM must individually justify the efficacy of the margin model it uses for customer clearing and appears to contemplate that BD/FCMs could use models that diverge from ICC's model.

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[6] Until such time as the SEC finalizes its margin and segregation requirements for cleared security-based swaps, the CFTC-regulated Section 4d(f) account is the only option for the portfolio margin account.

[7] ICE Clear Credit LLC – Request for order pursuant to Section 36(a)(1) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), to provide exemptive relief from the application of Section 15(c)(3) of the Exchange Act and Rule 15c3-3 thereunder re: commingling of customer funds and portfolio margining, dated November 7, 2011, submitted to the SEC by Michael M. Philipp, Partner, Winston & Strawn LLP, as counsel to ICE Clear Credit LLC. ICC filed a companion petition on October 4, 2011 with the CFTC seeking similar exemptive relief pursuant to Section 713(a) of the Dodd-Frank Act.

[8] *See, e.g.*, MFA letter to the SEC on ICC's petition for an order permitting portfolio margining of single-name CDS and broad-based indices, filed with the SEC on June 13, 2012, available at https://www.managedfunds.org/wp-content/uploads/2012/06/SEC-Comment-Letter-in-Support-of-ICE-Portfolio-Margining-Petition-Final-MFA-Letter.pdf.

[9] Although the Order became effective on December 19, 2012, the SEC requested public comment on all aspects of the Order on or before February 19, 2013. On February 11, 2013, MFA submitted a comment letter in response to the Order, available at: http://www.sec.gov/comments/s7-13-12/s71312-1.pdf.

[10] CFTC Order, "Treatment of Funds Held in Connection with Clearing by ICE Clear Credit of Credit Default Swaps", at: http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/icecreditclearorder011413.pdf.

[11] Order at 75218. The SEC indicated that the Financial Industry Regulatory Authority ("**FINRA**") would provide assistance in evaluating each BD/FCM's margin methodology.

The Order allows the SEC or SEC Staff to provide temporary approval of a BD/FCM's margin methodology while the methodology is being evaluated prior to granting final approval.[12] On March 8, 2013, the SEC Staff issued Temporary Conditional Approval Letters (the "**Letters**") to seven BD/FCMs.[13] In issuing the Letters, the SEC has again taken a much different view from both its prior assessment of initial margin requirements for Dealers' proprietary CDS portfolios and from the CFTC's customer initial margin requirements by requiring that customers post 150-200%[14] of the ICC minimum margin level on a temporary basis. The temporary margin levels will apply until the SEC and FINRA have completed their review of each individual BD/FCM's customer margin methodology, and the SEC has issued final approval of such BD/FCM margin methodologies for purposes of the Order. MFA submitted comments to the SEC seeking urgent action for temporary approval of BD/FCM margin methodologies in response to this approval condition in the Order.[15] However, prior to the SEC Staff's issuance of the Letters, the SEC did not give the public (including the Associations and their members) any opportunity to review or provide any input into the temporary customer margin levels that have a direct and significant impact on the markets and their businesses. Unfortunately, the Letters do not explain either: (1) the margin disparity between customers and Dealers when trading the same CDS products, or (2) the disparity between the SEC's required customer margin level at 2 times the ICC minimum, and the CFTC's required customer margin level based on the ICC minimum.

II. Adverse Consequences to Investors of the Letters

The Associations strongly believe that the ICC model addresses the risks of CDS products and should apply to both customers and Dealers. When both the SEC and CFTC reviewed the ICC model, we believe they evaluated those models to address concerns related to the market movements and other risks attendant to the specific products covered. In doing so, both agencies determined that ICC's portfolio margin levels were sufficient to provide in excess of 99% confidence level coverage over a 5-day liquidation horizon for Dealer trades.[16] Indeed, the public policy concerns of failure are more significant at the Dealer-level than they are at the individual customer level, because the failure of a Dealer is a substantially greater threat to the financial system. The Associations submit that SEC and CFTC approval of the ICC model

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[12] *Id.*, n. 56.

[13] We believe it is unclear whether the SEC itself issued the Letters under the authority of the Order as final agency action, or as Staff interpretive guidance. Either way, market participants consider themselves to be bound by them as a practical matter.

