INVESTMENT COMPANY INSTITUTE

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August 8, 2011

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions (RIN 3038-AC99)

Dear Mr. Stawick:

The Investment Company Institute[1] ("ICI") appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("Commission" or "CFTC") Notice of Proposed Rulemaking ("NOPR") on the appropriate model for protecting the margin collateral posted by customers for cleared swap transactions.[2] Pursuant to Section 724 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the Commission must develop a regulatory structure for cleared swaps that promotes safety and soundness, including protection of cleared swaps customer collateral.[3]

Our members – registered investment companies – use derivatives as a means to pursue their stated investment objectives, policies, and strategies for efficient portfolio management purposes, often by hedging their investments from a decline in value.[4] Accordingly, we have a strong interest in the

[1] ICI 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 $13.1 trillion and serve over 90 million shareholders.

[2] CFTC Notice of Proposed Rulemaking: Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 76 Fed. Reg. 33818 (June 9, 2011).

[3] Section 724 of the Dodd-Frank Act is codified in Section 4d(f) of the Commodity Exchange Act ("CEA"), as amended.

[4] *See* Report of the Task Force on Investment Company Use of Derivatives and Leverage, Committee on Federal Regulation of Securities, ABA Section of Business Law, July 6, 2010. The issues discussed in the NOPR impact all registered

safety and soundness of the derivatives markets. For this reason ICI submitted a comment letter in response to the Commission's Advance Notice of Proposed Rulemaking (the "ANPR").[5] We commend the Commission for its efforts to seek public input on this issue, including holding meetings with relevant industry groups, conducting public roundtables on the protection of cleared swaps customer collateral, and issuing the ANPR to request public comment on a number of approaches to protect cleared swaps customer collateral.

Based upon our desire to minimize potential market disruption as standardized swaps migrate from bilateral transactions executed in the over-the-counter ("OTC") market to the framework of centralized clearing and exchange trading, as contemplated by the Dodd-Frank Act, and mindful of the costs this migration will entail, ICI believes that the model referred to in the NOPR as the Complete Legal Segregation Model and in the ANPR as Legal Segregation With Commingling, hereinafter, "LSOC," is at this time the most appropriate model for protecting margin posted by customers clearing swap transactions. ICI therefore recommends that the Commission adopt LSOC and that it do so in a timely manner because the marketplace needs sufficient time to begin implementing the operational and systems infrastructure necessary to facilitate a smooth transition to clearing, particularly with respect to the protection of cleared swaps customer collateral.

I. Background

Notwithstanding our preference for LSOC, ICI believes that the model referred to in the NOPR as the Physical Segregation Model and in the ANPR as the Full Physical Segregation Model, hereinafter, "Full Physical Segregation," would potentially provide the maximum protection for customer collateral. The NOPR notes that the Commission believes that the language of Section 4d(f) of the CEA supports consideration of the current OTC market practice for protecting counterparty margin as the appropriate starting point.[6] We agree. In this regard, Full Physical Segregation is the model most consistent with the current OTC market practice where funds post initial margin for OTC swap transactions in individual, segregated accounts at third-party custodians. Accordingly, ICI believes the Commission should continue to consider the Full Physical Segregation model for protection of customer collateral.

ICI is mindful, however, that Full Physical Segregation might impose costs and operational burdens on all market participants, including customers, and the derivatives industry as a whole that do

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investment companies, including mutual funds, closed-end funds, and ETFs. For purposes of this letter, we will refer to registered investment companies as "funds."

[5] *See* Advance Notice of Proposed Rulemaking for Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies, 75 Fed. Reg. 75162 (December 2, 2010) and Letter from Karrie McMillan, General Counsel, Investment Company Institute, to David A. Stawick, Secretary, Commodity Futures Trading Commission, dated January 18, 2011.

