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INVESTMENT COMPANY INSTITUTE

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December 7, 2020

Ms. Vanessa A. Countryman, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: *Proposed Order Granting Conditional Exemptions Under the Securities Exchange Act of 1934 in Connection With the Portfolio Margining of Swaps and Security-Based Swaps That Are Credit Default Swaps (File No. S7-13-12)*

Dear Ms. Countryman:

The Investment Company Institute[1] is pleased to have the opportunity to comment on the proposed exemptive order ("Proposed Order") issued by the Securities and Exchange Commission (SEC or "Commission") that would provide relief from certain provisions of the Securities Exchange Act of 1934 ("1934 Act") in connection with a program to portfolio margin cleared swaps and security-based swaps (SBSs) that are credit default swaps (CDSs).[2] ICI supports the Proposed Order, which would supersede and replace the Commission's December 2012 exemptive order ("2012 Order").[3] More

[1] The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$25.8 trillion in the United States, serving more than 100 million US shareholders, and US$8.3 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

[2] Proposed Order Granting Conditional Exemptions Under the Securities Exchange Act of 1934 in Connection With the Portfolio Margining of Swaps and Security-Based Swaps That Are Credit Default Swaps, 85 Fed. Reg. 70657 (Nov. 5, 2020), *available at* https://www.govinfo.gov/content/pkg/FR-2020-11-05/pdf/2020-24612.pdf.

[3] Order Granting Conditional Exemptions under the Securities Exchange Act of 1934 in Connection with Portfolio Margining of Swaps and Security-based Swaps, Exchange Act Release No. 68433 (Dec. 12, 2012), 77 Fed. Reg. 75211 (Dec. 19, 2012), *available at* https://www.govinfo.gov/content/pkg/FR-2012-12-19/pdf/2012-30553.pdf. The Commodity Futures Trading Commission (CFTC) issued individual orders to ICE Clear Credit and ICE Clear Europe granting conditional relief from CFTC requirements in connection with the portfolio margining program. *See* CFTC, Order, Treatment of Funds Held in Connection with Clearing by ICE Clear Credit of Credit Default Swaps (Jan. 13, 2013), *available at*
https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/icecreditclearorder011413.pdf;

broadly, ICI strongly supports efforts by the SEC and the CFTC to take a harmonized approach to portfolio margining that reflects the unique regulatory constraints to which our members—regulated investment companies—are subject.

I. Benefits of Portfolio Margining

ICI's members—including US registered investment companies ("registered funds"), such as mutual funds, ETFs, closed-end funds, and other funds that are regulated under the Investment Company Act of 1940 ("1940 Act"), and non-US regulated funds[4] (together with registered funds, "regulated funds")—use derivatives in a variety of ways. Derivatives are a particularly useful portfolio management tool in that they offer regulated funds considerable flexibility in structuring their portfolios.[5] For example, a regulated fund may use derivatives to hedge its positions or certain risks they present, equitize cash that it cannot immediately invest in direct equity holdings, manage its cash positions, and adjust portfolio duration, all in accordance with the investment objectives stated in the fund's prospectus.

ICI strongly supports the ability of regulated funds to commingle in one account customer funds for swaps and SBSs to permit portfolio margining in such an account. Portfolio margining allows netting of swaps and SBSs that are correlated on a risk management and economic basis in calculating margin requirements, which permits regulated funds to more efficiently allocate their margin. As the SEC and CFTC recently acknowledged, portfolio margining aligns margining and other costs more closely with the actual risks in a portfolio.[6] Maintaining two separate accounts for cleared swaps and cleared SBSs (or, respectively, uncleared swaps and non-cleared SBSs) is more expensive because funds must post full margin for both accounts, despite any offsetting positions in the accounts. Holding margin in separate

CFTC, Order, Treatment of Funds Held in Connection with Clearing by ICE Clear Europe of Credit Default Swaps (April 9, 2013), *available at* https://www.cftc.gov/sites/default/files/idc/groups/public/@requestsandactions/documents/ifdocs/icecleareurope4dfcds040913.pdf.

[4] "Non-US regulated funds" refer to funds that are organized or formed outside the United States and are substantively regulated to make them eligible for sale to retail investors, such as funds domiciled in the European Union and qualified under the UCITS Directive (EU Directive 2009/65/EC, as amended), Canadian investment funds subject to National Instrument 81-102, and investment funds subject to the Hong Kong Code on Unit Trusts and Mutual Funds.

