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

November 26, 2012

Via Electronic Submission: regs.comments@occ.treas.gov; regs.comments@federalreserve.gov; Comments@FDIC.gov; reg-comm@fca.gov; and RegComments@fhfa.gov

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2–3
Washington, DC 20219

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Mr. Alfred M. Pollard
General Counsel
Attention: Comments
Federal Housing Finance Agency
1700 G Street, NW
Fourth Floor
Washington, DC 20552

Mr. Gary K. Van Meter
Acting Director, Office of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102–5090

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

Ladies and Gentlemen:

Managed Funds Association ("MFA")[1] respectfully submits this letter regarding the proposing release entitled "Margin and Capital Requirements for Covered

[1] 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.

Swap Entities" (the "***Proposing Release***") issued by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency (collectively, the "***Prudential Regulators***"), whereby the Prudential Regulators have proposed margin requirements for certain swap dealers ("***SDs***"), major swap participants ("***MSPs***"), security-based swaps dealers ("***SBSDs***") and major security-based swap participants ("***MSBSPs***", and together with SDs, MSPs and SBSDs, "***covered swap entities***") pursuant to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("***Dodd-Frank***"). The purpose of this letter is to seek clarification and confirmation that the final version of the margin requirements proposed in the Proposing Release (the "***Proposed Rules***") will preserve the benefits of portfolio margining arrangements that provide for the cross-margining of cleared futures, options and swaps and security-based swaps ("***Cleared Products***") and uncleared swaps and security-based swaps ("***Uncleared Swaps***").[2] MFA has previously commented on the Proposed Rules as well as the proposed rules issued by the Commodity Futures Trading Commission (the "***CFTC***") on this same subject.[3] MFA is also concurrently filing a supplemental comment letter on the Proposed Rules.[4]

I. Executive Summary

Portfolio margining is an established, widely-used and highly beneficial practice in the derivatives marketplace. Portfolio margining allows a futures commission merchant (an "***FCM***") with respect to cleared swaps, options and futures, or a broker-dealer with respect to cleared security-based swaps, and an affiliated covered swap entity to calculate jointly the margin required to collateralize the risk exposure to a single customer with respect to its Cleared Products and Uncleared Swaps. Utilizing cross-margining, the customer is not required to post redundant initial margin to secure its Cleared Products and Uncleared Swaps, but each of the FCM or broker-dealer and

[2] MFA believes that broad portfolio margining across all product types would further benefit the market while maintaining appropriate collateral levels.

[3] *See* MFA's comments on the Prudential Regulators' Notice of Proposed Rulemaking on "Margin and Capital Requirements for Covered Swap Entities", 76 Fed. 27564 (May 11, 2011) filed with the Prudential Regulators on July 11, 2011, and on the CFTC's Notice of Proposed Rulemakings on "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants", 76 Fed. Reg. 23732 (Apr. 28, 2011) and on "Capital Requirements of Swap Dealers and Major Swap Participants", 76 Fed. Reg. 27802 (May 12, 2011) filed with the CFTC on July 11, 2011.

We note that, on October 17, 2012, the Securities and Exchange Commission (the "***SEC***") proposed rules for the margin requirements for uncleared security-based swaps held at SBSDs and MSBSPs. *See* SEC, "Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers", 77 Fed. Reg. 70213 (Nov. 23, 2012) (the "***SEC Proposed Rules***"). MFA has not, as of yet, commented on these proposed rules.

[4] *See* MFA's supplemental comment letter concerning the Proposed Rules, "Reopening of Comment Period for Notice of Proposed Rulemaking on Margin and Capital Requirements for Covered Swap Entities RIN 1557-AD43; RIN 7100-AD74; RIN 3064-AD79; RIN 3052-AC69; and RIN 2590-AA45", dated November 26, 2012.

covered swap entity remain adequately margined and secured with respect to such positions and each entity receives full variation margin payments with respect to those positions. This letter addresses the need to continue such current portfolio margining practices between Cleared Products and Uncleared Swaps. We note that, in its recently proposed rules for the margin requirements for uncleared security-based swaps held by SBSDs and MSBSPs, the SEC generally approved of portfolio margining between different product types.[5] These practices are consistent with newly adopted regulations for cleared swaps,[6] do not impair or interfere with the effect or purpose of the Dodd-Frank regulatory regime, and will support the transition to clearing.