[14] Under this procedure, end-users with virtually no credit risk would be required to post 150% of the ICC model, while end-users with greater credit risk would be required to post up to 200% of the ICC model.

[15] *See supra*, n. 8.

[16] We discuss in more detail below other attributes of the ICC margin model.

should provide substantial assurance that the model provides appropriate protection at both the Clearinghouse-level and Dealer-level.[17]

As noted, the SEC Staff has indicated that it believes each BD/FCM's margin model should withstand scrutiny as providing appropriate protection. We appreciate that sentiment, but believe that if ICC's margin methodology has already met the SEC's standards for protection of Clearinghouses and Dealers, then it is equally suitable for individual accounts held with a BD/FCM. We further believe that variation from the ICC model would be justified only in limited circumstances, such as collecting additional margin from customers with diminishing credit quality.[18] We respectfully disagree with action that the SEC (or its Staff) has taken in the Letters by both establishing an across-the-board multiplier for customer margin; and setting customer margin level at such a high level without any economic justification.

The Associations believe that such action has undermined policy goals that we all share, *i.e.*, to encourage clearing to reduce systemic risk, to protect investors, to reduce counterparty exposure and interconnectedness of both customers and Dealers, and to establish an integrated and coordinated regulatory framework. We regret that the Letters have had the reverse effect and have the perverse effect of undermining both overall systemic risk reduction and customer protection. We outline our reasons below.

A. Clearing Disincentives Contradict the Dodd-Frank Act.

OTC derivatives clearing is a pillar of the Dodd-Frank Act, as policy makers recognized that central clearing of these transactions would mitigate systemic risk. Many customers on the

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17 In approving the ICC portfolio margining regime, the SEC concluded that ICC's methodology is "consistent with Section 17A(b)(3)(F) of the [Exchange] Act, including ICC's obligation to ensure that its rules be designed to assure the safeguarding of securities and funds in the custody or control of the clearing agency or for which it is responsible." *See* ICC Margin Order at p. 5; *see also supra* note 5. In the ICC Margin Order, the SEC also determined that ICC's portfolio margining methodology is adequately designed to ensure prompt and accurate clearance and settlement of CDS, including indices that must be cleared under CFTC rules and provisions of Title VII of the Dodd-Frank Act. Specifically, the SEC has satisfied the requirement under Section 17A(b)(3)(F) of the Exchange Act that the rules of a clearing agency be "designed to remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions and to assure the safeguarding of securities and funds in the custody or control of the clearing agency or for which it is responsible." *Id.* at p. 4. In addition, on May 17, 2011, ICE Trust received a notice of "no objection" from the Federal Reserve Bank of New York with respect to the ICE portfolio margining methodology. On July 12, 2011, ICE Trust also received a notice of "no objection" of such methodology from the New York State Banking Department. To validate the safety and soundness of risk management enhancements to its portfolio margining methodology, ICC engaged Finance Concepts, an independent risk management consultant, to provide a third-party review. In its March 2011 study entitled, "A Stress Test of the ICE Margin Requirements for Large Multi-Asset Portfolios," Finance Concepts made the following conclusions: "(i) ICE variation margin levels were sufficient to cover liquidation costs under the most extreme credit conditions and (ii) the margin relief for long-short positions based on Index Decomposition constitutes a prudent and well-founded methodology for warehousing risk associated with multi-index, multi-obligor CDS portfolios."

18 We discuss such circumstances in more detail below.

buy-side agreed with this provision, even though the cost of clearing would be higher than the cost of transacting bilaterally. The collapse of Lehman Brothers harmed the Associations' members along with many other market participants. Prior to this collapse, the risk of counterparty default of large financial institutions was an afterthought for most market participants. Many came out of the experience focused on ways to protect collateral in a default scenario. The market reaction led to the policy response of increased central clearing. Congress enacted all of Title VII of the Dodd-Frank Act to foster derivatives clearing and as a partial response to the 2008 financial crisis.

