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

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Via Electronic Submission: https://comments.cftc.gov

David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street N.W.
Washington, DC 20581

Re: Notice of Proposed Rulemaking on Protection of Collateral of Counterparties to Uncleared Swaps

Dear Mr. Stawick:

Managed Funds Association ("MFA")[1] appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the "Commission") on its December 3, 2010 Notice of Proposed Rulemaking on *Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy* (the "Proposed Rule").[2] MFA strongly supports the goals of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")[3] to enhance transparency and reduce systemic risk. In addition, we generally support measures aimed at increasing protections for counterparty assets posted as collateral for uncleared swaps. To that end, MFA believes that it is essential for swap counterparties to have the right to elect individual segregation of initial margin for uncleared swaps on commercially reasonable terms. Such individual segregation not only protects counterparty property in the event of a swap dealer ("SD") or major swap participant ("MSP") default, but also ensures stability and integrity in the over-the-counter ("OTC") derivatives markets.

Accordingly, we strongly support the Proposed Rule. We also appreciate the opportunity to offer our views on various aspects of the Proposed Rule that we believe will enhance it and

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1 MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.9 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

2 75 Fed. Reg. 75432.

3 Pub. L. 111-203, 124 Stat. 1376 (2010).

assist the Commission in adopting a final rule that is in the best interests of counterparties and the overall functioning of the marketplace.

I. Tri-Party Agreements

While the Proposed Rule seems to imply that an SD or MSP is required to offer segregation of initial margin to its counterparty in the form of a tri-party agreement among the SD or MSP, the counterparty and the custodian,[4] we believe that the Proposed Rule should be clarified to explicitly require that the custody of initial margin be pursuant to a tri-party agreement. We believe that this is the clear intent of the language in Section 23.602(b), that "any agreement for the segregation of Margin pursuant to this Section shall be in writing, [and] shall include the custodian as a party". Further, this position is consistent with statements of the Commission and staff during the discussions preceding the vote on issuance of the Proposed Rule.[5]

Many of our largest members have already negotiated tri-party agreements with respect to their initial margin for uncleared swaps, but we believe all counterparties should have the right to these protections. If counterparties to a swap are not parties to the custodial agreement (*i.e.*, are not in contractual privity with the custodian), then the SD or MSP essentially maintains exclusive control over its counterparties' collateral and the counterparties will not be able to protect their rights to their initial margin. Therefore, tri-party custodial arrangements best accomplish the Dodd-Frank objective of protecting counterparties.[6] Allowing SDs or MSPs to establish segregation arrangements inconsistent with that objective would frustrate Congressional intent and harm counterparties and the markets.

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[4] We note that an MSP may be the counterparty of an SD. In those circumstances, an MSP ought to be entitled to the same protection as other counterparties with regard to the segregation of its initial margin. The Proposed Rule implies equivalence between an MSP and an SD, but this will not always be the case. Generally, SDs are market makers, while MSPs are non-dealers with substantial positions in swaps. Thus, since there are fundamental differences in the businesses, structures and other characteristics of SDs and MSPs, the Commission should not use the same regulatory regime to oversee such different market participants.

[5] *See* CFTC Webcast Archive, November 19, 2010 Open Meeting on Fifth Series of Proposed Rules under the Dodd-Frank Act, *available at* http://www.capitolconnection.net/capcon/cftc/111910/wmarchive.htm, where in attempting to ensure that the Proposed Rule permitted the use of tri-party agreements, Commissioner Chilton asked Commission staff whether the Proposed Rule forestalled the use of such. In responding to Commissioner Chilton's question, Robert B. Wasserman, Commission Associate Director, Division of Clearing and Intermediary Oversight, stated that, with respect to initial margin, the Proposed Rule provides counterparties the right to elect to require segregation of their initial margin posted as collateral for uncleared swaps. Continuing, he asserted that, if a counterparty elects such segregation, the Proposed Rule requires a tri-party agreement with the SD, the counterparty, and the custodian.