[5] Foreign regulation also contemplates use of derivatives by regulated funds. Article 51(2) of the UCITS Directive, for example, gives Member States the power to permit UCITS to employ techniques and instruments relating to transferable securities and money market instruments, including derivatives, for the purpose of "efficient portfolio management," subject to investment limits and diversification requirements set out in the UCITS Directive.

[6] *Portfolio Margining of Uncleared Swaps and Non-Cleared Security-Based Swaps*, 85 Fed. Reg. 70536, 70537 (Nov. 5, 2020), *available at* https://www.govinfo.gov/content/pkg/FR-2020-11-05/pdf/2020-23928.pdf ("Joint Request for Comment"). For ICI's comment letter on the Joint Request for Comment, please see Letter to Mr. Christopher Kirkpatrick, Secretary, Commodity Futures Trading Commission, and Ms. Vanessa A. Countryman, Secretary, Securities and Exchange Commission, from Sarah A. Bessin, Associate General Counsel, Investment Company Institute, dated Dec. 7, 2020.

accounts increases operational risk, because it requires the posting of multiple separate margin payments and separate withdrawals of excess collateral from the accounts. It also may reduce the ability of counterparties to net positions upon default or bankruptcy. The ability to engage in portfolio margining benefits regulated funds and their shareholders because it allows funds to efficiently meet their margin requirements, while allocating assets not required to satisfy margin requirements to more productive use in effectuating the funds' investment strategy.

II. Background

The Proposed Order would supersede and replace the 2012 Order, which granted conditional relief from compliance with certain provisions of the 1934 Act to (i) SEC-registered clearing agencies that are also registered with the CFTC as derivatives clearing organizations ("clearing agency/DCOs") and (ii) SEC-registered broker-dealers that are also registered with the CFTC as futures commission merchants (BD/FCMs). The 2012 Order provided this relief in connection with portfolio margining of cleared CDSs (including both swaps and SBSs) in a segregated account established and maintained in accordance with Section 4d(f) of the Commodity Exchange Act. The Proposed Order would eliminate or modify some of the conditions in the 2012 Order.

ICI supported the 2012 Order. We had previously submitted a comment letter requesting clarity and consistency in the SEC's and CFTC's approach to portfolio margining in a commingled account of cleared swaps and SBSs that are CDSs.[7] Since the 2012 Order was issued, ICI's members have participated in a variety of portfolio margining programs that rely on the 2012 Order. Members report that these programs are beneficial to regulated funds and their shareholders because the programs allow funds to carry single name CDS positions alongside with CDS index swaps for hedging, offset, or arbitrage purposes. In addition, the programs allow funds to carry margin covering multiple positions in a single account, have transparency into the entire margin pool, apply consistent margining and administration requirements, and review positions on a single account statement. Centralization in this manner facilitates risk management by fund counterparties and reduces operational risk.

II. Conditions of the Proposed Order

We generally support the SEC's modifications in the Proposed Order of the conditions in the 2012 Order. We have comments on two of the proposed modifications, as detailed below.

First, the Proposed Order would eliminate conditions in the 2012 Order that contemplated potentially expanding the CDS portfolio margining program to securities accounts. These conditions, which were tied to the compliance date of the SEC's final rules on margin for non-cleared SBSs, would have

[7] *See* Letter to Mr. David A. Stawick, Secretary, Commodity Futures Trading Commission, and Ms. Elizabeth Murphy, Secretary, Securities and Exchange Commission, from Dorothy Donohue, Deputy General Counsel, ICI, dated April 9, 2012, *available at* https://www.ici.org/pdf/26027.pdf.

provided customers with the option to portfolio margin cleared CDSs in an SBS account subject to SEC regulation.

Regulated funds and their advisers, however, are subject to unique regulatory requirements regarding the protection of fund assets. These requirements limit the ability of regulated funds to engage in portfolio margining arrangements in a securities account or an SBS account. For example, as fiduciaries to their clients, advisers to regulated funds require strong protections for fund collateral when funds trade in the derivatives markets and generally require counterparties to post collateral to the regulated funds in order to protect shareholders against counterparty risk.[8] Registered funds must ensure that their collateral arrangements satisfy the custody restrictions of the 1940 Act, which require that funds maintain their assets on a segregated basis with a third-party custodian, typically a bank.[9] Because of the 1940 Act's custody restrictions, registered funds may not permit their collateral to be rehypothecated.[10] UCITS funds are also subject to regulatory restrictions regarding posting of collateral and maintenance of assets with a designated custodian.[11] Our members therefore would not object to elimination of these conditions, as regulated funds typically do not engage in portfolio margining in a securities account or an SBS account.