On March 11, 2013, mandatory clearing became a reality after the CFTC implemented its clearing mandate for the largest asset classes – interest rate swaps and CDS indices. Market participants subject to the CFTC clearing mandate as of March 11, and those in subsequent categories who wish to clear voluntarily, are highly motivated to clear the entire credit asset class, both CDS indices and single-name CDS. Some buy-side firms would also like to backload their uncleared legacy CDS trades to central clearing. However, the Letters act as a strong disincentive for customers to clear, or backload into clearing, any single-name CDS.[19] They also act as a disincentive for market participants who are not yet subject to the CFTC's clearing mandate to clear voluntarily their CDS indices, since the entire portfolio can achieve appropriate portfolio margining offsets under a master netting agreement if the CDS indices and single-name CDS remain traded and held bilaterally. Therefore, absent a change in policy by the SEC, those customers will continue to trade CDS products in an uncleared environment. Inhibiting such voluntary clearing and backloading directly undermines the goal of reducing systemic risk by bringing more clearing-eligible trades into Clearinghouses.

Under the terms of the Letters, if a customer seeks to achieve these offsets by clearing single-name CDS, the customer faces a punitive economic barrier: the margin amount on the customer's total portfolio margin account would double, even if it adds only one single-name CDS.[20] The following example illustrates the practical impact of the Letters:

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[19] On April 15, 2013, ICC launched its customer clearing offering for certain single-name CDS. *See* ICC Circular, available at: https://www.theice.com/publicdocs/clear_credit/circulars/Circular_2013_011_FINAL.pdf. As of the date of this letter, we understand that no customer has yet cleared any single-name CDS at ICC.

[20] With respect to the iTraxx® Europe CDS indices (the "**iTraxx class**"), we note that the addition of a single-name CDS position could arise after a Restructuring credit event is triggered with respect to a reference entity in the applicable index, whereby a single-name CDS trade on such reference entity would be created. The first category of market participants under the CFTC's clearing implementation rule are required to clear the iTraxx class starting on April 26, 2013. By letter to ICC dated April 22, 2013 (the "**ICC Response Letter**"), SEC Staff clarified that in the event an account holds only CDS indices, and if a single-name CDS is spun-out of an iTraxx position among such CDS indices into the account, by narrow exception, SEC Staff will not require the 150% or 200% multiple, assuming no other single-name CDS are held in the account. However, any other situation in which a single-name CDS is held in the account at any time with CDS indices would lead to the imposition of the 150% or 200% customer margin requirement. *See* the ICC Response Letter, available at: http://www.sec.gov/rules/exorders/2013/34-68433-responses.pdf.

- Assume a clearing customer has a portfolio of 50 CDS indices, with a total notional of $500 million and an initial margin requirement of $10 million based on the ICC margin methodology approved by the SEC and the CFTC.

- Assume next that the customer adds one single-name CDS position to its portfolio, which offsets some of the index risk and would lower, under ICC's margin methodology, the required margin to $9.9 million.

- Under the Temporary Conditional Approval, that margin would immediately be doubled for the customer to $19.8 million, based on the presence of one security-based swap in the portfolio.

This strikes us as a disproportionate outcome without any risk-based justification. In addition, if the sole single-name CDS position in the customer's portfolio is subsequently closed, the margin obligations with respect to the account that now holds only CDS indices would have to continue to be margined at the 150-200% level. This result is based on recent confirmation by SEC Staff that a customer account that holds at various times both single-name CDS and CDS indices is subject to the margin requirements of the Order.[21]

Because some of the Associations' members are larger buy-side firms that have become subject to the CFTC's March 11 clearing mandate, they have no choice but either to pay this excessive margin, or forego the benefits of portfolio margining and leave their existing CDS index positions uncleared, and both their existing and new single-name CDS trades uncleared. In addition, many other buy-side firms in the second category of market participants must begin voluntary clearing of their CDS indices to prepare for the CFTC's June 10, 2013 clearing compliance deadline. These buy-side firms are either deterred from increasing their cleared volumes before June 10, thus undermining an orderly transition to mandatory clearing, or are forced, at a material cost, to split their portfolios.[22] In our view, either choice penalizes the buy-side.