Portfolio margining between Cleared Products and Uncleared Swaps has been permitted by the CFTC and the SEC for a number of years without adverse effects on the market or its participants, despite the recent market crisis.[7] These practices continue to be broadly employed by market participants today. Negatively affecting these practices would require significant changes to market structures and a substantial aggregate increase in margin that clients and banks would be required to post to secure these transactions. By contrast, continued use of portfolio margining would facilitate a smooth transition to the mandatory clearing regime for swaps while motivating market participants both to clear where possible and to maintain balanced portfolios that include both Cleared Products and Uncleared Swaps. The absence of portfolio margining would, counter to the objectives of Dodd-Frank, lead participants to prefer Uncleared Swaps as a means to realize the benefits of portfolio risk reduction. Because portfolio margining enables market participants to use capital more efficiently, its continued availability would also help counteract excessive demand for the more limited range of assets that will be eligible for use as collateral, thereby reducing market distortions with respect to a more limited supply of collateral. For these reasons, we respectfully request that the Prudential Regulators confirm that the final version of the Proposed Rules will take into

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5 *See* SEC Proposed Rules, 77 Fed. Reg. at 70259 ("The goal of modeling proposed new Rule 18a-3 on the broker-dealer margin rules is to promote consistency with existing rules and to facilitate the portfolio margining of security-based swaps with other types of securities.").

6 Although the SEC has proposed rules relating to the segregation of customer margin posted to SBSDs and MSBSPs to secure and guarantee security-based swaps, the SEC has not, as of the date of this letter, proposed rules relating to the segregation of customer margin held by clearing agencies and broker-dealers to secure or to guarantee cleared security-based swaps. As a result, we cannot address the treatment of cleared security-based swaps in the same level of detail in which we address other swaps in this letter. However, we anticipate that the SEC's approach will be broadly similar to that of the CFTC, at least with respect to the issues relevant to the requests made in this letter.

7 Portfolio margining has been broadly accepted under various regulatory regimes. FINRA permits portfolio margining for certain products pursuant to NASD Rule 2520(g) and NYSE Rule 431(g). The Options Clearing Corporation, Chicago Mercantile Exchange, Inc., New York Portfolio Clearing, LLC and LCH.Clearnet, Ltd. also permit portfolio margining between certain products.

account current portfolio margining practices with respect to Cleared Products and Uncleared Swaps in such a way as to preserve the benefits of these arrangements.[8]

II. Background

Portfolio margining is grounded in the application of a risk-based margin methodology that computes margin requirements based on the overall risk of a portfolio. To the extent that market risks of positions are correlated so as to hedge one another, portfolio margining frees up excess margin while continuing to account adequately for the market risks relating to these positions. As a result, current portfolio margining practices provide liquidity necessary for sound, properly functioning capital markets.

Market participants are currently able to use portfolio margining with respect to cleared futures, options and over-the-counter ("***OTC***") derivatives positions cleared through FCMs and uncleared OTC derivatives positions entered into with FCMs' affiliated, but separate, dealers through the use of master netting agreements. Under such arrangements, two affiliated entities that serve an individual customer as both a swap counterparty through the dealer entity and clearing agent through an affiliated FCM assess their total exposure to the customer and assess the value of the liens on affiliate-held collateral (described below) and on the potential for excess collateral and liquidation value to be held within the affiliated group. The dealer and the FCM then determine the necessary initial margin or upfront collateral required across both entities for protection in the event of default by the relevant customer.[9] Pursuant to a master netting agreement, the customer grants to the dealer a second priority lien on the customer's cleared positions account (*i.e.*, on the liquidation rights to the positions and on the collateral posted to secure its cleared positions). The customer reciprocally grants to the FCM a second priority lien on its transactions with, and any initial margin or upfront collateral posted to, the dealer. In addition, the dealer and the FCM have cross-termination rights pursuant to the master netting agreement in the event that the customer defaults on its obligations to either the FCM or the dealer. If the customer defaults with respect to positions at the FCM and the FCM liquidates the customer's cleared positions account, the dealer will be able to terminate the uncleared positions which it holds. Conversely, if the customer defaults and the dealer terminates the uncleared positions, the FCM will be entitled to liquidate the customer's cleared positions. After taking into account any

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[8] MFA recognizes that portfolio margining arrangements may involve covered swap entities that are subject to several different regulatory regimes, including bank regulatory regimes (which would include regulation pursuant to Sections 23A and 23B of the Federal Reserve Act). As a representative of customers of FCMs and dealer institutions, MFA members are not among those entities subject to these various regulatory regimes, and therefore this letter is not intended to address such subjects. Nevertheless, MFA believes that portfolio margining has been found beneficial by all parties involved, and would urge that its use be continued as a method of satisfying collateral requirements.