[6] Section 724(c) of the Dodd-Frank Act, enacting Section 4s(l) of the Commodity Exchange Act ("CEA"), provides that "at the request of a counterparty to a swap that provides funds ... to a swap dealer or major swap participant to margin … the obligations of the counterparty, the swap dealer or major swap participant shall segregate the funds … for the benefit of the counterparty" and shall do so with an "independent third-party custodian."

II. Availability of Commercially Reasonable Terms and Use of Independent Custodian

To ensure that the Congressional intent underlying new CEA Section 4s(l) is reflected in the marketplace, the Commission must ensure that the segregation of collateral posted in connection with an uncleared swap is available on commercially reasonable terms. The Commission can assure such availability by: (i) providing counterparties the right to choose a qualified custodian that is unaffiliated with, and independent of, their SD or MSP counterparty; and (ii) requiring that an SD or MSP disclose to its counterparties all costs, if any, that the SD or MSP will charge to the counterparty for electing the use of a segregated account in advance of the decision to segregate and the selection of a custodian.

The Proposed Rule requires that an SD or MSP obtain confirmation from its counterparty regarding the counterparty's election to segregate any initial margin before the parties confirm the terms of a swap.[7] MFA agrees with this requirement, although we have no particular view as to the frequency at which an SD or MSP should provide notice to its counterparty of its right to segregate initial margin, the seniority of the counterparty's officer that receives such notice, or the time period for confirming the counterparty's election. As a guiding principle, the Commission should resolve all of these issues in a manner that provides counterparties with commercially reasonable opportunities to make informed elections regarding the segregation of collateral. Our one specific request is that the Commission affirmatively require that SDs and MSPs act on an election to segregate initial margin within a commercially reasonable time.

A. Designation of Independent Custodian

As required by the Dodd-Frank Act, the Commission is seeking to implement rules that facilitate the segregation of initial margin with an "independent third-party custodian".[8] With respect to selecting the custodian, we recommend that the Commission clarify that neither party to an uncleared swap has the right to dictate the designation of a custodian pursuant to Section 4s(l) of the CEA. Each of the SD, MSP and counterparty has a unique interest in choosing a custodian. Accordingly, to balance the parties' interests, we propose that the Commission require that an SD or MSP offer its counterparty at least two unaffiliated, independent bank or trust company custodial options. In addition, an SD or MSP should not have the right to unreasonably refuse a custodian chosen by the counterparty (that is different from the ones proposed by the SD or MSP) so long as the custodian meets certain criteria, discussed below.[9] This approach assures that any custodian chosen is acceptable to both parties to the swap contract.

We acknowledge that the use of a custodian affiliated with the SD or MSP may be convenient under certain circumstances. Therefore, we do not object to the use of an affiliated

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[7] Proposed Rule 23.601(d).

[8] *See* Section 724(c) of the Dodd-Frank Act adding Section 4s(l)(3) of the CEA.

[9] Counterparties, for example, may find it more efficient to use a single custodian for all of their collateral covering multiple SDs or MSPs, so ensuring the viability of their proposal is important.

custodian in all cases. However, we believe that the final rule adopted by the Commission should provide that, if the SD or MSP proposes an affiliated custodian, then the affiliate must be one of at least three custodial options (rather than one of two options as discussed above). This practice will prevent SDs and MSPs from effectively dictating the use of specific or affiliated custodians. Further, when defining what constitutes an "independent third-party custodian", we suggest that the Commission's rules related to independence focus on control rather than mere ownership.

The Commission should also require that each custodian offered by an SD or MSP meets certain uniform criteria in order to promote common standards across different custodial options, whether affiliated or unaffiliated, and ensure consistent baseline offerings by SDs and MSPs to all counterparties. For example, we suggest that the Commission specify that the custodian must be regulated by a federal or state bank regulator, be authorized under federal or state laws to exercise corporate trust powers, and have equity of at least $200,000,000.

