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March 27, 2014

Marcia E. Asquith  
Office of the Corporate Secretary  
FINRA  
1735 K Street, NW  
Washington, DC 20006

Re: Margin Requirements (Regulatory Notice 14-02)

Dear Ms. Asquith:

The Investment Company Institute (“ICI”)<sup>1</sup> is submitting this letter in response to a request for comment by the Financial Industry Regulatory Authority (“FINRA”) on the proposed amendments to FINRA Rule 4210 for transactions in the To Be Announced (“TBA”) market.<sup>2</sup> The TBA Margin Proposal would require FINRA members carrying forward transactions with customers in “Covered Agency Securities”<sup>3</sup> to: (i) collect from non-exempt accounts both maintenance margin and variation margin and (ii) collect from exempt accounts<sup>4</sup> variation margin, subject to a minimum transfer amount

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<sup>1</sup> The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$16.3 trillion and serve over 90 million shareholders.

<sup>2</sup> Margin Requirements, Regulatory Notice 14-02 (January 2014), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p439087.pdf> (“TBA Margin Proposal”).

<sup>3</sup> The definition of “Covered Agency Security” would include TBA transactions, as defined in FINRA Rule 6710(u), for which the difference between trade date and settlement date is greater than one business day, certain mortgage pool transactions, as defined in FINRA Rule 6710(x), for which the difference between trade date and settlement date is greater than one business day and transactions in collateralized mortgage obligations, as defined in FINRA Rule 6710(dd), for which the difference between trade date and settlement date is greater than three business days.

<sup>4</sup> The term “exempt account” is defined in FINRA Rule 4210(a)(13) to include a number of institutional accounts, including registered investment companies. FINRA has expanded this definition with respect to certain types of transactions in Covered Agency Securities to include institutional investors that are independently audited entities with more than \$1.5 million of net current assets and more than \$1.5 million of net worth. See FINRA Rule 4210(e)(2)(F) /08, n. 2.

of \$250,000.<sup>5</sup> The TBA Margin Proposal establishes a one-day time frame for posting of variation margin and a close-out requirement after five business days (even if a capital charge is taken) unless a customer posts variation margin.

ICI appreciates FINRA's concern that the lack of exchange of margin in the TBA market may create a potential for counterparty risk that could raise concerns about systemic risk to the financial markets. We strongly support FINRA's adoption of a rule that requires posting of variation margin for transactions between a broker-dealer and an exempt account. To mitigate the systemic risks identified by FINRA as the basis for the TBA Margin Proposal, it is essential, however, to modify the TBA Margin Proposal as follows:

- ***Require Two-Way Margining and Authorize Use of Tri-Party Custody Arrangements.*** The new rule should require broker-dealers to post variation margin to customers when Covered Agency Securities transactions are in-the-money to the customer and the customer, thus, is subject to payment and delivery risk of the FINRA member. In addition, the rule should allow investment companies registered under the Investment Company Act of 1940 ("ICA") to use tri-party custody arrangements both to hold posted margin in compliance with requirements of the ICA and to hold margin posted to the registered investment company by the broker-dealer for operational convenience.
- ***Revise the Definition of "Covered Agency Securities."*** Transactions settling within three business days should not be treated as Covered Agency Securities transactions because they do not pose material risk beyond the ordinary settlement cycle.
- ***Minimum Transfer Amount Should be Increased.*** The TBA Margin Proposal should be amended to raise the minimum transfer amount to \$500,000 and eliminate any requirement that the FINRA member take a capital charge if it elects to rely on such minimum provided it has adopted appropriate risk limits, policies, and procedures.
- ***Eliminate the Close-Out Obligation.*** The TBA Margin Proposal should not result in the close-out of a Covered Agency Securities transaction for which the customer/counterparty has not posted margin within five business days of the call provided that the member firm takes a capital charge in lieu of collecting variation margin from an exempt account.
- ***Appropriate Transition Period.*** We request that customers and FINRA members be given at least one year to comply with the TBA Margin Proposal, once adopted.

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<sup>5</sup> FINRA proposes that the amount of any uncollected mark-to-market loss be deducted in computing the member's net capital at the close of business following the business day the mark-to-market loss was created.

We discuss all of these matters in more detail below.

### Background

According to the TBA Margin Proposal, most trading of agency mortgage-backed securities (“MBS”) takes place in the TBA market, which is characterized by transactions with forward settlements. The agency MBS market is one of the largest fixed income markets, and investment companies registered under the ICA (“registered funds”) are significant investors in these instruments. Registered funds own a substantial amount of MBS with taxable bond funds holding the vast majority of those assets.<sup>6</sup> Investing in the TBA market also allows registered funds to obtain the desired mortgage exposures without having to own the underlying MBS directly.

As noted by FINRA, the exchange of margin in the TBA market has not been common practice. As a practical matter, broker-dealers have neither collected any variation margin or “mark-to-market loss” with respect to exempt accounts nor taken any capital charge in lieu of collateral.<sup>7</sup> We understand that broker-dealers have not been required to take the capital charge in lieu of collecting mark-to-market loss because of FINRA guidance that allows member firms not to take the capital charge if they have risk limits in place.<sup>8</sup> FINRA noted that this paradigm has created a potential for counterparty exposure that is inconsistent with the type of margining that is required for bilateral instruments entered into by institutional counterparties in other markets. FINRA also stated that the Treasury Market Practices Group (“TMPG”) of the Federal Reserve Bank of New York adopted best practices recommendations that require margining of forward-settling agency MBS transactions by all counterparties, including “exempt accounts and broker-dealers.”<sup>9</sup> In light of the growth of the TBA market, the number of participants and the credit concerns that have been raised in recent years, FINRA was of the view that there is a need to establish margin requirements for the TBA market that

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<sup>6</sup> As of September 30, 2013, registered funds held \$553 billion in MBS. ICI Data.

<sup>7</sup> Under the current margining rules, broker-dealers are required to charge maintenance margin of 5 percent plus the mark-to-market loss to non-exempt accounts. For exempt accounts, broker-dealers are not required to charge either maintenance margin or initial margin but are required to collect the mark-to-market loss in the position or take a capital charge in lieu of collection of the mark-to-market loss.

<sup>8</sup> See TBA Margin Proposal, *supra* note 2, at 10 n. 15 (“To recap, Interpretation /03 of FINRA Rule 4120(e)(2)(F) provides that, in lieu of deducting from capital 100 percent of any marked to the market losses in exempt accounts and having to obtain margin as well as any marked to the market losses from non-exempt mortgage bankers’ accounts, members may make a determination in writing of a risk limit for each such exempt account and non-exempt mortgage banker’s account”).

<sup>9</sup> TMPG, Best Practices for Treasury, Agency Debt, and Agency Mortgage-Backed Securities Markets, *available at* [http://www.newyorkfed.org/tmpg/bestpractices\\_052313.pdf](http://www.newyorkfed.org/tmpg/bestpractices_052313.pdf) (“TMPG Best Practices”).

will cover not only smaller investors (which are covered under the current rules)<sup>10</sup> but also cover larger, institutional investors that comprise the major part of the market.

Therefore, FINRA proposes to require its members to collect variation margin from exempt counterparties for transactions in Covered Agency Securities and to collect variation and maintenance margin equal to 2 percent of the market value of the securities from non-exempt accounts when the current exposure on the transaction exceeds \$250,000. The TBA Margin Proposal suggests that the reference to “current exposure” relates only to the exposure that the broker-dealer has to the customer and not the exposure that the customer has to the broker-dealer.<sup>11</sup> Exempt counterparties generally include FINRA members, banks, savings associations, insurance companies, investment companies, states or subdivisions, pension plans, and persons meeting specified net worth requirements and other conditions.<sup>12</sup> Transactions cleared through a registered clearing agency and subject to margin requirements of the clearing agency would not be subject to the proposed requirements. Variation margin would be required only to the extent that the “current exposure” exceeded the minimum transfer amount of \$250,000, subject to the broker-dealer taking a capital charge with respect to any uncollateralized mark-to-market loss below \$250,000. Broker-dealers would be required to close out all customer positions for which a margin call has not been met within five business days even if the broker-dealer has taken a capital charge.