B. Excessive Customer Margin Undermines Investor Protections.

First, as illustrated above, the Temporary Conditional Approval inhibits customer clearing, leaving more trades in the uncleared regime. In bilateral uncleared trades, the customer has no external protections against the default of its bilateral dealer counterparty. Therefore, an unintended consequence of the Letters is to force customers to remain in the unprotected, bilateral margin regime. In that regime, customer margin is held as unprotected working capital

[21] *Id.*

[22] We discuss below the possibility that a customer would choose to clear both CDS indices and single-name CDS in separate accounts and two different BD/FCMs.

with a dealer counterparty, exposing the buy-side to potential material losses in the event of a dealer counterparty's failure.[23]

Second, because the additional or "excess" margin (*i.e.,* the margin above the ICC minimum margin that the BD/FCMs are required to collect)[24] requirement effectively forces a customer to execute its single-name CDS bilaterally with dealer counterparties, even if it is required to clear its CDS indices, the excess margining effectively multiplies the customer's counterparty credit risk. This increase in a customer's credit risk exposure results from the customer's loss of the offsets it realized when it had both its single-name CDS and the offsetting CDS indices with the dealer counterparty, thereby leaving only a net counterparty credit exposure to the dealer counterparty.

Third, the excess margin that customers who were to decide to use the ICC portfolio margining program would be required to post would currently be held at the BD/FCM, not at the Clearinghouse.[25] The customer would thus have increased counterparty credit risk to the BD/FCM. In instances where a BD/FCM is less creditworthy than its customer, which is the case for certain buy-side clients, the requirement to post such excess margin to the BD/FCM is an anomalous outcome. In all instances, requiring clients to hold funds with more third parties than necessary, through the posting of excess margin to BD/FCMs, amplifies counterparty credit exposure, and thus interconnectedness in the marketplace. This interconnectedness increases systemic risk, in direct opposition to fundamental goals of the Dodd-Frank Act.

Fourth, a buy-side firm that is required to post excess margin without a risk-based justification undermines its ability to deploy capital more productively. Customers will have to dedicate increased funds to meet initial margin obligations which are not risk-driven, directly reducing their ability to support their investing and hedging activities, and to meet liquidity requirements, particularly in stressed periods.

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[23] An exception to this lack of customer initial margin protection in bilateral, uncleared transactions is the use of tri-party segregation arrangements. In such an arrangement, an unaffiliated custody bank or other institutional custodian assumes responsibilities for safeguarding a customer's individually segregated initial margin under a three-way contract among the custodian, the pledgor (in this case, the customer) and the secured party (in this case, the dealer counterparty). The unaffiliated custodian is also responsible for investing, transferring and releasing the customer's initial margin under the terms of the three-way contract.

[24] To clarify, our reference to "excess" margin refers to 150-200% initial margin posted by a clearing customer in excess of the amount required by the Clearinghouse. This meaning is distinguished from the term "excess margin securities" as defined in Rule 15c3-3 of the Exchange Act.

[25] We understand that ICC intends to implement a "Legal Segregation with Operational Commingling, or "LSOC", "with excess" model in the second or third quarter of 2013. Under this model, excess margin could be held at the Clearinghouse, not at the BD/FCM. Until such time that ICC has implemented an "LSOC with excess" model, the customer would have increased counterparty credit risk to the BD/FCM.

C. Excessive Customer Margin Exacerbates Systemic Risk.

Excessive customer margin requirements can increase systemic risk as customers are required to meet unnecessarily large initial margin calls. Provisioning for losses beyond the worst possible ones increases systemic risk, rather than reducing it. This increased systemic risk occurs because excessive initial margin calls force "wrong way", *i.e.*, pro-cyclical calls of collateral that magnify stress effects by draining customers of liquidity just when it is most needed to prevent or mitigate a customer default event. There is no corresponding protective benefit served by such margin calls. After a default, the excess margin will be returned to the customer (or, if the customer defaults, the customer's bankruptcy estate).

In addition, some buy-side firms, in an effort to continue their CDS trading and hedging activities to manage the risks of their businesses, will forego clearing in one commingled account to avoid the 150-200% margin required by the Letters. As a result, these buy-side firms would be forced to split their CDS portfolios. They would most likely continue to keep their single-name CDS uncleared, as described above. Even if a customer were to choose to clear its single-name CDS, separately to avoid the margin multiple on commingled portfolios (and, because there is no facility for BD/FCMs individually to maintain split CDS index accounts and single-name CDS accounts for their customers), the customer would have to establish two separate CDS accounts with two BD/FCMs, one for CDS indices and one for single-name CDS. In either situation, the separate CDS portfolios would be directional, unhedged portfolios. Directional portfolios pose higher risk to both BD/FCMs and, as explained above, to customers. In the aggregate, this higher risk from unhedged portfolios could increase systemic risk.

