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

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Via Electronic Submission: baselcommittee@bis.org
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Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

International Organization of Securities Commissions
C/ Oquendo 12
28006 Madrid
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Re: Basel-IOSCO Consultative Document on Margin Requirements for Non-Centrally-Cleared Derivatives

Dear Sir or Madam:

Managed Funds Association[1] welcomes the opportunity to provide comments to the Working Group on Margining Requirements of the Basel Committee of Banking Supervision and the International Organization of Securities Commissions ("**WGMR**") in response to its Consultative Document on "Margin Requirements for Non-Centrally-Cleared Derivatives" (the "**Consultation Paper**").[2] MFA strongly supports the efforts by the WGMR to provide for an international framework for measures to reduce risk in the derivatives markets. Indeed, MFA commends the commitment of the WGMR to establish a single unified framework that will provide a global standard for margining non-centrally-cleared derivative contracts ("**non-cleared derivatives**"). Accordingly, in providing comments to the Consultation Paper, MFA seeks to assist with the development of an effective, appropriate and consistent international regime for margin requirements for non-cleared derivatives.

Non-cleared derivatives provide an important, and at times the only practically available, mechanism for market participants to manage risk effectively. While MFA supports the

[1] Managed Funds Association ("**MFA**") represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent and fair capital markets. MFA, based in Washington, DC, is an advocacy, education and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and all other regions where MFA members are market participants.

[2] The Consultation Paper is available at: www.bis.org/publ/bcbs226.pdf.

transition of standardized derivatives to clearing, we appreciate that the WGMR recognizes that central clearing will not be suitable for all derivatives, and that market participants will therefore continue to use certain non-cleared derivatives to address specific risk scenarios on a bespoke basis. In light of the importance of the risk management function of non-cleared derivatives, MFA members welcome the initiative to establish a margin requirements framework for non-cleared derivatives that ensures that the margin requirements applied to non-cleared derivative transactions appropriately reflect and address the risks to the financial system presented by such transactions.

I. Executive Summary: Overarching Comments on the Margin Proposals in the Consultation Paper

MFA supports the efforts of the WGMR to provide for an international framework for bilateral exchange of initial and variation margin. MFA particularly supports the requirement to exchange variation margin on a bilateral basis, which reflects and reinforces the current market "best practice". However, MFA respectfully urges the WGMR to consider the cumulative effect of the Consultation Paper's further proposals on the liquidity of the non-cleared derivatives markets. The proposals should not unduly impinge on market participants' ability to transact on the non-cleared derivatives markets, given their critical role in allowing market participants to meet their risk management needs. Unless carefully managed and monitored, the aggregate impact of the proposals could place unwarranted burdens on market participants, particularly in the period before the market has transitioned to mandatory clearing. Thus, MFA respectfully urges the WGMR in the final recommendations to take into consideration the risk management needs of participants in the non-cleared derivatives markets and to avoid recommendations that could compromise their ability to manage risk effectively. Further, MFA looks forward to the results of the quantitative impact study to assess the effect of the proposed margining requirements on the orderly functioning and liquidity of the non-cleared derivatives markets, and urges the WGMR to consider the results of the study when finalizing the proposals.[3]

In light of our overarching concerns, and more specifically as set out below, we respectfully urge the WGMR in the final recommendations to take into consideration the importance and continued viability of certain non-cleared derivatives as customized risk management tools.

Initial margin. MFA supports the bilateral exchange of initial margin, provided that the initial margin requirements appropriately reflect and address the risks to the financial system presented by the relevant non-cleared derivative transaction. However, we are concerned that buy-side market participants will bear their sell-side counterparties' costs associated with negotiating, establishing and maintaining segregated custodian accounts for counterparties. We are also concerned that the increased cost of trading non-cleared derivatives could reduce liquidity and adversely impact market participants' ability to properly hedge their portfolios. We therefore respectfully request that the WGMR's final recommendations consider the overall cost and liquidity impact of the proposed margining requirements.

[3] *Id.* at 31.

Portfolio margining. MFA strongly supports the proposal to allow quantitative initial margin models to account for risk on a portfolio basis. For portfolio margining to achieve the intended risk offset benefits, initial margin models should account for risk offsets across suitably correlated cleared and non-cleared derivative and non-derivative products. MFA strongly believes that such portfolio margining within a single cross-product master netting agreement is instrumental in mitigating the potential shortfall in eligible collateral while still ensuring sufficient reserves to preserve systemic safety. Such portfolio margining arrangements account adequately for the risks of a portfolio, while avoiding the capital inefficiencies of over-collateralization. In addition, such portfolio margining arrangements encourage market participants to enter into mutually offsetting transactions, and to maintain balanced and appropriately hedged portfolios.