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<sup>10</sup> Under existing interpretive guidance, broker-dealers are required to impose a 5 percent margin requirement plus any mark-to-market loss on non-exempt accounts. *See* Exhibit I to Interpretations to FINRA rule 4210(e)(2)(F).

<sup>11</sup> The TBA Margin Proposal states that member firms might post margin to customers with respect to Covered Agency Securities transactions, but the proposed rule text does not require such posting. The TBA Margin Proposal also does not establish any operational framework to facilitate posting of collateral by broker-dealers to customers. *See, e.g.*, TBA Margin Proposal, *supra* note 2, at 4 (“members must collect variation margin, which is consistent with the approach taken by the TMPG best practices and includes the posting of margin between all counterparties, including broker-dealers”). *See also id.* at 10 n. 18 (“FINRA staff has consulted with the SEC staff concerning the net capital treatment of variation margin posted by a broker-dealer with a counterparty. It is anticipated that the SEC will issue guidance, such that if certain conditions are met, the resulting receivables can be treated as an allowable asset in computing net capital”). A customer will have “exposure” to the broker-dealer selling MBS to the customer throughout the life of the transaction because the customer is subject to the risk that the broker-dealer will not deliver the promised securities. The value of the customer’s exposure increases to the extent that the purchase price for the securities agreed between the customer and the broker-dealer at inception of the transaction is lower than market value of the securities. FINRA refers to the difference between the customer’s agreed purchase price and the market price of the referenced securities as the “unrealized gain” in the transaction. Similarly, the value of the broker-dealer’s exposure to the customer increases to the extent that the purchase price for the securities agreed between the customer and the broker-dealer is higher than the market value of the securities. This difference is what FINRA refers to as the “mark-to-market loss in the position.”

<sup>12</sup> *See* FINRA Rule 4210(a)(13) and FINRA Rule 4210(a)(4).

In addition, the TBA Margin Proposal would require FINRA members to make a determination in writing of a risk limit to be applied to each counterparty with which they engage in Covered Agency Securities transactions (although there is no indication that this risk limit could be used to eliminate a capital charge when a broker-dealer elects not to collect mark-to-market losses from exempt accounts). FINRA also proposes to establish a new reporting obligation with respect to concentrated credit exposures and a prohibition on entry into new Covered Agency Securities transactions that could increase credit exposure (from the broker-dealer's perspective) above designated thresholds.

### Discussion

#### *FINRA Should Require Two-Way Margining*

To better protect counterparties of broker-dealers (which are treated by FINRA as “customers” of the member firm)<sup>13</sup> and the TBA markets generally, we strongly urge FINRA to require its members to post variation margin to their counterparties at the same level and in the same manner as required for the counterparty. This fundamental requirement also is consistent with the TMPG's Best Practices.<sup>14</sup> Two-way margin is critical to managing risk for Covered Agency Securities transactions as well as for the reduction of a build-up of systemic risk at institutions that engage in a significant number of these transactions. We believe that a two-way margining requirement protects counterparties (such as registered funds) and mitigates credit exposure and fail risk generally in the marketplace due to a concentration of TBA transactions at a limited number of broker-dealer firms. TBA transactions involve two-sided exposures in the same way as futures, options, swaps, repurchase transactions and securities lending transactions. The definition of “current exposure” included in the final rule should include the exposure that the customer has to the broker-dealer as well as the exposure that the broker-dealer has to the customer, and the rule should mitigate both of those exposures by requiring bilateral margining.

The daily collection of variation margin serves to remove current exposure from the TBA markets for all participants and to prevent exposures from accumulating. Two-way exchange of variation margin will provide protection to market participants against the market value losses that could otherwise build up at broker-dealers (*i.e.*, the entities that engage in significant volume of TBA transactions), which could threaten systemic stability in the financial markets.

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<sup>13</sup> TBA Margin Proposal, *supra* note 2, at 10 n. 14 (“Under the proposal, a “counterparty” is defined as any person that enters into a Covered Agency Securities transaction with a member and includes a “customer” as defined in paragraph (a)(3) of FINRA rule 4210”).

<sup>14</sup> See TMPG Best Practices, *supra* note 9 at 3.

In connection with uncleared derivatives markets, we have consistently advocated for a two-way margining requirement globally to reduce systemic risk and promote central clearing.<sup>15</sup> We were gratified that the international regulators adopted a bilateral margining requirement as part of the final policy framework establishing minimum standards for margin requirements for non-centrally cleared derivatives.<sup>16</sup> The international standards recognize that two-way margin is an essential component of managing risk for derivatives transactions as well as for reducing systemic risk in the derivatives markets. We recommend that FINRA include this important protection in its proposed margin rule for the TBA market.<sup>17</sup>

*FINRA Should Allow Independent Custodians to Hold Collateral Posted by Registered Funds*

We request that registered funds be permitted to have their assets posted as variation margin for their TBA transactions to be held with an independent custodian. Use of a third-party, regulated U.S. bank custodian must be allowed where the counterparty posting collateral is a registered investment company. Under Section 17 of the ICA, registered funds are required to hold their assets (including

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<sup>15</sup> Letter from Karrie McMillan, General Counsel, ICI, and Dan Waters, Managing Director, ICI Global, to Wayne Byres, Secretary General, Basel Committee on Banking Supervision, Bank for International Settlements, and David Wright, Secretary General, International Organization of Securities Commissions, dated March 14, 2013, *available at* <http://www.ici.org/pdf/27111.pdf>; Letter from Karrie McMillan, General Counsel, ICI, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated February 4, 2013, *available at* <http://www.ici.org/pdf/26967.pdf>; Letter from Karrie McMillan, General Counsel, ICI, and Dan Waters, Managing Director, ICI Global, to Wayne Byres, Secretary General, Basel Committee on Banking Supervision, Bank for International Settlements, and David Wright, Secretary General, International Organization of Securities Commissions, dated September 27, 2012, *available at* <http://www.ici.org/pdf/26529.pdf>; Letter from Karrie McMillan, General Counsel, ICI, to David A. Stawick, Secretary, CFTC, dated September 13, 2012, *available at* <http://www.ici.org/pdf/26500.pdf>.

<sup>16</sup> Margin Requirements for Non-Centrally-Cleared Derivatives, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, September 2013, *available at* <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD423.pdf> (“BCBS/IOSCO Report”).

<sup>17</sup> In our view, FINRA has the necessary authority to require these changes and to require posting of margin by member firms just as FINRA clearly has authority to require member firms to collect maintenance and variation margin from customers (*i.e.*, in this case, “counterparties,” because, as the TBA Margin Proposal explains, counterparties to Covered Agency Securities transactions are deemed to be “customers”). In the event that FINRA believes that it does not have authority to adopt a rule requiring FINRA member firms to post margin, we urge FINRA to request that the Securities and Exchange Commission (“SEC”) adopt such a rule and require broker-dealers that enter into Covered Agency Securities transactions to post margin equal to the mark-to-market loss in the broker-dealer’s position pursuant to the SEC’s general authority to regulate margin under Section 7 of the Securities Exchange Act of 1934 (“Exchange Act”) and its authority to regulate broker-dealers under Section 15 of the Exchange Act. We respectfully request that incorporation of a broker-dealer margin posting requirement be added as a condition to approval of the TBA Margin Proposal.

those posted as margin) with a qualified custodian, which typically must be a regulated bank.<sup>18</sup> Under the ICA, absent specific procedures and annual board approvals that are not practical for funds or specific SEC relief, registered funds are precluded from holding their collateral with a dealer that is not a bank. In addition, tri-party custody arrangements should be permitted for holding margin posted to a registered fund by a broker-dealer. As an operational matter, use of custodians to hold collateral posted by broker-dealers would be necessary because registered funds may not have the infrastructure to hold, oversee and invest (in the case of cash collateral) assets posted by broker-dealers as collateral to the registered fund.

More generally, we believe that tri-party arrangements provide important protection to all counterparties and operational safeguards and conveniences to the broker-dealers.<sup>19</sup> Use of these arrangements reduces operational risk by allowing parties to hold and transfer collateral through well-capitalized custodial banks, leveraging existing, industry-standard documentation and collateral management models that have worked efficiently in the over-the-counter swaps and repo (*i.e.*, “tri-party repo”) contexts.