Separate accounts for single-name CDS and CDS indices present other adverse consequences as well. First, separate accounts would yield inconsistent treatment of single-name CDS versus CDS indices in an insolvency, if either (1) CDS indices are cleared and single-name CDS are held bilaterally, or (2) if both single-name CDS and CDS indices are cleared, but the positions are held in accounts at different BD/FCMs, which splits the portfolios into directional ones, as explained above. Second, separate accounts eliminate the significant benefits in capital efficiencies that should be realized through portfolio margining.

Finally, to avoid the additional margin charges resulting from CDS clearing under the Temporary Conditional Approval, customers may simply curtail or stop hedging for risk management purposes. This result clearly would also have systemic risk implications.

D. Excessive Customer Margin Harms Market Efficiency.

Strong liquidity in single-name CDS trading helps reduce pricing distortions between the individual single-name CDS and the CDS index of which each name is a constituent. This is not dissimilar to the equity markets where the arbitrage opportunities between the S&P 500 and each of its constituents are virtually non-existent, because of strong liquidity on both sides of the market. Without a healthy and robust single-name CDS market, CDS indices would suffer significant mispricing relative to the true value of their constituent single-names. This ultimately hurts the end-users of CDS indices that are using the product to hedge corporate credit risk. The

efficient hedging of this credit risk allows these institutions to supply credit to the capital markets. At the margin levels imposed by the Letters, the buy-side would be largely disincentivized from continuing to trade single-name CDS in any meaningful volume. As a result, these pricing distortions would be exacerbated. This is a significant unintended adverse consequence which not only hurts the single-name CDS market, but also devalues the use of CDS indices for hedgers of corporate credit risk.

E. Excessive Customer Margin Harms Competition.

Unless customers face margin levels that are reasonable and consistent with the levels afforded to Dealers, the capital required for clearing will be significantly greater for customers than for Dealers. This inequality puts customers at a substantial competitive disadvantage, with no justification under the Dodd-Frank Act. This inequality will not only create a significant economic barrier to buy-side clearing, but will substantially restrain the healthy evolution of increased liquidity that should develop with increased clearing.

Materially disparate margining for the buy-side, and all market participants other than Dealers, puts such market participants at a material competitive disadvantage to Dealers, who have been permitted to use cleared CDS portfolio margining programs for over a year. This competitive disadvantage inhibits the development of open competitive markets. Burdened by unequal margin requirements, all non-Dealer participants in the market will be unable to make competitive bids and offers, thus relegating them to the positions of permanent price takers. Liquidity will thus remain concentrated, as it is today in the bilateral markets, in a relatively small number of the largest players. Such liquidity concentration both undermines price competition and concentrates risk. This resulting liquidity concentration further entrenches the dominant position of a select number of Dealers and prevents new dealer entrants and alternative liquidity providers from entering the market.[26] This is because any such new dealer entrants and alternative liquidity providers, who themselves are not clearing members, would also have to post margin at the 150-200% level, like customers, and therefore could never compete effectively with the self-clearing Dealers.

III. Rationales for Application of Consistent, Risk-Based Margin Treatment

A. ICC has a Proven Risk-Based Margin Model for CDS Products.

During our recent meetings, the SEC Staff further indicated that they may be revisiting the adequacy of the 5-day liquidation time horizon for cleared CDS customer positions under ICC's portfolio margining methodology. Both the SEC and the CFTC approved ICC's 5-day

[26] Section 3(f) of the Exchange Act requires the SEC to consider whether its rules and actions will promote efficiency, competition, and capital formation. In addition, Section 36 of the Exchange Act allows the SEC to "conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors."(emphasis added). We submit that the Temporary Conditional Approval fails to meet both standards.

liquidation horizon for Dealers' cleared CDS positions. In doing so, as noted both agencies determined that ICC's portfolio margin levels were sufficient to provide in excess of 99% confidence level coverage over a 5-day liquidation horizon for ICC's clearing member CDS trades. We understand that SEC Staff is considering requiring the ICC model to double the liquidation horizon to 10 days for cleared CDS customer positions, but without any explanation. We note that the CFTC has determined that a minimum liquidation time of 5 days is required for cleared CDS under its final rules for derivatives clearing organizations.[27] But for uncleared swaps and security-based swaps, both the CFTC and the SEC have proposed the longer 10-day liquidation time horizon.[28] The SEC has not provided any data or other quantitative justification for treating customers' cleared CDS trades as presenting more risk or less liquidity than Dealers' cleared CDS trades.