[6] 76 Fed. Reg. 33818 at 33825.

not currently exist in the OTC market. During the Commission's October 22, 2010 Staff Roundtable on Individual Customer Collateral Protection (the "Roundtable"), several participants indicated that if Full Physical Segregation was implemented, initial margin levels for cleared swap transactions would increase by more than 50 percent, and would undoubtedly have other effects, such as an increase in derivatives clearing organization ("DCO") guaranty fund contribution levels applicable to futures commission merchant ("FCM") members.[7] While we cannot be sure as to what the costs would be, it is likely that initial margin levels would increase under such a revamped model. There would also likely be significant operational and infrastructure costs associated with Full Physical Segregation, including, but not limited to, the establishment of multiple customer accounts at each DCO, FCM and settlement bank, across all asset classes. Although funds may be willing to bear these additional costs and, in fact, funds currently incur costs for the use of individual, segregated accounts at tri-party custodians to post their initial margin for their uncleared OTC swap transactions, the majority of funds believe that the cost-benefit analysis, driven by the best interests of their shareholders, weighs in favor of LSOC for cleared swap transactions.

Consequently, we recommend that the Commission move forward with LSOC at this time rather than the alternatives it is continuing to consider, namely, (i) a modified LSOC model under which a DCO would be permitted to access the collateral of the non-defaulting cleared swaps customers of a defaulting member FCM, after it applies its own capital to cure the default and also the guaranty fund contributions of its non-defaulting FCM members and (ii) a model permitting each DCO to choose the level of protection that it would provide cleared swap customer collateral of its FCM members.[8] Of these three alternatives, we agree with the Commission that LSOC, subject to addressing the concerns discussed below, strikes the best balance between benefits and costs in order to protect cleared swaps customers' collateral because it would mitigate the risk that a DCO would access the collateral of non-defaulting cleared swap customers to cure an FCM default, also referred to as "Fellow-Customer Risk."

II. LSOC

A. Investment Risk

Although LSOC generally would mitigate Fellow-Customer Risk, LSOC would not eliminate the risk that each cleared swaps customer would share *pro rata* in any decline in value of FCM or DCO investments made with collateral posted by customers in connection with cleared swaps, also referred to as "Investment Risk."[9] Section 4d(f) of the CEA permits FCMs and DCOs to invest cleared swaps

[7] A transcript of the Roundtable is available at http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission6_102210-transcrip.pdf.

[8] 76 Fed. Reg. 33818 at 33819. These latter two are referred to in the NOPR as the Legal Segregation With Recourse Model (Moving Customers to the Back of the Waterfall in the ANPR) and the Optional Model, respectively.

[9] *See* 76 Fed. Reg. 33818 at 33821, 33826 and 33827.

customers' collateral in limited enumerated investments and the Commission is proposing that such instruments include those referenced in CFTC Rule 1.25.[10]

As noted above, swaps customers in the current OTC market are able to segregate all posted margin for OTC swap transactions with independent third-party custodians and they are generally able to negotiate the rehypothecation options with their counterparties (*i.e.,* direct the investments in which such margin may be invested pursuant to bilateral agreement). Given that LSOC would involve some mutualization of Investment Risk among cleared swaps customers, ICI recommends that the Commission, as well as the relevant self-regulatory organizations, undertake to monitor closely FCMs' and DCOs' investment of cleared swaps customers' collateral as part of a comprehensive regulatory framework for the protection of cleared swaps customer collateral. It would be unfortunate if in moving to centralized clearing, swaps customers lose control over the instruments in which their collateral is invested, potentially subjecting them to asset classes with a risk profile outside of their investment mandate.

ICI recognizes that the Commission is currently considering amendments that would narrow the scope of permissible investments under CFTC Rule 1.25. Some ICI members have concerns regarding the scope of permissible investments under CFTC Rule 1.25, such as the credit, currency and duration risk of such instruments, even as proposed to be amended, in the context of investment and rehypothecation of cleared swaps customer collateral. To provide an opportunity to fully address these concerns in light of the Commission's current proposal on protecting cleared swaps customer contracts and collateral, ICI recommends that the Commission reopen the comment period on its proposal to amend Rule 1.25.[11]

B. <u>One Day Risk</u>

While LSOC would mitigate Fellow-Customer Risk in most cases, it would not entirely eliminate this risk. In the event of a default by a member FCM, a DCO would allocate collateral of the defaulting FCM between the FCM's defaulting and non-defaulting cleared swap customers based upon the data provided by the FCM to the DCO the day prior to default. Therefore, such allocation would not reflect movement in the FCM's cleared swaps portfolio of such customers on the day of the default. The Commission recognizes that this allocation would not reflect any such movement.[12] This "one-day lag" could be significant, especially during periods of market volatility. For this reason, ICI recommends that the Commission consider additional means of mitigating this risk, if possible.