Specifically, tri-party custodian arrangements provide for the custodian to assume certain responsibilities with respect to safeguarding the interests of both counterparties, including maintaining custody of the collateral and being involved in effecting the transfer of funds and securities between the two parties. This arrangement helps to avoid market disruptions in the case of a default by a counterparty or other event necessitating access to the collateral. The protections provided to the counterparties from this structure are important to managing the risk created by exposure to a particular counterparty. These tri-party arrangements also can help prevent fraud and misappropriation of collateral. Similarly, this structure serves to reduce the bankruptcy and default risks in the financial system associated with a particular counterparty.

We have made similar comments to the SEC with respect to collateral posted by registered funds for their security-based swap transactions. We are enclosing a copy of our letter to the SEC, which provides detailed information regarding the arrangements currently in place for holding collateral of registered funds. We describe the protections provided by tri-party arrangements and explain how these arrangements afford dealers appropriate control over collateral posted by counterparties.

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<sup>18</sup> In addition to Section 17, the ICA contains six separate custody rules for the different types of possible custody arrangements: Rule 17f-1 (broker-dealer custody); Rule 17f-2 (self custody); Rule 17f-4 (securities depositories); Rule 17f-5 (foreign banks); Rule 17f-6 (futures commission merchants); and Rule 17f-7 (foreign securities depositories). Foreign securities are required to be held in the custody of a foreign bank or securities depository. Although Rule 17f-1 permits registered funds to use a broker-dealer custodian, the rule imposes conditions that are difficult in practice to satisfy.

<sup>19</sup> We understand that other types of counterparties (*e.g.*, separate accounts managed by investment advisers) also may prefer to use tri-party arrangements to hold collateral that they post to broker-dealers.

*FINRA Should Modify the Definition of Covered Agency Securities*

We request that the definition of “Covered Agency Securities” be modified to include only TBA transactions and Specified Pool Transactions for which the difference between trade date and contractual settlement date is greater than three business days rather than one business day as currently proposed. We believe that defining forward transactions to include transactions settling one business day after the trade date is inconsistent with the current margining regime for regularly-settled transactions. A broker-dealer has until T+5 to collect payment in a cash account for a purchase of securities before the position must be liquidated.<sup>20</sup>

Moreover, we believe that a requirement to margin TBA transactions and Specified Pool Transactions for which the difference between trade date and contractual settlement date is shorter than three business days would impose a cost that is wholly disproportionate with the risk. Although margining does reduce counterparty credit risk, it can introduce operational and other risks.<sup>21</sup> For example, the TMPG Report noted that operational aspects of margining would involve “middle-and back-office resources and systems . . . to mark unsettled positions using current and readily available pricing sources . . . . If securities were pledged as collateral, current pricing information and margin calls would be needed to ensure the sufficiency of the collateral. Systems and resources must also be prepared to communicate and respond to margin calls, reconcile possible disputes, and manage collateral flows and settlement.”<sup>22</sup> As the TMPG Report recognized, there is a potential for mistakes or errors to occur in each step of the margining process, which should be considered in evaluating when margin requirements should apply. We agree with TMPG that it is critical to evaluate “the level and nature of operational risk that the [margining] process incurs”<sup>23</sup> and believe requiring counterparties to post margin against these instruments that settle in three days or fewer will create more systemic and operational risks than it will mitigate. If this requirement were to be adopted by FINRA, in many cases, counterparty collateral would be delivered to the broker-dealer after the transactions have settled, which would expose the counterparty to broker-dealer bankruptcy risk at a time when the broker-dealer

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<sup>20</sup> This five day period is consistent with the payment cycle for fully-paid security transactions. See Section 220.8(b) of Regulation T (requiring, for purchases in a cash account, payment within one “payment period” (*i.e.*, the three business days pursuant to SEC Rule 15c6-1(a)) plus two business days).

<sup>21</sup> See Report of the TMPG, Margining in Agency MBS Trading (November 2012) at 4, available at [http://www.newyorkfed.org/tmpg/margining\\_tmpg\\_11142012.pdf](http://www.newyorkfed.org/tmpg/margining_tmpg_11142012.pdf) (noting that margining would involve functions such as “measuring forward exposures, marking open positions, calculating the margin amount, communicating margin calls to counterparties, and delivering and receiving collateral”) (“TMPG Report”).

<sup>22</sup> *Id.* at 6.

<sup>23</sup> *Id.* at 5.



has no exposure to the customer and would create unnecessary costs of return and potential difficulties in identifying the settlement details for the broker-dealer.

Although settlement of more than three business days would, in our view, be the minimum time period that would be appropriate for a transaction to be treated as a Covered Agency Security transaction, we believe that longer time periods also may be appropriate. In that regard, we urge FINRA to consult with the economic and regulatory margining staff at the Board of Governors of the Federal Reserve System and the SEC's Division of Economic and Risk Analysis to better evaluate the point at which the risk mitigation from collateral posting would outweigh the operational risks and costs as well as the history of fails in Covered Agency Securities transactions. We believe that it is important for FINRA to address the fact that imposing margin requirements on customers introduces operational and other risks, which is appropriate only if the benefits from posting margin outweigh these risks.

*FINRA Should Increase the Minimum Transfer Amount*

FINRA proposes to require variation margin for transactions when the current exposure exceeds \$250,000 and to require member firms to take a capital charge in respect of such "*de minimis* transfer amount."<sup>24</sup> Minimum transfer amounts are intended to balance the benefits of collecting variation margin against the operational risks in making frequent transfers of collateral. FINRA fully understood this balance in the TBA Margin Proposal when it states that it "recognized the potential operational burdens of collecting margin" and intended to impose a minimum transfer amount "consistent with other derivatives markets."<sup>25</sup>

We urge FINRA to increase the minimum transfer amount to at least \$500,000, below which the counterparties would not have to exchange margin. We do not believe FINRA would achieve either of its articulated goals with the current amount. First, although we support FINRA's intention to propose a minimum transfer amount that is set sufficiently low to ensure that current exposure does not build up before variation margin is exchanged between counterparties, we do not believe amounts below \$500,000 would result in significant build up of current exposure. Moreover, a minimum transfer amount that is set too low would result in more frequent transfers of collateral and increase the potential for operational risk as described above. Frequent transfers of collateral also would increase transaction costs. Second, the proposed minimum transfer amount would not be consistent with standards in the derivatives markets. Under the international agreed upon margin policy framework

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<sup>24</sup> TBA Margin Proposal, *supra* note 2, at 5 ("...FINRA proposes to provide for a minimum transfer amount of \$250,000...below which the member need not collect margin (provided the member deducts the amount outstanding in computing net capital as provided in SEA rule 15c3-1 at the close of business the following business day))."

<sup>25</sup> TBA Margin Proposal, *supra* note 2, at 5.

for uncleared derivatives, global regulators agreed to a €500,000 minimum transfer amount.<sup>26</sup> We expect U.S. regulators to propose a minimum transfer amount that is consistent with the international standards.<sup>27</sup>

Finally, we request that FINRA clarify that broker-dealers will not be required to take a capital charge with respect to customer exposure up to the minimum transfer amount. We believe that requiring broker-dealers to take a capital charge will eliminate the minimum transfer amount as a practical matter. In our experience, broker-dealers are generally unwilling to take a capital charge and, as a result, broker-dealers will elect to collect small amounts of variation margin rather than suffer a hit to capital. This modification will not in any way jeopardize the objectives of the new margining regime because the exposure due to the unsecured exposure underlying the minimum transfer amount is by definition “*de minimis*.”

#### *FINRA Should Eliminate the Close-Out Obligation*

FINRA proposes that if variation margin is not posted by a counterparty to secure the mark-to-market loss in respect to the counterparty’s position within five business days from the date the loss was created, the member would be required to take promptly liquidating action unless FINRA grants the member an extension. Under the TBA Margin Proposal, liquidation would appear to be required even if the broker-dealer member were to take a capital charge.