We submit that the liquidation time horizon, also known as the closeout period, for a single buy-side customer's cleared CDS positions should not be longer than that for the direct clearing member's entire portfolio of cleared CDS positions, of which the customer's cleared CDS positions represent a much smaller subset. In other words, we are aware of no basis for treating the portfolio of one class of market participant different from that of another class, for purposes of determining the amount of time needed for liquidation.

We also wish to point out the observable history regarding the adequacy of the 5-day liquidation horizon under ICC's portfolio margining methodology. Since the issuance of the ICC Margin Order in late 2011, the SEC and FINRA have had more than a year to observe the soundness of ICC's portfolio margining methodology from a risk management perspective with respect to ICC clearing members' proprietary positions in CDS index contracts and offsetting single-name CDS contracts. ICC intends to use the same methodology for its CDS customer portfolio margining program. The SEC has also reviewed and approved enhancements to ICC's methodology which have been in effect for over a year. These enhancements include: the use of a jump-to-default requirement; mean absolute deviation as a measure of spread volatility; implementing an auto-regressive process to obtain multi-horizon risk measures; enhanced spread response scenarios; liquidity margin requirements; and base concentration charges. These same factors would also apply to customers of BD/FCMs, because BD/FCMs are required to comply with ICC's approved model in basing their customer initial margin levels for customers' CDS positions. In addition, a 5-day horizon has been in place for Dealer-to-Dealer activity at ICC since 2009.

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[27] *See* CFTC Final Rule on "Derivatives Clearing Organization General Provisions and Core Principles", 76 Fed. Reg. 69334 (Nov. 8, 2011) at 69438, §39.13(g)(2)(ii), available at: http://www.gpo.gov/fdsys/pkg/FR-2011-11-08/pdf/2011-27536.pdf (for most cleared swaps, requiring a minimum five-day time horizon that the CFTC subsequently could choose to shorten).

[28] *See* SEC Proposed Rule, "Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security- Based Swap Participants and Capital Requirements for Broker-Dealers" (RIN 3235–AL12; File No. S7-08-12), 77 Fed. Reg. 70214 (Nov. 23, 2012), at 70338, Proposed Margin Rule 18a-1(d)(9)(ii)(A); *see also* CFTC Proposed Rule, "Margin Requirements for Uncleared Swaps and Capital Requirements for Swap Dealers and Major Swap Participants" (RIN 3038–AC97 and RIF 3038-AD54), 76 Fed. Reg. 23732 (Apr. 28, 2011), at 23746, Proposed Margin Rule 23.155(b)(2)(vi).

Further, we note that the 5-day liquidation horizon has been analyzed as being fully sufficient even in view of observed market behavior during the default of Lehman, as an example of a period of extreme market stress. As Lehman defaulted over the second weekend of September 2008, significant spread widening was observed between Monday, September 15 and Wednesday, September 17. On Thursday, September 18, the credit spreads returned to their pre-default levels. As Lehman was a large seller of credit protection, the CDS market needed approximately 3 days to absorb the created risk dislocation, and to provide position replacement for market participants. The spread-level fluctuations, accounted for in the spread dynamics requirements, were the main manifestation of the market reaction to the Lehman default. There were no other idiosyncratic defaults during this period. The ICC CDS portfolio margining risk methodology, however, conservatively provisions for multiple defaults during the selected 5-day liquidation horizon. Moreover, during that period, dealer counterparties provided continuous two-sided quotes to the same extent as previously. In short, there was ample liquidity in the market, albeit at the wider spreads that are accounted for by the ICC margin model.