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[10] *See* 17 C.F.R. 1.25. *See also* Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions, 75 Fed. Reg. 67642 (November 3, 2010) ("CFTC 1.25 Proposal") (the Commission is proposing to amend CFTC Rule 1.25 to narrow the scope of permissible investments in certain respects to limit the use of instruments that may pose a significant risk to market participants).

[11] *See* CFTC 1.25 Proposal, *supra* note 10.

[12] *See* 76 Fed. Reg. 33818 at 33826 and 33827.

First, ICI recommends that in addition to the consideration of stringent and enforceable recordkeeping standards to ensure that the DCO has complete, accurate and timely records of the FCM's individual cleared swaps customer positions and margin levels (as discussed in the next paragraph), the Commission consider requiring the FCM to transmit such records to the DCO as frequently as technologically feasible, and not merely at least once each business day. Second, if, in lieu of fully up-to-date records of client positions and margin at the time of a client default, there is an initial misallocation of customer property, the Commission should require such situation to be corrected as soon as practicable so that property of the non-defaulting customers is not applied to the obligations of the defaulting customer(s).

C. Reporting and Recordkeeping

The risk of inadequate or inaccurate reporting or recordkeeping is inherent in any custodial or trading relationship. Given the level of detailed information that will be required to ensure legal separation within a commingled account, however, accurate and timely reporting of position level data with respect to each underlying cleared swaps customer will be particularly important to the successful implementation of LSOC. It will be critical to the viability and success of LSOC that the Commission mandate reporting and recordkeeping requirements for this purpose and mandate that DCOs adopt and enforce rules which require their member FCMs to comply with the reporting and recordkeeping requirements. In that connection, we also urge the Commission to require DCOs to monitor their member FCMs for compliance with such rules, including periodic audits. Further, it will be vitally important that the Commission conduct stringent oversight of DCOs' compliance with their self-regulatory obligations in this area. We respectfully request that the Commission so provide in final rules.

D. Other Issues

Pursuant to prior precedent, a DCO is permitted to access the collateral of non-defaulting futures customers to cure a default in certain circumstances.[13] We therefore request that the Commission make clear in final rules implementing LSOC that the position set forth in Interpretative Statement No. 85-3 is not applicable to cleared swaps transactions or the collateral of cleared swaps customers of a defaulting member FCM of a DCO.

III. Optional Model

Pursuant to our comment letter in response to the ANPR, we continue to believe that, due to the legal, regulatory, operational, and other issues which would be presented, it would not be appropriate to implement individual customer collateral protection on an optional basis. In addition, optionality could result in a situation where the riskiest customers would opt into models providing for

[13] *See* CFTC Interpretative Statement No. 85–3, Regarding the Use of Segregated Funds by Clearing Organizations Upon Default by Member Firms (Aug. 12, 1985) ("Interpretative Statement No. 85-3").

Fellow Customer Risk and the more conservative customers would opt out of such models. This result could concentrate risk in the system. We can also see how due to competitive pressures, the more conservative customers that initially opted out of models providing for Fellow Customer Risk would eventually be compelled to opt into such models to keep their trading costs in line with their competitors.[14]

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If you have any questions on our comment letter, please feel free to contact me directly at (202) 326-5815 or Heather Traeger at (202) 326-5920.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel

cc: Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott D. O' Malia, Commissioner
Ananda Radhakrishnan, Director, Division of Clearing and Intermediary Oversight
Robert B. Wasserman, Associate Director, Division of Clearing and Intermediary Oversight

[14]If the operational, cost and other allocation issues could be sorted out so that only customers who chose a certain model would pay for the costs for that model, we could potentially be supportive of an optional model. At this point, we have not identified a means to isolate and ensure the separation of such costs.