[9] In no event is the amount of initial margin or upfront collateral less than the minimum amount required to cover the customer's cleared portfolio held by the FCM, as calculated by the relevant derivatives clearing organization ("***DCO***") on a standalone basis (*i.e.*, without reference to offsetting positions held by the affiliated dealer entity).

proceeds from liquidated or terminated positions, the FCM will use the customer's initial margin or upfront collateral posted to the FCM to satisfy any remaining customer obligations to the FCM, while the dealer will concurrently use the customer's initial margin or upfront collateral posted to the dealer to satisfy any remaining customer obligations to the dealer. In the event that either the FCM or dealer have a shortfall, the dealer may apply excess initial margin or upfront collateral held at the FCM, or the FCM may apply excess initial margin or upfront collateral held at the dealer, after the customer's obligations to each are met individually.

In light of the security arrangements described above, the FCM and dealer, as a group, are able to offer the customer margin relief in respect of the amount of margin posted with the dealer, to the extent that the sum of the margin calculated on a standalone basis for the dealer and FCM would exceed the margin required to protect the FCM and the dealer taken together. Accordingly, in the event of a customer default, both the FCM and dealer have concluded that they are adequately collateralized, but at the same time the customer is not required to post initial margin or upfront collateral to each entity in excess of the amount required to collateralize adequately both the FCM and dealer taken together subject to any cleared position minimum margin requirements required at any entity.[10] As discussed above, this reduction in collected margin is possible because, in the event of a customer default, subject to the FCM's priority in the cleared margin and subject to the dealer's priority in margin posted to it, each of the FCM and dealer may access excess customer initial margin or upfront collateral held by the other prior to its return to the customer's estate.

Many dealers and FCMs currently offer portfolio margining arrangements to their buy-side counterparties whose portfolios include certain Cleared Products and Uncleared Swaps, conferring margin optimization benefits to those customers while maintaining appropriate standards of collateralization in the event of customer default. The migration of OTC derivatives to clearing pursuant to Dodd-Frank will divide portfolios that today benefit from portfolio margining into separate cleared and uncleared segments. If these segments were then subject to separate, independent margining regimes, this segmentation would reverse the benefits of current portfolio margining practices. If Cleared Products were independently margined based on the margining rules of DCOs while Uncleared Swaps were subject to separate margin requirements, without either the dealer or the FCM being able to take into account the potential liquidation value or the potential for excess margin in the transactions that the other holds with the customer, the total margin would exceed suitable portfolio margin levels. The Prudential Regulators have acknowledged the viability of portfolio margining models[11] in the Proposed Rules. We ask the Prudential Regulators expressly to confirm allowance for the continued practice of portfolio margining between Cleared Products and

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[10] *See* Section V.B for a further discussion of how the security interest on the customer account at the FCM is consistent with the CFTC Regulations.

[11] That is, cross-product margining between uncleared swaps and security-based swaps entered into with a covered swap entity. *See* Proposed Rule §__.8(b).

Uncleared Swaps when adopting the final version of the Proposed Rules so as to provide certainty to the market that it will be able to continue to realize the risk-reducing benefits of portfolio margining under the new regulatory regime.

III. Portfolio Margining Across Cleared and Uncleared Swaps Is Beneficial to the Market as a Whole and Promotes Clearing

We respectfully submit that current portfolio margining practices could effectively be applied in the post-Dodd-Frank swaps regulatory regime through continued use of master netting agreements or similar arrangements that implement portfolio margining across Cleared Products and Uncleared Swaps. As clarified above, portfolio margining enables market participants to avoid posting redundant initial margin or upfront collateral while ensuring that the FCM or broker-dealer and covered swap entity both have access to sufficient collateral in the event of a customer default and still requiring full variation margin payments to be made to each entity. Therefore, portfolio margining eliminates excess initial margin or upfront collateral and avoids a reduction in market liquidity resulting from segregated Cleared Products and Uncleared Swaps regimes. Without portfolio margining, these increased costs of trading would be passed on to swaps end-users and thereby would reduce liquidity and competitiveness in the markets as well as raise the costs of hedging. Furthermore, portfolio margining allows capital to be invested more effectively (*i.e.*, not tied up as redundant initial margin securing swaps positions) without compromising the safety of individual covered swap entities or the system as a whole.