For these reasons, and in light of the further safeguards administered by BD/FCMs against customer default risk that are described in Section III.B. below, we strongly believe that there is no basis for systematic disparate treatment between buy-side and sell-side market participants at the ICC minimum margin level. This Clearinghouse margin baseline is the result of modeled assessments of product risk for portfolio-specific margin calculations. BD/FCMs have the discretion to determine, on a customer-by-customer basis, any appropriate premiums or multipliers that should be applied over and above the Clearinghouse baseline for less creditworthy customers.

B. <u>There are Ample BD/FCM Protections in the Clearing Environment</u>.

For cleared CDS, customer accounts are individually margined on a gross basis, versus on a net omnibus basis. This means that, just like Dealers subject to ICC's margin levels at only 100%, BD/FCMs assess margin for each customer with each margin call. In prior omnibus margining regimes, certain Clearinghouses collected customer margin from FCMs on a net basis across customers. This net margining resulted in the aggregate customer account at any given point being potentially under-margined on an absolute basis. This is not the case for cleared CDS. Each customer is margined in isolation (*i.e.*, on a gross basis), as if it were a direct cleared account, just like ICC's direct participants.

As a result of gross margining, the BD/FCM is exposed, in the event of a customer default, only to any intraday market moves (*i.e.*, shortfall in variation margin or initial margin related to new, risk-increasing, positions that are not offset by new, risk-reducing, positions) for that individual defaulting customer. The BD/FCM has multiple layers of safeguards against any such shortfall, based on its ongoing oversight of each customer's trading patterns and credit standing. These safeguards are numerous and include:

1. Initial margin collected from the customer

2. Intraday trading limits, expressly conveyed to the customer and enforced through immediate rejection, in real-time under current straight-through-processing as currently in effect under CFTC rules, of trades that exceed limits
3. Discretion to adjust trading limits, or to decline to accept new trades
4. Continuous credit supervision of the customer
5. Concentration limits, with initial margin increasing as concentration increases
6. Cross-collateral rights with the customer on other assets of the customer held at the BD/FCM or the BD/FCM's affiliates, if agreed by the parties
7. Regulatory capital reserves required held proportional to cleared customer exposure

We understand that all BD/FCMs that are seeking to clear single-name CDS for customers have represented to the SEC and FINRA that they have in place programs to assess the individual counterparty risk of their customers, require additional margin over and above the Clearinghouse minimum, as appropriate, and otherwise apply the safeguards noted above. Customer clearing documentation with BD/FCMs contains the contractual authority of the BD/FCM to call for additional margin to cover mark-to-market exposure. In addition, the BD/FCM has both SEC and CFTC capital held in support of customer cleared exposure. Further, the Clearinghouse that supports customer clearing determines margin requirements under its methodology for each customer account, sets maximum concentration limits for customer positions (such concentration limits are lower than concentration limits for proprietary accounts) and also monitors its risk exposure to each BD/FCM.

We also note that the CFTC approved the 110% margin multiplier proposed by Clearinghouses for speculative positions. In doing so, the CFTC maintained the principle of margining trades on the basis of their character and not on the class of market participants.[29] The SEC may wish to consider using the CFTC's margin-setting principles in approving customer margin levels for cleared CDS positions to achieve closer alignment with the CFTC's margin approach and additional protection. The CFTC's action here proportionately applies additional

[29] In this regard, we note that portfolio margining regimes that involve a different type of product traded by participants in a different market, such as the Options Clearing Corporation's ("**OCC**") portfolio margining regime for equity options, are not good precedent for setting standards that apply to cleared CDS portfolio margining programs. The OCC's options portfolio margining regime is available to any broker or dealer registered pursuant to Section 15 of the Exchange Act, and any person or entity approved for uncovered options. To be eligible for OCC's portfolio margining program, customers (other than broker-dealers and certain non-broker-dealer affiliates of the carrying broker-dealer) must meet merely the basic standards for having an options account at OCC. ICC's cleared CDS portfolio margining program is also available to both broker-dealers and customers, but provided that customers qualify as "eligible contract participants" as defined in Section 1a(18) of the CEA. Equity options and cleared CDS products also present very different product risk profiles. With options, it is possible to create positions that have theoretically infinite payoff profiles (*e.g.*, short straddles). While CDS products do present jump-to-default risk, that risk has been assessed and modeled based on robust testing of default scenarios. In contrast to the payoff profile of certain equity options, with CDS, the protection seller's contingent payment amount on a reference entity's default is bounded under the CDS contract.

margin to individual counterparty credit risk by account type, and does not apply an indiscriminate margin multiple across all buy-side firms.