In our view, this fails to recognize the efficacy of the capital charge. We believe that FINRA should retain its current interpretation that permits members to take a charge to net capital in lieu of collecting the mark-to-market loss from exempt accounts. Allowing broker-dealers to deduct the exposure from net capital would provide sufficient incentive for broker-dealers to collect variation margin from their counterparties without requiring them to close out the account within a set period of time. Reliance on capital charges to mitigate systemic risk when margin is not collected is a fundamental cornerstone of the SEC’s and FINRA’s financial responsibility rules for broker-dealers and security-based swap dealers.<sup>28</sup> There is no reason to believe that it would be less effective with

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<sup>26</sup>The BCBS/IOSCO originally proposed to subject counterparties to a minimum transfer amount not to exceed €100,000 but raised the minimum transfer amount to €500,000 when it issued its final policy framework. See BCBS/IOSCO Report, *supra* note 16.

<sup>27</sup>In 2011, the Commodity Futures Trading Commission proposed a minimum transfer amount of \$100,000. This proposal was issued, however, before the proposal and adoption of the margin policy framework by the international regulators. Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 FR 23732 (April 28, 2011), available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-9598a.pdf>.

<sup>28</sup>See Capital, Margin and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 FR 70214, 70242 (Nov. 23, 2012), available at <http://www.gpo.gov/fdsys/pkg/FR-2012-11-23/pdf/2012-26164.pdf> (“The proposed capital charge in lieu of margin is

respect to Covered Agency Securities transactions than it is in connection with other types of transactions.

Moreover, imposing a close-out obligation only on broker-dealers fails to recognize the bilateral exposure inherent in Covered Agency Securities transactions. Counterparties are exposed to the broker-dealer at all times yet FINRA does not propose to impose a similar punitive action for accounts for which a broker-dealer has failed to post variation margin. FINRA has not specified in any detail the rationale for proposing to amend its current position, and we urge FINRA not to retain this proposed requirement.

*FINRA Should Recognize Offsets and Margin Reduction due to Unrealized Gains*

FINRA should apply general netting and off-set principles to margining of Covered Agency Securities transactions just as it has done with respect to margining of similar transactions, such as “when issued” securities.<sup>29</sup> In addition, as FINRA has done in other contexts, the rule should provide, when calculating variation margin excess, that any mark-to-market gain in the Covered Agency Securities transaction benefitting the counterparty will be subtracted from the margin requirement and released to the counterparty or used to off-set other obligations.

*FINRA Should Provide a One-Year Compliance Date*

We are concerned that a six month compliance period would be too short to provide adequate time for market participants to prepare for the new requirements. Although market participants have in place written agreements for a significant portion of the TBA market, all of these agreements will have to be amended to reflect the new requirements adopted by FINRA. Tri-party custodial arrangements for registered funds also will have to be amended for every fund. There will be thousands of agreements that will have to be renegotiated and executed within the compliance period. In addition, a number of registered funds are not currently authorized to post collateral to broker-dealers under their existing investment policies. To post variation margin, these funds will need to obtain shareholder approval, which will take time to obtain. We do not believe six months would provide an adequate period of time for market participants to amend all the necessary agreements and to obtain the required shareholder approvals.

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designed to address situations where a nonbank SBSB does not collect sufficient (or any) collateral to cover potential future exposure relating to cleared and non-cleared security-based swaps”). See also SEC Rule 15c3-1(c)(2)(xii) (When a “pattern day trader” fails to meet special maintenance margin calls, as required (*i.e.*, within five business days from the date the margin deficiency occurs), on the sixth business day only, a member is required to deduct from net capital the amount of unmet maintenance margin calls for its pattern day traders); FINRA Rule 4210(e).

<sup>29</sup> See Rule 4210(f)(3)(A)/01 “Offsetting Position.”

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Finally, we are concerned that a short time period may result in dealers pressuring registered funds and other counterparties to sign agreements with unfavorable terms to complete the process before the compliance deadline. We do not believe it is appropriate to create a situation where registered funds and other counterparties are compelled to negotiate agreements to continue trading in these markets under the pressure of an unnecessarily short deadline.

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We appreciate the opportunity to provide comments on FINRA's proposal to establish margin requirements for the TBA market. We believe that FINRA should incorporate the recommendations discussed above, which will make the margin requirements workable for market participants, including registered funds, and achieve FINRA's regulatory objectives. If you have any questions on our comment letter, please feel free to contact me at (202) 218-3563, Sarah Bessin at (202) 326-5835, or Jennifer Choi at (202) 326-5876.

Sincerely,

/s/

Dorothy M. Donohue  
Acting General Counsel

cc: Stephen Luparello, Director, Division of Trading and Markets, SEC  
Michael A. Macchiaroli, Associate Director, Division of Trading and Markets, SEC

Norm Champ, Director, Division of Investment Management, SEC  
Doug Scheidt, Associate Director, Division of Investment Management, SEC

Enclosure



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December 5, 2013

Ms. Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549

Re: *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers (File No. S7-08-12) – Supplemental Comments to Letter of February 4, 2013 and Meeting with Staff on September 19, 2013*

Dear Ms. Murphy:

The Investment Company Institute (“ICI”)<sup>1</sup> is pleased to provide additional information to supplement our letter of February 4, 2013 (“February Letter”)<sup>2</sup> and meeting of September 19, 2013 regarding changes that we recommend the Securities and Exchange Commission (“Commission” or “SEC”) make to its proposed capital, margin, and segregation requirements for security-based swap dealers (“SBSDs”) and major security-based swap participants (“MSBSPs”).<sup>3</sup> Specifically, we urge the Commission to include the following revisions in its final rules:

- Require bilateral exchange of collateral by SBSDs/MSBSPs and their counterparties.

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<sup>1</sup> The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$16.1 trillion and serve over 90 million shareholders.

<sup>2</sup> Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated February 4, 2013, available at <http://www.ici.org/pdf/26967.pdf>.

<sup>3</sup> *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers*, 77 FR 70214 (Nov. 23, 2012) (“Proposal”), available at <http://www.gpo.gov/fdsys/pkg/FR-2012-11-23/pdf/2012-26164.pdf> implementing regulations under Title VII of The Dodd Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”), Pub. L. 111-203, 124 Stat. 1376 (2010).

- Not impose capital charges on SBSBs/MSBSPs<sup>4</sup> when their counterparties elect to have their collateral held at a third-party bank custodian.
- Permit all counterparties to post collateral for both cleared and uncleared security-based (“SB”) swaps through a third-party bank custodian.
- Prohibit SBSBs from using funds in the customer reserve account held for one customer to benefit another customer.
- Allow counterparties to SB swaps to withdraw excess collateral from the special custody account at a third-party bank custodian securing their obligations.
- Permit the application of thresholds for initial margin.

These changes would significantly strengthen customer protections and incentivize SBSBs to act prudently when entering into SB swaps in recognition that they have a “stake in the game” (by virtue of the margin they must post). These revisions also would reduce operational risk by allowing parties to hold and transfer collateral through well-capitalized custodial banks, leveraging existing, industry-standard documentation and collateral management models that have worked efficiently in the over-the-counter swaps and repo (*i.e.*, “tri-party repo”) contexts.

We again strongly urge the Commission to require SBSBs to post initial and variation margin to their non-SBSB counterparties at the same level and in the same manner as required for a non-SBSB counterparty. Adopting this fundamental requirement would make the SEC’s margin rules consistent with the final policy framework issued by the Basel Committee on Banking Supervision (“BCBS”) and the International Organization of Securities Commissions (“IOSCO”) that establishes minimum standards for margin requirements for non-centrally cleared derivatives.<sup>5</sup> We believe it is imperative that the SEC not diverge from these internationally agreed standards, which are critical to the protection of counterparties (such as registered funds), the reduction of a build-up of systemic risk at institutions that engage in a significant amount of swap transactions, and the prevention of regulatory arbitrage. In the BCBS/IOSCO Report, BCBS/IOSCO explained that the group had determined that a greater reliance on margin would provide a more effective risk mitigant than imposition of higher

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<sup>4</sup> Although most MSBSPs would not be subject to a capital charge under the Proposal, the Proposal provides that MSBSPs that are dually-registered as broker-dealers would be subject to a charge. Proposal, *id.* at 70256 n. 466. In our view, neither these MSBSPs nor SBSBs should be subject to such a charge.