The market benefits of portfolio margining between Cleared Products and Uncleared Swaps would ease the market transition to the mandatory clearing requirements of Dodd-Frank. Initially, during the transition to mandatory clearing, only certain swaps will be cleared. While the cohort of cleared swaps is expected to expand over time, market participants will necessarily continue to hold positions in Uncleared Swaps (with many of these positions held at covered swap entities affiliated with FCMs or broker-dealers that hold their Cleared Products accounts). With respect to those remaining swaps that cannot be cleared, portfolio margining will encourage market participants to use Cleared Products to offset the risk of their remaining Uncleared Swaps positions. If not allowed to engage in portfolio margining between these positions, a market participant will be forced to post redundant initial margin or upfront collateral for its Cleared Products and its Uncleared Swaps, even when such transactions offset one another.

There are numerous examples of swaps contracts that market participants will not be required or able to clear. For example, single-name credit default swaps ("***CDS***") are regulated by the SEC and index CDS are regulated by the CFTC. It appears that the CFTC will require index CDS to be cleared before the SEC requires single-name CDS to be cleared. Moreover, an extensive range of sovereign CDS is not currently offered for clearing. Without portfolio margining, market participants who hold positions in cleared and uncleared CDS will be required to post redundant margin to secure their uncleared portfolios of CDS, especially as the full universe of CDS are not offered for clearing despite the fact that some of the Uncleared Swaps may otherwise offset some of

the cleared ones.[12] Similarly, there are many types of rates swaps that are currently used in portfolio margining, but that are not presently clearable and for which there is no certain timeline for these products to become eligible for clearing. These rates products include swaptions, caps, floors, cross-currency swaps and inflation swaps.

Also, consistent with a primary objective of Dodd-Frank, portfolio margining will encourage market participants to use Cleared Products. If a customer's market risk with respect to a particular Uncleared Swap position can be hedged (from the market participant's perspective) by either a Cleared Product or an Uncleared Swap, without the benefits of portfolio margining across Cleared Products and Uncleared Swaps, the market participant would need to enter into an Uncleared Swap to realize margin efficiencies. Even if Uncleared Swaps carry higher initial margin requirements, if a market participant has a large portfolio of Uncleared Swaps,[13] that market participant would be motivated to take advantage of portfolio margining across its Uncleared Swaps and, therefore, may enter into Uncleared Swaps to hedge this specific risk. If, by contrast, portfolio margining across Cleared Products and Uncleared Swaps were available, market participants would have an incentive[14] to use Cleared Products to hedge

[12] As of the date of this letter, only CDS on the components of the major indexes have been offered for clearing, whereas single-name CDS that are not components of the indexes are not yet eligible for clearing. ICE Clear Credit currently clears 59 index CDS, 152 corporate single-name CDS, and 4 sovereign single-name CDS and ICE Clear Europe currently clears 44 index CDS and 121 single-name CDS. The CME Group (through CME Clearport) does not offer clearing for as many swaps. Currently, the CME Group offers clearing for a few index credit swaps and is considering adding single-name CDS that are index constituents later this year. The CME Group may offer clearing for additional single-name CDS in the future. By contrast, DTCC tracks data on over a thousand reference entities, including 922 corporate single-name CDS. Therefore, during the initial transition to clearing, a large number of CDS will not be available for clearing at the time the mandatory clearing requirement becomes effective and may not be available to be cleared for some time after that date. Further, clearing with respect to other potentially highly correlated CDS asset classes such as CDS on asset-backed securities may not be in place for a long time to come.

[13] Market participants will be more likely to have a large portfolio of Uncleared Swaps during the transition to mandatory clearing.

[14] There are higher costs associated with Uncleared Swaps. First, the margin requirements for Uncleared Swaps are mandated to be as high or higher than the margin requirements for cleared swaps. Second, there are more risks associated with Uncleared Swaps than there are with cleared swaps and, therefore, a market participant will be subject to higher potential costs associated with Uncleared Swaps than the potential costs associated with Cleared Products. Therefore, to the extent that a market participant is able to rely on portfolio margining between Uncleared Swaps and Cleared Products, a market participant will already be incentivized to take advantage of the reduced costs associated with Cleared Products. However, without the benefits of portfolio margining between Cleared Products and Uncleared Swaps, so long as many products are not available for clearing and portfolios effectively must continue to include some Uncleared Swaps, the market participant will be more likely to take advantage of the portfolio margining benefits that would be available if the entire portfolio is limited to Uncleared Swaps, because the costs of having to post redundant collateral for Uncleared Swap positions and Cleared Product positions in the absence of portfolio margining would likely exceed the additional cost of dealing in Uncleared Swaps.

this risk and to promote ongoing expansion by central counterparties (including DCOs and clearing agencies) of the products available to be cleared.