IV. Requested Remedial Actions

In order to promote efficiency, competition, capital formation and the protection of investors[30], we respectfully suggest that the SEC re-consider the economic effects and financial burden of the Temporary Approval Condition on CDS investors. Customers are already significantly affected by the Letters; customers are effectively barred from clearing, and are compelled to split their portfolios and bear additional costs and counterparty risks. We understand there to be no reason for CDS clearing to be less capital-efficient or more burdensome for customers of clearing members than for clearing members.

For the reasons set forth above, we respectfully urge the SEC and the CFTC to work together to coordinate an integrated regulatory framework for portfolio margining. Toward this end, we specifically request that the SEC:

1. Issue final approval of the margin methodologies of the seven BD/FCMs that have applied for evaluation by SEC Staff and FINRA as expeditiously as possible and in a coordinated, not piecemeal, manner, and in any event, as soon as possible in advance of the CFTC's June 10, 2013 clearing compliance deadline for certain CDS indices for the second category of market participants. In doing so, we respectfully urge the SEC to approve a customer margin level that is based on the levels approved by the SEC and the CFTC in late 2011 for BD/FCMs.

2. In the interim, amend the Letters to permit customer margin levels consistent with those approved by the SEC and the CFTC in late 2011 for BD/FCMs.

We believe these remedial actions are warranted by the Dodd-Frank Act, and the SEC's own Order, to achieve more sensible and comparable portfolio margin requirements between the SEC and CFTC. We believe such actions would be fully consistent with the mandate of the Dodd-Frank Act and would further investor protection.

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[30] *See* Exchange Act Sections 3(f) and 36; *see also supra* note 26.

Please do not hesitate to contact Laura Harper, Assistant General Counsel of MFA, or the undersigned with any questions that your agencies or Staffs might have regarding this letter.

Respectfully submitted,

/s/ Stuart J. Kaswell

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/s/ Carl B. Wilkerson

Carl B. Wilkerson
Vice President & Chief Counsel, Securities & Litigation, American Council of Life Insurers

/s/ Jiří Krol

Jiří Krol
Director of Government and Regulatory Affairs
Alternative Investment Management Association

cc: The Hon. Elisse B. Walter, SEC Commissioner
The Hon. Luis A. Aguilar, SEC Commissioner
The Hon. Troy A. Paredes, SEC Commissioner
The Hon. Daniel M. Gallagher, SEC Commissioner

John Ramsay, Acting Director, Division of Trading and Markets, SEC
Jim Burns, Deputy Director, Division of Trading and Markets, SEC
Peter J. Curley, Associate Director for Clearance and Settlement, SEC
Michael Macchiarolli, Associate Director, Office of Broker-Dealer Finances, SEC

The Hon. Jill E. Sommers, CFTC Commissioner
The Hon. Bart Chilton, CFTC Commissioner
The Hon. Scott D. O'Malia, CFTC Commissioner
The Hon. Mark P. Wetjen, CFTC Commissioner

Ananda Radhakrishnan, Director, CFTC Division of Clearing and Risk

Annex

Managed Funds Association (MFA) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and all other regions where MFA members are market participants.

The American Council of Life Insurers (ACLI) is a Washington, D.C.-based trade association with more than 300 legal reserve life insurer and fraternal benefit society member companies operating in the United States. ACLI advocates in federal, state and international forums. Its members represent more than 90 percent of the assets and premiums of the U. S. life insurance and annuity industry. In addition to life insurance, annuities and other workplace and individual retirement plans, ACLI members offer long-term care and disability income insurance, and reinsurance.

The Alternative Investment Management Association (AIMA) is the trade body for the hedge fund industry globally; AIMA's membership represents all constituencies within the sector – including hedge fund managers, fund of hedge fund managers, prime brokers, fund administrators, accountants and lawyers. AIMA's membership comprises over 1,300 corporate bodies in over 40 countries.