Second, the Proposed Order would modify the conditions in the 2012 Order regarding the obligation of a BD/FCM to enter into a nonconforming subordination agreement. The modified conditions

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[8] Margin requirements for swaps, both in the United States and abroad, require dealers to post both variation margin and, subject to an ongoing transition period, initial margin, to fund counterparties. The US prudential regulators similarly require SBSDs to post as well as to collect both variation and initial margin against SBSs. The SEC's margin rules for SBSs do not require SBSDs (other than bank SBSDs, which are not subject to the rules) to post margin to counterparties. Although we contemplate that regulated funds and their investment advisers may seek contractually to require SBSDs to post variation and initial margin to the funds, it is not certain that such SBSD counterparties will do so.

[9] Under the 1940 Act, registered funds are required to custody their assets in accordance with Section 17 of the 1940 Act. The SEC has adopted separate custody rules governing different types of assets. Although Rule 17f-1 under the 1940 Act permits registered funds to use a BD custodian, the rule imposes conditions that are difficult in practice to satisfy. Non-US regulated funds, such as UCITS, are similarly subject to requirements regarding the safekeeping of their assets. *See* EU Directive 2009/65/EC, as amended.

[10] Rule 17f-1, for example, provides that a BD custodian must physically segregate fund assets from other assets held by the BD and mark such assets to identify them as the fund's property. The rule prohibits the BD from having any power to assign, hypothecate, pledge, or otherwise dispose of the fund's assets, except at the fund's direction and for its account. Furthermore, the fund's assets cannot be subject to a lien or charge of any kind in favor of the BD. Rule 17f-6 under the 1940 Act permits registered funds to maintain initial margin with an FCM in connection with the fund's cleared futures and options transactions (and, pursuant to no-action relief, swap transactions), subject to strict conditions intended to safeguard fund assets, including a requirement that the FCM comply with the CFTC's segregation rules. While Rule 17f-6 permits the FCM, under certain circumstances, to place the fund's assets with another FCM, clearing organization, or bank, the FCM may do so only in compliance with CFTC requirements, including obtaining an acknowledgement that the assets are held on behalf of the FCM's customers in accordance with the Commodity Exchange Act.

[11] Article 22 of the UCITS Directive states that assets held in custody by the depositary shall not be reused for its own account by the depositary or by any third party to whom custody has been delegated, subject to an exception for fully collateralized, client directed, securities lending.

would clarify that the cleared swap customer must affirm that claims to "customer property," as defined in the Securities Investor Protection Act of 1970 (SIPA) or the stockbroker liquidation provisions of the US Bankruptcy Code,[12] against the BD/FCM will be subordinated only to the claims of securities customers and SBS customers, not to the claims of general creditors. ICI supports this clarification. This approach is appropriate because the cleared swap customer may have claims against the BD/FCM, *e.g.,* for uncollected settlement payments or other amounts owed to it over and above the amounts received by it through application of the commodity broker liquidation regime, consistent with application of the "legally segregated operationally comingled" (LSOC) regime that the CFTC adopted in Part 22 for cleared swaps and Part 190. There is no policy basis to disadvantage cleared swap customers as compared to other general creditors of a BD/FCM and, therefore, their claims to "customer property" should not be subordinated to claims of general creditors, but only to the claims of securities customers and SBS customers.

We request that the SEC confirm in any final order that existing cleared swap customers would not need to amend their agreements to provide revised affirmations reflecting the new language contemplated by the Proposed Order. Instead, the SEC should clarify in any final order that affirmations provided pursuant to the 2012 Order were intended to, and should be read to, provide for subordination of claims solely to securities customers and SBS customers and not to general creditors. The revised language in the proposed modified conditions should be required to be included in affirmations only on a going-forward basis for new cleared swap customers. We believe this approach is consistent with the SEC's intention to "better clarify" the language required to be used in affirmations under the 2012 Order and appreciate the SEC's clarification, which would facilitate more efficient implementation.[13]

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[12] 11 U.S.C. §741.

[13] *See* Proposed Order at 70661.

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We appreciate the opportunity to provide feedback on the Proposed Order. If you have any questions on our comment letter, please feel free to contact me at [redacted].

Sincerely,

/s/ Sarah A. Bessin

Sarah A. Bessin
Associate General Counsel

cc: The Honorable Jay Clayton, Chairman
The Honorable Hester M. Peirce
The Honorable Elad L. Roisman
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