As noted above, in the present marketplace, swap dealers provide portfolio margining to their customers utilizing Uncleared Swaps and cleared futures products. If similar portfolio margining is not available across Cleared Products and Uncleared Swaps, customers that currently rely on portfolio margining will face substantially higher initial margin requirements for an otherwise equivalent portfolio, without a risk-based justification. The unavailability of portfolio margining across these products would have the following adverse unintended consequences: (i) customers would be discouraged from transacting in Cleared Products on a voluntary basis; (ii) once clearing is mandatory, customers could find participating in the swaps market to be cost prohibitive; and (iii) returns that buy-side firms would otherwise be able to deliver to their investors would be diminished due to posting excessive initial margin or upfront collateral. These adverse consequences would jeopardize the transition to mandatory central clearing, impair liquidity, and constitute a material impediment to buy-side support for, and access to, clearing.

Pursuant to Section 39.13(g)(10) of the CFTC Regulations, a DCO "shall limit the assets it accepts as initial margin to those that have minimal credit, market, and liquidity risks" but shall not accept letters of credit as initial margin for swaps. Under Proposed Rules §__.6(a), a covered swap entity would be permitted to collect as initial margin for Uncleared Swaps only cash and certain debt obligations guaranteed by the Federal government or certain Federal agencies. Hence, both the Proposed Rules and the CFTC Regulations would place limits on what may constitute initial margin for swaps. Due to the limited universe of acceptable collateral, after the effective date for the mandatory clearing requirement, there is a material risk that there will be a scarcity of collateral acceptable for use as initial margin for both cleared and uncleared derivatives. The high demand from market participants for acceptable collateral will increase its price and the increased costs will be passed on to all market participants, including end-users. By contrast, portfolio margining mitigates the demand for acceptable collateral, thereby reducing its cost and decreasing the cost of swaps trading for all market participants.

Allowing portfolio margining practices between Cleared Products and Uncleared Swaps under the final version of the Proposed Rules also encourages customers to maintain balanced portfolios, because customers are rewarded for entering into transactions that mitigate the risks of other transactions in the customer's portfolio through a reduction in the aggregate amount of margin posted that results when the aggregate portfolio contains opposing positions. Encouraging each customer to maintain a balanced, or hedged, portfolio, taking into account both Cleared Products and Uncleared Swaps, reduces systemic risk.

IV. Portfolio Margining is Consistent with the Proposed Rules

Proposed Rules §__.8(b) would allow market participants to submit initial margin models that differ from the initial margin calculations set forth in Appendix A of the Proposed Rules so long as the submitted initial margin model conforms to the

requirements of Proposed Rules §__.8 and is approved by the relevant Prudential Regulator. Proposed Rules §__.8(b)(1) further provides that "[t]o the extent that a qualifying master netting agreement between a covered swap entity and its counterparty governs swaps or security-based swaps that were entered into before, on, and after the effective date, the covered swap entity may use its initial margin model to calculate the amount of initial margin to be collected pursuant to §__.3 … with respect to all swaps and/or security-based swaps transactions governed by such qualifying master netting agreement, regardless of whether they were entered into before, on, or after the effective date." These provisions demonstrate recognition by the Prudential Regulators of the utility of portfolio margining as among Uncleared Swaps held with the covered swap entity. Portfolio margining between Cleared Products and Uncleared Swaps should, by logical extension, be similarly consistent with these provisions, since portfolio margining would result in posted margin at least equal to the aggregate margin that would have been assessed if all Cleared Products and Uncleared Swaps had been subject to the same margining regime. Portfolio margining between Cleared Products and Uncleared Swaps thus provides market participants with an equitable means to calculate their initial margin requirements across Cleared Products and Uncleared Swaps. Permitting such portfolio margining in an initial margin model provides the flexibility that the nature of the swaps market necessitates. Without this flexibility, overall market liquidity will be reduced and transaction costs (which are borne by end-users) will be greater because of the higher initial margin costs imposed on market participants.