<sup>5</sup> *Margin Requirements for Non-Centrally-Cleared Derivatives*, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, September 2013, *available at* <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD423.pdf> (“BCBS/IOSCO Report”).

capital levels because: (i) margin is more targeted to a particular transaction and marketplace and is easy to adjust; (ii) capital is easily depleted whereas margin can be topped up, even intraday; (iii) margin allows for immediate liquidity; and (iv) requiring posting of collateral incentivizes more prudent behavior by market participants by forcing them to internalize the costs of risk taking.<sup>6</sup>

The remainder of this letter focuses on the SEC's proposed capital charge on an SBSB when its counterparty exercises its right to elect an independent bank custodian to hold collateral (which was specifically discussed at our September meeting).<sup>7</sup> We believe that an imposition of such a capital charge on an SBSB would result in adverse consequences and that such a result is unnecessary to satisfy the SEC's regulatory objectives for the reasons discussed below. We provide more detailed information regarding the arrangements currently in place for holding collateral of funds registered under the Investment Company Act ("ICA") that may be helpful to the SEC.

Specifically, this letter describes: (1) how the current tri-party agreements should satisfy the requirements under Proposed Rules 18a-3 and 18a-4; (2) the significant protections provided by the tri-party arrangements; (3) the current use of these arrangements and industry efforts to expand their use with the implementation of the Dodd-Frank requirements; and (4) terms we believe should be required in tri-party collateral agreements to address any residual concerns that the SEC may have regarding appropriate control by SBSBs over collateral posted by counterparties.

## I. Background

In October 2012, the Commission proposed capital, margin, and segregation rules for SBSBs and MSBSPs that are modeled on existing rules applicable to broker-dealers. According to the Proposal, the collateral collection obligation, in connection with which the counterparties transfer collateral to SBSBs or MSBSPs in the form of initial margin or variation margin, is intended to provide the SBSB or MSBSP with sufficient margin to cover the SBSB's (or MSBSP's) exposure to the counterparty on a cleared or bilateral SB swap in the event of counterparty default and liquidation of the position.<sup>8</sup>

Even though Dodd-Frank expressly requires SBSBs and MSBSPs to allow counterparties to hold initial margin posted in respect to non-cleared SB swaps at an independent, third-party custodian, the Proposal discourages exercise of this right and treats SB swap positions for which collateral is held

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<sup>6</sup> *Id.* at 3.

<sup>7</sup> See Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy, 78 FR 66621, 66623 (Nov. 6, 2013) ("CFTC Protection of Collateral Release") (CFTC recognized that "Congress' description as a 'right' of what would otherwise be a simple matter for commercial negotiation suggests that this decision is an important one, with a certain degree of favor given to an affirmative election").

<sup>8</sup> Proposal, *supra* note 3, at 70246.

through a third-party custodian the same way as an uncollateralized position by requiring the SBSB and certain MSBSPs to take a capital charge because the collateral is held away.<sup>9</sup> The Commission explained that this proposed capital charge was necessary because collateral held through a custodian would be insufficient to protect the SBSB from losses if the counterparty defaults. The SEC reasoned that the collateral would not protect the SBSB because the SBSB would not have physical possession or control over the collateral or be able to liquidate the collateral promptly without intervention of another party.<sup>10</sup>

We respectfully disagree with the SEC's analysis for the reasons described below. We believe the SEC should seek to fulfill Congress' intent and encourage use of independent, third-party custodial arrangements to hold both initial and variation margin, subject to compliance with state uniform commercial code requirements and provision by custodians of the types of collateral transfer and reporting safeguards provided currently in the tri-party repo market.<sup>11</sup>

Moreover, as discussed in our February Letter, registered funds may be precluded from holding their collateral with an SBSB or MSBSP that is not a bank. Under the ICA, registered funds are required to custody their assets in accordance with Section 17 of the ICA. Nearly all registered funds use a U.S. bank custodian for domestic securities although the ICA permits other limited custodial arrangements.<sup>12</sup> Rule 17f-1 permits registered funds to use a broker-dealer custodian, but the rule imposes conditions that are difficult in practice to satisfy. We do not believe that complying with the protective requirements under the ICA (and electing the right specifically provided by Dodd-Frank) should result in higher costs to registered funds, especially when third-party custodial arrangements would achieve the SEC's regulatory objectives.

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<sup>9</sup> *See id.* at 70246.

<sup>10</sup> *Id.* at 70246 – 70247.

<sup>11</sup> We also request that the Commission clarify in any rule it ultimately adopts that it would be permissible for counterparties to hold cleared SB swaps and related collateral through a custodial bank that is a member of a SB swap clearinghouse, regardless of whether the custodial bank is an SBSB. The rule also should clarify that the custodial bank would be authorized to hold all excess counterparty margin in a segregated account in the counterparty-customer's name and post with the clearinghouse the counterparty's required margin for the cleared SB swap.

<sup>12</sup> In addition to Section 17, the ICA contains six separate custody rules for the different types of possible custody arrangements: Rule 17f-1 (broker-dealer custody); Rule 17f-2 (self custody); Rule 17f-4 (securities depositories); Rule 17f-5 (foreign banks); Rule 17f-6 (futures commission merchants); and Rule 17f-7 (foreign securities depositories). Foreign securities are required to be held in the custody of a foreign bank or securities depository.



II. Tri-Party Collateral Agreements Satisfy the Requirements of Proposed Rules 18a-3 and 18a-4

Collateral posted for non-cleared swaps must meet certain conditions under Proposed Rule 18a-3 for a nonbank SBSB to count the collateral as equity in the counterparty's collateral account. One of the six conditions requires that the collateral be subject to "the physical possession or control of the nonbank SBSB and capable of being liquidated promptly by the nonbank SBSB without intervention by any other party."<sup>13</sup> Proposed Rule 18a-4(b) also expressly requires that "excess securities collateral" posted to any type of SBSB<sup>14</sup> in respect to either a cleared or a non-cleared swap be in the "physical possession or control" of the SBSB. Excess securities collateral includes initial margin and all other collateral in excess of the SBSB's exposure to the counterparty.

The requirement in the Proposal for "physical possession or control" allows collateral to be held either at the SBSB (*i.e.*, in its "physical possession") or at a third party so long as the collateral is under the "control" of the SBSB. In the broker-dealer context, the Commission has interpreted "control" to require that securities be held in one of several locations specified in Rule 15c3-3 and that the securities be free of liens and other restrictions that could impede the ability of the broker-dealer to liquidate the securities.<sup>15</sup> Permissible locations include banks.<sup>16</sup> As discussed below, a careful analysis of properly-structured, tri-party collateral arrangements indicate that they satisfy the SEC's definition of "control."

A. Tri-Party Collateral Arrangements Provide the Secured Party with "Control" over the Collateral.

Although an SBSB would not have physical possession of securities collateral under a tri-party custodial arrangement, the SBSB would have legal "control" over the securities and cash pledged to it but held by the custodian so long as the arrangement were structured to comply with Articles 8 and 9 of the Uniform Commercial Code ("UCC"). Section 8-106(d)(2) of the UCC provides that a secured party has "control" of a "security entitlement" if: "the securities intermediary has agreed that it will comply with entitlement orders originated by the ... [secured party] without further consent by the entitlement holder." In explaining the provision, the drafters noted that the provision allows a secured party that holds collateral through a "securities intermediary" to have control over the securities account and the assets held in the account, regardless of whether the intermediary is a custodian for the

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<sup>13</sup> See paragraph (c)(4)(i) of Proposed Rule 18a-3 under the Securities Exchange Act of 1934 ("Exchange Act").

<sup>14</sup> These include: bank SBSBs, stand-alone SBSBs and broker-dealer SBSBs.

<sup>15</sup> Proposal, *supra* note 3, at 70276 – 70277 and n. 665 (citing 17 CFR 240.15c3-3(c)).

<sup>16</sup> *Id.* at 70276-70277

pledgor or for the secured party.<sup>17</sup> Section 9-104 of Article 9 provides a similar right in respect to security entitlements over deposit accounts holding cash collateral. The term “security entitlement” is a property right that a person obtains in the contents of a securities account with a “securities intermediary.”<sup>18</sup> The concept of “security entitlement” provides a holder of the entitlement with a priority in the financial assets held in that account over the securities intermediary or the security intermediary's creditors.<sup>19</sup>

Article 8, which covers security interests in securities, was expressly adopted to provide more certainty to borrowers and lenders in light of changes in the manner in which securities are held. The determination of whether the secured party has a security interest in securities that have been posted as collateral depends upon whether the secured party has the present ability to have the securities sold or transferred without further action by the transferor. These rights are not required to be exclusive, and the secured party may (but is not required to) allow the debtor to retain rights of disposition over the account or securities, including through the right to substitute collateral. Moreover, the rights of the third party are not required to “spring” into being only upon a pledgor's default but can be in place throughout the term of the tri-party collateral arrangement.<sup>20</sup> “Control” is based on the contractual agreement directing the custodian to follow instructions from the secured party with respect to the custody account without first obtaining consent from the entitlement holder.