B. Costs

MFA respectfully recommends that the Commission require SDs and MSPs to provide counterparties with robust disclosure of all costs that the SD or MSP will charge to the counterparty if the counterparty elects to segregate its initial margin. With respect to such disclosure, the Commission should require the SD or MSP:

i. To present costs on an itemized basis and include fees and expenses of each proposed custodian option;

ii. To itemize any incentives, benefits or income that the SD or MSP will receive should a counterparty select a particular custodian; and

iii. To provide this disclosure to its counterparties sufficiently in advance of the initial transaction between the parties to give each counterparty sufficient time to evaluate alternatives, ask questions, negotiate terms and make an informed decision.

In addition, we respectfully ask the Commission to adopt rules that would prohibit the SD or MSP from requiring that the counterparty keep the cost disclosure statement confidential. If confidentiality were to become standard market practice, it would likely have a negative impact on competition among the SDs and MSPs in providing segregation.

Currently, our members with tri-party custody arrangements in place for the segregation of their uncleared swap initial margin typically do not pay any additional amounts to their respective dealer counterparties, but rather pay only reasonable custodial fees directly to their custodian. However, we are concerned that if the Commission should decline to adopt our recommendations, SDs and MSPs might choose to provide segregation at such an unreasonable price that it would effectively preclude counterparties from choosing segregation.

III. Preservation of Negotiated Counterparty Protection Agreements

MFA applauds the principle inherent in the Proposed Rule that counterparties should have the option of maximum protection for their collateral. Therefore, as discussed herein, we recommend that the Commission revise the Proposed Rule to codify the right to a tri-party custodial arrangement. However, we recognize that tri-party agreements are only one of several arrangements through which counterparties might protect their collateral delivered as margin for uncleared swaps. As a result, we appreciate that the Commission has retained the flexibility for counterparties to accept a less secure form of segregation. Moreover, we agree that the Proposed Rule should not limit or impede market participants' ability to negotiate each term related to the protection of their collateral posted for uncleared swaps because counterparties should have the freedom to use any form of negotiated collateral arrangement, not just those arrangements contemplated by the Proposed Rule.

IV. Variation Margin

New Section 4s(l)(2)(B) of the CEA clearly limits any segregation rights to initial margin.[10] MFA supports this limitation and agrees that it would be inappropriate to mandate segregation of variation margin. Thus, we support the Commission's decision to provide counterparties to uncleared swaps with the flexibility to negotiate separately the terms for the treatment of variation margin.

V. Release of Margin

To ensure that an SD or MSP has recourse to initial margin only when appropriate, the Proposed Rule requires that the custody agreement provide that turnover of control occur upon presentation of a written statement, signed under penalty of perjury, that a counterparty default has occurred. While MFA supports the use of sanctions (such as fines or the revocation of licenses) for taking improper recourse to collateral, it is not entirely clear that criminal sanctions, such as perjury, would be more effective in deterring parties from taking remedial actions preemptively or prematurely.

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[10] Section 724(c) of the Dodd-Frank Act, enacting new CEA Section 4s(1)(2)(B)(i) provides that "[t]he requirements described in paragraph (1) [SEGREGATION OF ASSETS HELD AS COLLATERAL IN UNCLEARED SWAP TRANSACTIONS] shall not apply to variation margin payments".

MFA appreciates the opportunity to comment on the Proposed Rule and respectfully submits these comments for the Commission's consideration. We would be pleased to meet with the members of the Commission or its staff to discuss our comments. If the Commission members or staff have any questions, please do not hesitate to call Carlotta King or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

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

cc: The Hon. Gary Gensler, Chairman
The Hon. Michael Dunn, Commissioner
The Hon. Bart Chilton, Commissioner
The Hon. Jill E. Sommers, Commissioner
The Hon. Scott D. O'Malia, Commissioner