V. Legal Authority for Portfolio Margining

A. Portfolio Margining Is Consistent with the CFTC Regulations Relating to Cleared Futures and Options

Currently, market participants are able to enter into valid master netting agreements between accounts holding cleared futures and options and accounts holding Uncleared Swaps. They are therefore able to establish a valid lien on the account at the FCM holding the cleared futures and options. Dodd-Frank has not imposed any new requirements that affect the segregation of cleared futures and options accounts (*i.e.*, accounts subject to section 4d(a) of the Commodity Exchange Act). Therefore, the adoption of Dodd-Frank and the regulations thereunder has not affected the validity of a covered swap entity's second lien on an account containing cleared futures and options held at an affiliated FCM.

B. Portfolio Margining Is Consistent with the Requirements of Part 22 of the CFTC Regulations

We understand that a portfolio margining regime is fully consistent with the "legally segregated, operationally commingled" model set forth in the recently adopted Part 22 of the CFTC Regulations.[15] In entering into a valid master netting

[15] *See* "Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions," 77 Fed. Reg. 6336 (February 7, 2012).

agreement among the customer, the FCM and the affiliated covered swap entity, the customer would grant a valid lien on its account at the FCM and the covered swap entity must be able to establish a valid security interest therein as well. Although an FCM is prohibited from granting a lien on its Cleared Swaps Customer Account,[16] a Cleared Swaps Customer itself "may grant a lien on the Cleared Swaps Customer's individual cleared swaps account (an 'FCM customer account') that is held and maintained at the Cleared Swaps Customer's FCM" that is subordinate to the lien of the FCM.[17] Moreover, the staff of the CFTC's Division of Clearing and Risk has expressly acknowledged that Part 22 of the CFTC Regulations does not prohibit a customer from granting a lien on its FCM customer account.[18] The FCM customer account consists of the rights to proceeds from the cleared swaps positions that are cleared through the DCO on behalf of the customer, and as a result, would also include the customer's rights relating to those cleared swaps positions to receive the return of initial margin posted to the FCM in support of those positions. Further, the CFTC confirmed that CFTC Regulation §22.2(d) permits "other entities (including affiliates of FCMs) to take a security interest in a Cleared Swaps Customer's FCM customer account in support of financing the Cleared Swaps Customer's margin obligations."[19] It follows that a covered swap entity affiliate of the FCM could establish a valid security interest in the FCM customer account of a Cleared Swaps Customer to secure a Cleared Swaps Customer's obligations in respect of Uncleared Swaps with the affiliated covered swap entity on behalf of such Cleared Swaps Customer. We respectfully submit that a covered swap entity would be able to establish a valid security interest under Part 22 in an FCM customer account and could therefore enter into a valid master netting agreement with an affiliated FCM and a customer.

C. Portfolio Margining is Expected to be Consistent with the Requirements for Segregation of Accounts for Cleared Security-Based Swaps

Although the SEC has proposed rules relating to the segregation of customer margin posted to SBSDs and MSBSPs to secure and guarantee security-based swaps, the SEC has not, as of the date of this letter, proposed rules relating to the

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[16] "Cleared Swaps Customer Account" means "any account for the Cleared Swaps of Cleared Swaps Customers and associated Cleared Swaps Customer Collateral that: (1) a futures commission merchant maintains on behalf of Cleared Swaps Customers (including, in the case of a Collecting Futures Commission Merchant, the Cleared Swaps Customers of a Depositing Futures Commission Merchant) or (2) a derivatives clearing organization maintains for futures commission merchants on behalf of Cleared Swaps Customers thereof." CFTC Regulation §22.1.

[17] 77 Fed. Reg. 6352.

[18] *See* CFTC Staff Letter No. 12-28 (Oct. 17, 2012) ("Regulation 22.2(d) does not prohibit a Cleared Swaps Customer from granting security interests in, rights of setoff against, or other rights in its own Cleared Swaps Customer Collateral, regardless of whether those assets are held in the Cleared Swaps Customer's FCM customer account. Furthermore, nothing in the rule is intended to inhibit this right of the Cleared Swaps Customer.").