In practice, pledgors and secured parties memorialize the pledge of securities and the grant of “control” to the secured party through an “account control agreement” among a pledgor, secured party and securities intermediary. As required by condition (ii) of Proposed Rule 18a-3 applicable to nonbank SBSBs with respect to collateral collected for non-cleared SB swaps and the more general requirements of Proposed Rule 18a-4, the agreement allows collateral to be liquidated promptly by the secured party-SBSB without intervention by any other party.<sup>21</sup>

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<sup>17</sup> See UCC Official Comments to Section 8-106, Comment 4 (“Subsection (d)(2) provides that a purchaser has control if the securities intermediary has agreed to act on entitlement orders originated by the purchaser if no further consent by the entitlement holder is required. Under subsection (d)(2), control may be achieved even though the transferor's original entitlement holder remains listed as the entitlement holder”).

<sup>18</sup> See UCC Section 8-102(a)(17) (“Security Entitlement means the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5”).

<sup>19</sup> Uniform Law Commission, the National Conference of Commissioners on Uniform State Laws, UCC Article 8, Investment Securities (1994) Summary. See UCC Section 8-102(a)(14) (Security Intermediary means (i) a clearing corporation; or (ii) a person, including a bank or broker, that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity”).

<sup>20</sup> UCC Official Comments to Section 8-106, Comment 7.

<sup>21</sup> Proposed Rule 18a-3(c)(4)(iii).

Under a typical control agreement, the secured party will have an unconditional right to dispose of the assets upon any triggering event, such as the pledgor's default or the pledgor's failure to maintain sufficient equity in the collateral account. The secured party also will have the right to exclusive control over the account simply by delivering a notice of exclusive control to the custodian, which the custodian has no right to question.

To provide protection to the pledgor against overreaching by the secured party, the secured party will typically covenant to the pledgor that it will not submit a notice of exclusive control or seek to exercise remedies in respect to the pledged securities account and securities in the account unless the pledgor has defaulted or there has been a similar triggering event, such as a termination event or "specified condition" under the Master Agreement published by the International Swaps and Derivatives Association, Inc. ("ISDA").<sup>22</sup> This approach provides certainty to the parties because it ensures that the securities intermediary will follow the instructions of the secured party.<sup>23</sup>

Courts have recognized the legitimacy of collateral control arrangements and enforced them in accordance with their terms,<sup>24</sup> noting that, to view the arrangements in any other light would be to ignore commercial reality.<sup>25</sup> This recognition of tri-party collateral arrangements by the courts ensures that condition (c)(4)(iv) of Proposed Rule 18a-3 would be met by relying on a properly drafted control agreement.<sup>26</sup>

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<sup>22</sup> The concept of a "Specified Condition" is included in the ISDA Credit Support Annex as a trigger for exercise of default remedies by the secured party under the ISDA Credit Support Annex. The triggering events are subject to definition by the parties through designation in Paragraph 13 of the ISDA Credit Support Annex.

<sup>23</sup> See UCC Official Comments to Section 8-106, Comment 7 ("In many situations, it will be better practice for both the securities intermediary and the purchaser to insist that any conditions relating in any way to the entitlement holder be effective only as between the purchaser and the entitlement holder. That practice would avoid the risk that the securities intermediary could be caught between conflicting assertions of the entitlement holder and the purchaser as to whether the conditions in fact have been met. Nonetheless, the existence of unfulfilled conditions effective against the intermediary would not preclude the purchaser from having control").

<sup>24</sup> See *Scher Law Firm v. DB Partners I LLC*, 27 Misc.3d 1230(A), 911 N.Y.S.2d 696 (Kings County 2010) (finding that a broker-dealer's security interest in collateral was perfected by the control agreement, and the broker-dealer obtained control over the collateral pursuant to the control agreement in accordance with the requirements of UCC 8-106(d)); see also *SIPC v. Lehman Brothers Inc.*, 433 B.R. 127 (Bankr. S.D.N.Y. 2010) (rejecting an argument by a pledgor of collateral to a bankrupt broker-dealer under a control agreement that the pledged collateral should be excluded from the definition of "customer property" under the Securities Investor Protection Act ("SIPA") because the assets were not in the "possession" of the debtor and, thus, never "held" by the debtor. The Court found that the assets held under the tri-party agreement "were under the dominion and control of [the debtor]").

<sup>25</sup> *SIPC v. Lehman Brothers Inc.*, *supra* note 24 (noting as well that failure to enforce the control provided to a secured party over collateral held through a properly-documented, tri-party custody arrangement "disregards the commercial reality of the agreements among the parties").

<sup>26</sup> Proposed Rule 18a-3(c)(4)(iv).

B. Tri-Party Collateral Arrangements Satisfy the Requirements that the Assets be Held Free of Liens and Held at an Appropriate Location

According to the SEC, the term “possession or control,” as used in Rule 15c3-3, means that a broker-dealer may not lend, rehypothecate or use the referenced assets in its business.<sup>27</sup> Collateral posted through a third-party custodian and held in a special custody account would be held free of liens, other than the lien imposed by the agreement in favor of the secured party.<sup>28</sup> Under the tri-party arrangement, similar to the requirement for broker-dealers under Rule 15c3-3, the secured party could not lend, rehypothecate or use these assets in its business.

Allowing SB swap counterparties to post securities and other collateral through a special custody account at third-party bank custodian would be consistent with the requirement under Proposed Rule 18a-3 that the instruments be held in one of five specified ways – one of which is to be “in the custody or control of a bank as defined in section 3(a)(6) of the [Exchange] Act.”<sup>29</sup>

III. Tri-Party Collateral Arrangements Incorporate Significant Protections for Secured Party and Pledgor

A. Tri-Party Collateral Arrangements Provide Protections Against Operational Risk

By centralizing margin operations at a custodial bank, counterparties can more easily standardize transfer times, minimize transfer errors, facilitate cross-product netting of collateral posted and received and provide for transparency through online custodial systems and confirmations. As the custodial banks have proven in the tri-party repo market, they are well positioned to process multiple transactions simultaneously on their books and offer streamlined and automated collateral allocation and substitution capabilities.<sup>30</sup> Custodial banks also can offer economies of scale to counterparties and efficiencies based on the fact that they have existing systems to handle margining and appropriate staffing levels and expertise. Because the custodian is independent, custodial employees also may not have an incentive to expropriate customer margin if the SBSD experiences liquidity issues (*e.g.*, as was the case with MF Global).

By leveraging custodial infrastructures to handle margin transfers, investment of cash, and recordkeeping, counterparties can ensure that collateral is posted and returned (when no longer

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<sup>27</sup> Proposal, *supra* note 3, at 70278.

<sup>28</sup> In some cases a collateral control agreement will include a lien in favor of the custodian sufficient to cover advances made by the custodian or the custodian’s fees. Where this is included in the agreement, the secured party will typically require that the custodian subordinate its lien to that of the secured party.

<sup>29</sup> Proposal, *supra* note 3, at 70351.

<sup>30</sup> Task Force on Tri-Party Repo Infrastructure, Payments Risk Committee, Final Report, February 15, 2012.

needed) quickly and efficiently, and collateral posting can be minimized through netting collateral postings across positions and establishing a net equity (in a similar manner as contemplated by Regulation T and Rule 4210 of the Financial Industry Regulatory Authority (“FINRA”) in respect to broker-dealer margin accounts).<sup>31</sup> In addition, from an operational perspective, custodians significantly improve the margining process by facilitating efficient management of collateral (whether posted by a counterparty or an SBSB or MSBSP), transparency into collateral positions and robust operational infrastructures. Therefore, contrary to the Proposal’s suggestion that custodial arrangements increase systemic risk and, in particular, solvency risk in respect to SBSBs, the use of custodial arrangements reduces systemic risk, enhances the audit trail and ensures that security interests are properly perfected and available for a secured party to act on as a result of the “control” of collateral provided to the SBSB or MSBSP by the tri-party arrangement.

B. Collateral Held by a Custodian Allows the Pledgor (including an SBSB or MSBSP Posting to a Counterparty) to Manage Its Portfolio

Section 4(d) of the 1994 (New York Law version) ISDA Credit Support Annex, which is the collateral agreement customarily used by SBSBs, MSBSPs, and SB swap counterparties in the United States, provides for substitution of collateral upon notice to, but without consent from, the secured party. Although this provision may be modified by parties in Paragraph 13 of the Annex, the default provision allows for free rights of substitution of collateral. In practice, this provision allows the pledgor flexibility to reinvest collateral while maintaining collateral in the required amount at the custodian. This flexibility ensures that a pledgor – whether an SBSB, MSBSP or counterparty – can efficiently and effectively manage its portfolio and use its assets, even when those assets are subject to a lien. These arrangements mitigate the risk that posting of collateral, particularly by an SBSB or MSBSP, will cause a “liquidity drain.”<sup>32</sup> All of the major bank custodians have built on-line systems that provide real-time transparency into the substitution process, which benefits both the secured party and pledgor.

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<sup>31</sup> For a rule authorizing consolidation and netting across accounts, see FINRA Rule 4210(f)(5) (“When two or more accounts are carried for a customer, the margin to be maintained may be determined on the net position of said accounts, provided the customer has consented that the money and securities in each of such accounts may be used to carry or pay any deficit in all such accounts”).

<sup>32</sup> See Proposal, *supra* note 3, at 70267 (noting that commenters to margin proposals published by the Commodity Futures Trading Commission (“CFTC”) and the bank regulators indicated that requiring segregation of initial collateral, in particular, would cause “a massive liquidity drain” and would harm the marketplace by limiting the availability of swap collateral).

### C. Use of Tri-Party Collateral Arrangements Makes Customer Assets Readily Identifiable in Bankruptcy

Congress added an express segregation right for counterparties to SBSBs and MSBSPs for their non-cleared swaps initial margin to provide greater protections to counterparties upon the bankruptcy of an SBSB or MSBSP.<sup>33</sup> The SEC described the intent of segregation as generally facilitating identification of customer assets upon a broker-dealer's bankruptcy and increasing the possibility that the assets will be physically available at the bankrupt broker-dealer to be returned to the customer or transferred to a solvent institution.<sup>34</sup>

Bankruptcy treatment of SB swaps is subject to some uncertainty. SBSBs are subject to the stockbroker liquidation provisions of the U.S. Bankruptcy Code ("Bankruptcy Code"),<sup>35</sup> and Dodd-Frank suggests – although it has not yet been decided by a bankruptcy court – that both cleared and uncleared SB swaps and the related collateral should be deemed "securities accounts" as defined in the stockbroker liquidation provisions.<sup>36</sup> It is also not clear whether the SB swap positions and related collateral would be considered to be customer property for purposes of SIPA, which SBSBs may opt into by voluntarily becoming a member of the Securities Investor Protection Corporation ("SIPC"). The Proposal addressed the uncertainty in treatment under the Bankruptcy Code and under SIPA by requiring counterparties of SBSBs who have elected to segregate initial margin to agree to subordinate their claims against the SBSB to the claims of all SB swap counterparties of the SBSB to the extent that the segregated assets are not treated as customer property in a liquidation of the SBSB.<sup>37</sup>

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<sup>33</sup> Proposal, *supra* note 3, at 70275 ("The objective of individual segregation is for the funds and other property of the counterparty to be carried in a manner that will keep these assets separate from the bankruptcy estate of the SBSB or MSBSP if it fails financially and becomes subject to a liquidation proceeding. Having these assets carried in a bankruptcy-remote manner protects the counterparty from the costs of retrieving assets through a bankruptcy proceeding caused, for example, because another counterparty of the SBSB or MSBSP defaults on its obligations to the SBSB or MSBSP").

<sup>34</sup> Proposal, *supra* note 3, at 70276 ("Rule 15c3-3 requires a broker-dealer that maintains custody of customer securities and cash (a 'carrying broker-dealer') to take two primary steps to safeguard these assets. The steps are designed to protect customers by segregating their securities and cash from the broker-dealer's proprietary business activities. If the broker-dealer fails financially, the securities and cash should be readily available to be returned to the customers. In addition, if the failed broker-dealer is liquidated in a formal proceeding under SIPA, the securities and cash should be isolated and readily identifiable as 'customer property' and, consequently, available to be distributed to customers ahead of other creditors").

<sup>35</sup> Proposal, *supra* note 3, at 70274.

<sup>36</sup> *Id.* The term "securities account" is used in Section 741 of the Bankruptcy Code in defining the terms "customer" and "customer property."

<sup>37</sup> The logic of requiring subordination is that the counterparty should not need the benefit of priority status with respect to posted collateral upon the bankruptcy of an SBSB because the segregated assets should be treated as bankruptcy remote as a result of the tri-party arrangement. In light of the uncertainty regarding treatment in bankruptcy, the SEC added this conditional waiver and provided that, if the segregation is not effective in treating the counterparty assets as being outside of the bankruptcy estate, then the counterparty will be treated as having a *pro rata* priority claim to customer property. See Proposed Rule 18a-4 and Proposal, *supra* note 3, at 70287-70288.

In light of the clear intention of Congress to provide greater protection to counterparties to non-cleared SB swaps in bankruptcy of an SBSB or MSBSP by the grant of a segregation right for initial margin, the Commission should encourage the use of the existing right of segregation under section 3E(f) of the Exchange Act by not imposing capital charges. The Commission should provide for expanded use of tri-party arrangements, in respect to both initial and variation margin. The broader availability of tri-party arrangements would protect all types of counterparties to SB swaps (including SBSBs and MSBSPs) upon the bankruptcy of the counterparty to which their collateral has been pledged. The fact that the bankruptcy treatment of counterparty assets upon the bankruptcy of an SBSB is subject to some uncertainty is not a reason to reject this approach. The Commission has addressed the uncertainty through its proposed subordination requirement. Moreover, it is clear that counterparties as well as the market generally would benefit as result of the stronger and more equitable bankruptcy process that would be possible when counterparty property is readily identifiable, not commingled with assets of the debtor and not available for misuse by the debtor as it is heading towards insolvency.

IV. Use of Tri-Party Collateral Arrangements is Well Understood by Market Participants and Will Likely be Expanded with Implementation of Dodd-Frank Rules

Control agreements are widely used with respect to non-cleared derivatives transactions. As noted above, registered funds are required to use these arrangements to comply with Section 17(f) of the ICA.<sup>38</sup> Pension funds and other institutional investors often rely on the arrangements as well. Control agreements typically include standard, contractual terms that make clear that collateral is pledged for the benefit of the secured party and ensure that both the pledgor and secured party have the benefits of the arrangement but are protected against misuse of the collateral by the other party.

ISDA recently published a standard form of control agreement as a result of a three-and-a-half-year long project involving dealers, buy-side counterparties and custodians.<sup>39</sup> The ISDA model form is designed to be supplemented by an annex that is agreed between the parties so that the agreement may be customized.<sup>40</sup> The model form is clear, easy to negotiate (since the Annex includes selection menus) and fully compliant with UCC requirements to ensure that the secured party has a perfected priority security interest in the collateral.

Tri-party arrangements are tailored to work with the ISDA master agreement and other standard documentation to provide predictability regarding default and early termination triggers and

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<sup>38</sup> See *supra* note 12 and accompanying text.

<sup>39</sup> Although the ISDA form of control agreement was designed for use in connection with posting of initial margin by the counterparty, the form could be adopted for other situations, including for posting of variation margin by the counterparty and for posting of both initial and variation margin by the dealer.