[19] 77 Fed. Reg. 6352.

segregation of customer margin held by clearing agencies and broker-dealers to secure or to guarantee cleared security-based swaps. We expect that the SEC will propose and adopt rules that are harmonized with the account segregation rules recently adopted by the CFTC. Because we believe the lien on the FCM customer account holding cleared swaps to be valid, we believe that a lien on the individual customer account at a broker-dealer holding cleared security-based swaps similarly should also be valid.

D. Portfolio Margining Does Not Raise Concerns Similar to Those in *In re Lehman*

In prior discussions of cross-margining arrangements with representatives of regulators, concerns have been raised that cross-margining arrangements may be rendered ineffective by the decisions in the *Lehman*[20] and *SemCrude*[21] cases relating to the enforceability of "triangular setoff". In those cases, the bankruptcy courts evaluated the enforceability of cross-affiliate setoff arrangements pursuant to separate agreements between one counterparty and two or more counterparties that are affiliates of each other. However, no lien was granted with respect to the obligations subject to set-off. Finding that such arrangements failed to satisfy the requirement of "mutuality" that is a condition to the exercise of an unsecured right of setoff under the Bankruptcy Code, the courts found these arrangements to be unenforceable against a bankrupt defaulting party.

Portfolio margining referred to herein differs fundamentally from the unsecured cross-affiliate set-off arrangements that were at issue in the *Lehman* and *SemCrude* cases. Unlike the arrangements in those cases, portfolio margining arrangements pursuant to master netting agreements include the grant of a perfected security interest in assets that the customer maintains, such as posted collateral, receivables and the liquidation value of its portfolio. In other words, there is a direct link between the dealer or FCM, the amounts owed to it, and the lien granted to it directly by the customer.

MFA recognizes that the security interest in an FCM customer account or an individual customer account at a broker-dealer, used to secure Uncleared Swaps at an affiliated covered swap entity, may become subject to the provisions of Chapter 7 of the Bankruptcy Code in the event of the bankruptcy of a broker-dealer (*i.e.*, a securities broker), an FCM (*i.e.*, a commodity broker), or the provisions of the Securities Investor Protection Act of 1970. However, we believe that the security interest of a covered swap entity in a customer's FCM customer account or individual customer account at a broker-dealer would be valid even in such a bankruptcy.[22] We believe that these arrangements would be enforceable as perfected security interests securing "safe harbor" transactions under the Bankruptcy Code and other major insolvency regimes, notwithstanding the

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[20] *In re Lehman Brothers Inc.*, 458 B.R. 134 (Bankr. S.D.N.Y. Oct. 4, 2011).

[21] *Chevron Products Co. v. SemCrude, L.P. (In re SemCrude, L.P.)*, 428 B.R. 590 (D. Del. 2010).

[22] As noted above, the staff of the CFTC has confirmed the authority of the customer to grant the security interest.

commencement of an insolvency proceeding against the customer. Thus, the validity and enforceability of the lien should not be affected by the issues of mutuality discussed in these decisions.

VI. Request for Confirmation and Clarification on Certain Provisions within the Proposed Rules

As noted, we understand that the second lien on an individual customer's cleared swaps account at the FCM created by a master netting agreement is valid under Part 22 of the CFTC Regulations. Because the SEC's regulations on segregation of accounts at the clearing agencies or broker-dealers holding cleared security-based swap positions and related initial margin should be harmonized with the related CFTC rules, we believe that the second lien granted to the covered swap entity in the cleared security-based swaps account should also be valid. Furthermore, the validity of a lien on the customer's cleared futures account at an FCM is unaffected by Dodd-Frank. Therefore, initial margin models of a covered swap entity should be able to account for collateral posted with an affiliated FCM in respect to cleared futures, options and swaps (or a broker-dealer in respect to cleared security-based swaps) subject to a master netting agreement to avoid requiring customers to post redundant collateral as initial margin with the covered swap entity in respect of Uncleared Swaps.

Accordingly, we respectfully request that the Prudential Regulators confirm that the final version of the Proposed Rules would preserve the benefits of portfolio margining by not prohibiting:

1. an initial margin model that accounts for portfolio margining between Cleared Products and Uncleared Swaps (pursuant to a master netting agreement under which the customer grants the Covered Swap Entity a security interest in its FCM customer account or individual customer account with a broker-dealer); and

2. a security interest granted in the FCM customer account or the individual customer account at a broker-dealer and the collateral contained therein to qualify as "eligible collateral" under the Proposed Rules and to be used as initial margin for Uncleared Swaps.