<sup>40</sup> See *ISDA Publishes ISDA 2013 Account Control Agreement (ACA)* at [press@ISDA.org](mailto:press@ISDA.org).

remedies. The documentation allows a secured party to act quickly in liquidating collateral so as to mitigate market risk. Under the 2002 ISDA Master Agreement, bankruptcy defaults take effect without notice although other defaults, as well as termination events, require written notice by the non-defaulting party to the defaulting party. Payments are due with respect to defaults on the date specified by the non-defaulting party (which may be the date of the bankruptcy or notice) or two business days later, with respect to a termination event. Standard control agreements, including the ISDA model template, provide for immediate enforcement of a notice of exclusive control by the custodian so that a defaulting party may not withdraw assets. There is little or no practical difference in timing between exercise of default remedies when collateral is held under a custodial arrangement and when collateral is held directly by a secured party.

#### V. Recommended Terms to Include in Tri-Party Collateral Arrangements

For the reasons discussed above, we believe that the Commission should confirm that tri-party agreements satisfy the requirements in Proposed Rules 18a-3 and 18a-4. If the Commission believes certain mandatory terms are necessary in such agreements,<sup>41</sup> we recommend the following provisions for the protection of both counterparties:<sup>42</sup>

- *Account Plating.* A control agreement would provide that the account be appropriately labeled by the custodian to reflect the pledge relationship, the name of the secured party and the name of the pledgor (i.e., “[Name of Pledgor] for the benefit of [Name of Secured Party], as pledgee”). Labeling in this manner: (i) clarifies that the pledgor has pledged and not sold the assets; (ii) avoids confusion from a tax perspective regarding beneficial ownership; and (iii) identifies the lien and nature of secured party’s interest in the account.
- *Compliance with Entitlement Orders.* The control agreement would prohibit the custodian from accepting instructions with respect to the account from persons other than the secured party and the pledgor. Until the occurrence of an event of a default, termination event or “specified condition” under the ISDA Master Agreement<sup>43</sup> between the secured

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<sup>41</sup> We recommend that the Commission require that segregation be subject to a written agreement that includes the custodian as a party. *See* CFTC Protection of Collateral Release, *supra* note 7, at 66627 (CFTC recently adopted rules to require written agreements that include the custodian as a party in respect to tri-party arrangements for initial collateral for swaps).

<sup>42</sup> The ISDA model form includes all of the protective provisions described below (other than collateral substitution, which is addressed in the ISDA Credit Support Annex rather than in the model control agreement).

<sup>43</sup> “Termination events” are defined in Section 5(b) of the ISDA Master Agreement and include events such as illegality, force majeure and events that the parties define, such as a debt ratings downgrade or a drop in a party’s net asset value. The term “specified condition” is defined in the Credit Support Annex to the ISDA Master Agreement to mean an event that excuses obligations of parties to post or return collateral and triggers a right to terminate the affected transactions. Specified conditions are selected by parties to the Master Agreement, and include events such as illegality, a change in tax laws, and a credit deterioration as a result of a merger.



party and the pledgor (a “Notice of Exclusive Control” or “NEC Event”), the custodian would be allowed to accept instructions from both the secured party and the pledgor. The secured party would covenant not to issue such instructions unless and until the occurrence of an NEC Event, but the custodian would be obligated to follow instructions even if the secured party breached its covenant. In the absence of an NEC Event, the pledgor would agree with the secured party to provide only limited instructions allowing it to substitute collateral of equal value in accordance with procedures agreed with the secured party. The control agreement would clearly prohibit the custodian from accepting any further instructions from the pledgor upon the occurrence of an NEC Event.<sup>44</sup>

- *Specified Withdrawal Rights.* A control agreement would include a restriction on the ability of the pledgor to withdraw collateral except in the event that the pledgor simultaneously substitutes for the withdrawn collateral eligible collateral of equal value.
- *Notice of Exclusive Control.* A control agreement would include a provision allowing the secured party to obtain exclusive control over the pledgor’s posted collateral through an NEC. The terms would specify that custodian has no right to question the right of the secured party to submit the NEC, and the custodian would be obligated, upon receipt from the secured party to do so, immediately to turn over possession of the collateral to the secured party and take any other steps requested to liquidate the collateral and use such proceeds to pay to the secured party all amounts owed by pledgor. The agreement would include a covenant by the secured party not to submit an NEC unless an NEC Event has occurred and is continuing.
- *Custodian Covenants.* A custodian would be required to covenant not to hold a lien over the account or its assets or if the parties agree that custodian may have a limited lien (*e.g.*, to cover custodial fees and overdraft lines), the custodian would expressly subordinate its right and lien to that held by secured party.<sup>45</sup>

With respect to other “margin” accounts, the broker-dealer community has at times been reluctant to allow customers to post margin and collateral through a tri-party custody arrangement for

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<sup>44</sup> This language typically reads as follows: “The Custodian hereby acknowledges the security interest granted to Secured Party by Pledgor in the Posted Collateral. The Custodian will comply with the “entitlement orders” (as defined in Section 8-102(a)(8) of the Uniform Commercial Code of the State of New York) concerning the Account originated by Secured Party without further consent by Pledgor until this Agreement is terminated as provided herein. Except for substitution of collateral, as provided in section \_\_\_\_\_, the Custodian agrees not to act on entitlement orders or other instructions originated by any other person with respect to the Account unless it has received the prior written consent of the Secured Party.”

<sup>45</sup> Other provisions that counterparties and dealers often require in connection with tri-party collateral arrangements are: (i) a representation that the custodian is not an affiliate of either of the other parties; (ii) a representation that the custodian is a bank, as defined in the Exchange Act; and (iii) a covenant by the custodian to hold the collateral in the United States.

securities margin accounts because these arrangements restrict the ability of the broker-dealers to freely use customer collateral to finance their own operations. Because of these concerns, broker-dealers have recommended that the tri-party arrangements that are required to be used with respect to collateral posted by registered funds be subject to a number of unnecessary requirements that are inconsistent with the requirements on registered funds and do not reflect the realities of commercial law. For example, broker-dealers have proposed that (1) customers not be allowed to withdraw assets from the account even though the assets are in excess of the applicable margin requirements,<sup>46</sup> (2) collateral substitutions and investments of customer cash in money market instruments be prohibited unless the broker-dealer provides an instruction allowing for such withdrawals,<sup>47</sup> and (3) broker-dealers be able to freely use and invest the collateral for their own benefit (*i.e.*, rehypothecate the posted collateral).<sup>48</sup> We recommend that the SEC not adopt these or impose any other restrictions on tri-party arrangements beyond those we have suggested above. We believe concerns about broker-dealer financing should not be addressed by imposing unnecessary requirements on tri-party arrangements and such unnecessary terms should not be carried over to tri-party collateral arrangements for SB swap transactions.

## VI. Conclusion

We strongly urge the Commission to recognize and encourage the use of tri-party collateral arrangements for both initial and variation margin in connection with both cleared and non-cleared SB swaps. In addition, the Commission should not impose a capital charge on an SBSB or MSBSP for transactions for which its counterparty elects to have its collateral held at an independent custodian. A capital charge is unnecessary given the legal recognition that a secured party under a tri-party control agreement has the same right to control the collateral as if the secured party held physical possession of the collateral or held the collateral in an account in the secured party's name at its own custodian.<sup>49</sup> Imposing a capital charge also is inconsistent with the intent of Congress in granting an explicit right, under the Dodd-Frank Act, for counterparties to hold initial margin at an independent, third-party custodian.

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<sup>46</sup> This limitation is stricter than the rules regarding customer withdrawals from margin accounts under Regulation T and FINRA Rule 4210, which allow for withdrawals without consent. *See, e.g.*, FINRA Rule 4210(b).

<sup>47</sup> As discussed above, the flexibility to provide for substitution of collateral and investment of cash in money market instruments is important to fiduciaries in managing registered funds or other types of funds and customer assets to manage the portfolio and provide for reasonable returns on the posted collateral.

<sup>48</sup> Compare this term to Rule 17f-6 under the ICA, which provides that margin delivered to a futures commission merchant ("FCM") by a registered fund may be invested by the FCM only in accordance with strict limitations provided under rules of the CFTC.

<sup>49</sup> UCC Official Comments to Section 8-106, Comment 7.

Ms. Elizabeth M. Murphy  
December 5, 2013  
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We appreciate the opportunity to provide supplemental comments on the Proposal. If you have any questions on our comment letter, please feel free to contact me at (202) 326-5815, Sarah Bessin at (202) 326-5835, or Jennifer Choi at (202) 326-5876.

Sincerely,

/s/

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General Counsel

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The Honorable Daniel M. Gallagher  
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