We further submit that the interest in the FCM customer account or the individual customer account at a broker-dealer does not conflict with the Prudential Regulators' overriding policy concerns regarding collateral quality. We respectfully request that the Prudential Regulators confirm the requests in (1) and (2) above by adding text similar to the following to the preamble of the final version of the Proposed Rules:

> An approved initial margin model that accounts for risk on a portfolio basis may also take into account all products (including cleared swaps and security-based swaps) that are

approved for model use and that are subject to a single legally enforceable cross-product master netting agreement.

The lien on the FCM customer account represents an interest in the initial margin posted with an FCM and, in turn, with a DCO. As discussed above, under Section 39.13(g)(10) of the CFTC Regulations, a DCO may only accept as initial margin with respect to Cleared Products assets "that have minimal credit, market and liquidity risks." On the other hand, the Proposed Rules permit a covered swap entity to collect initial margin that consists of immediately available cash funds, any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by the United States and senior debt obligations of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Federal Home Loan Banks and the Federal Agricultural Mortgage Corporation and any "insured obligation" of a Farm Credit System bank.[23] Although the types of collateral which an FCM or DCO may collect are not identical to the types of collateral that constitute "eligible collateral" under the Proposed Rules, an approved initial margin model should be able to account, through haircuts or otherwise, for any perceived increased risk associated with the permissible forms of collateral under Section 39.13(g)(10) of the CFTC Regulations. In addition, because the FCM customer account subject to the master netting agreement (and the positions and collateral within said account) is held by an FCM which is affiliated with the covered swap entity, the covered swap entity would be able to monitor, and even potentially limit, the types of collateral posted as initial margin to secure cleared swaps in the FCM customer account.[24] In this manner, the covered swap entity could ensure that the FCM or broker-dealer only accepts "eligible collateral" to secure cleared futures, options and swap positions in the relevant FCM customer account. Therefore, we believe that collateral posted with the FCM and a DCO (or a broker-dealer and a registered clearing agency) subject to a master netting agreement can be fully aligned with the Prudential Regulators' policy concerns regarding collateral quality.

VII. Conclusion

In conclusion, we respectfully request that the Prudential Regulators consider the issues discussed above and provide the requested clarifications and confirmations. We ask that the Prudential Regulators confirm that an initial margin model that allows portfolio margining between Cleared Products and Uncleared Swaps can satisfy the margin requirements under the final version of the Proposed Rules. In addition, we ask that the Prudential Regulators confirm that entry into a lien on an account holding Cleared Products and related margin would be equivalent to the collection of "eligible collateral" by a covered swap entity for purposes of the Proposed Rules. We believe, as discussed above, that the continued practice of portfolio margining between Cleared Products and Uncleared Swaps will preserve and provide benefits to the entire swaps market by promoting liquidity and reducing the costs of entering into swaps,

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[23] Proposed Rules §__.6(a).

[24] A similar arrangement would exist between the covered swap entity and its affiliated broker-dealer that holds the customer's cleared security-based swap positions and related collateral.

while supporting Dodd-Frank's systemic risk management objectives. Furthermore, we believe that a portfolio margining structure that allows cross-margining between Cleared Products and Uncleared Swaps will encourage swaps participants to enter into cleared swaps and cleared security-based swaps rather than Uncleared Swaps, especially during the transition period to mandatory clearing as more swaps become available to be cleared.[25] We respectfully request that the Prudential Regulators provide guidance on these issues at their earliest possible convenience, but, in any event, no later than the effective date of the mandatory clearing requirements under Section 2(h) of the Commodity Exchange Act and Section 3C of the Securities Exchange Act. Without guidance by such time, swaps and security-based swaps customers, including those that are today clearing voluntarily in advance of the mandate, will face uncertainty as to whether they are required to post significant amounts of redundant capital with covered swap entities, thereby hindering clearing and reducing liquidity in the marketplace to the detriment of all market participants. Furthermore, because portfolio margining is currently extensively practiced between cleared and uncleared derivatives, we respectfully request that the Prudential Regulators refrain from taking any regulatory action that would disrupt these arrangements as the mandatory clearing requirement is implemented.

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[25] For a discussion of this incentive, please see n.14.

MFA thanks the Prudential Regulators for the opportunity to provide comments on the Proposed Rules. Please do not hesitate to contact Laura Harper, Assistant General Counsel, or the undersigned at (202) 730-2600 with any questions the Prudential Regulators or their respective staffs might have regarding this letter.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President & Managing Director, General Counsel