Margin thresholds. MFA does not believe that thresholds are an appropriate tool for managing the liquidity impact of the proposed initial margin requirements. We are concerned that the introduction of thresholds would result in counterparties being treated unequally, with some counterparties being required to post no initial margin, or a significantly reduced amount after application of a high threshold.

IM schedule. MFA welcomes the proposed option for market participants to choose between using an approved initial margin model or a standardized initial margin schedule. We include a proposed amended sample schedule introducing greater granularity to the initial margin requirements applicable to different asset classes. Such granularity would enhance the utility of the initial margin schedule to market participants.

Ongoing review of requirements. We believe that both the cleared and the non-cleared derivatives markets will undergo substantial evolution over the coming years. Accordingly, we recommend that the WGMR plan for a regular review and, when appropriate, periodic adjustment, of the international standards for margin requirements in response to developments in the non-cleared derivatives markets.

II. Uniformity of Regulation

MFA believes, as a general matter, that the derivatives markets operate most efficiently where the margin requirements are harmonized and applied uniformly with respect to all non-cleared derivatives. A uniform set of margin requirements will facilitate orderly collateral management practices. In the absence of such uniformity, market participants, including MFA members, will have to monitor and comply with multiple margin regimes, which would be administratively difficult, costly and burdensome, and may increase the likelihood for errors and instances of non-compliance. Further, margin requirements that differ according to the jurisdiction encourage regulatory arbitrage and create market advantages for market participants established in certain jurisdictions over other market participants. Accordingly, we urge regulators across jurisdictions to coordinate with each other in order to ensure a uniform set of margin requirements in non-cleared derivatives markets.

III. MFA Responses to the Consultation Paper Questions

Implementation

Q1. What is an appropriate phase-in period for the implementation of margining requirements on non-centrally-cleared derivatives? Can the implementation timeline be set independently from other related regulatory initiatives (e.g. central clearing mandates) or should they be coordinated? If coordination is desirable, how should this be achieved?

MFA believes that the implementation of the margin requirements should be coordinated with the implementation of the central clearing requirements to ensure that the higher margin requirements applicable to non-cleared derivatives do not apply before central clearing is required. MFA also believes that non-cleared margin levels should appropriately address the particular risks posed by the relevant non-cleared derivative transaction. Further, with respect to the appropriate implementation timeline, the final margin requirements for non-cleared derivatives should be implemented only after mandatory clearing is fully phased in for a particular class of derivatives, and should then apply to all relevant categories of market participants simultaneously. Application of the margin requirements for non-cleared derivatives before central clearing is required and the requisite central clearing infrastructure is in place could penalize market participants for dealing in non-cleared derivatives without central clearing being available. Similarly, inconsistent implementation of the margin requirements in different jurisdictions, or within jurisdictions by different regulatory authorities, might fragment and unnecessarily disrupt the operation of the markets in non-cleared derivatives.

Element 1: Instruments subject to the margin requirements

Q2. Should foreign exchange swaps and forwards with a maturity of less than a specified tenor such as one month or one year be exempted from margining requirements due to their risk profile, market infrastructure, or other factors? Are there any other arguments to support an exemption for foreign exchange swaps and forwards?

Subject to the modified application of the prescriptive initial margin model requirements, as discussed below, MFA believes that foreign exchange swaps and forwards, regardless of their maturity, should be subject to margining requirements. However, such margining requirements should be set at appropriate levels that take into consideration the unique liquidity characteristics of foreign exchange swaps and forwards as compared to other non-cleared derivatives. In MFA's view, while the risk profile of foreign exchange swaps and forwards may merit their exemption from the central clearing requirement, the counterparty credit risk associated with non-cleared foreign exchange swaps and forwards should nevertheless be effectively addressed by requiring the bilateral exchange of margin.

However, as certain non-cleared foreign exchange swaps and forwards, such as foreign exchange swaps or forwards on the currencies of the G7 countries, are highly liquid, it would not be appropriate to apply all of the prescriptive initial margin model requirements to them. For example, a ten-day liquidation horizon would be manifestly inappropriate in relation to a short-term (*e.g.*, 30-day tenor) U.S. dollar/Euro foreign exchange forward. MFA therefore recommends that the initial margin requirements applicable to foreign exchange swaps and

forwards be subject to the same liquidation time horizon as cleared derivatives, or lower, as appropriate.

Element 2: Applicability of margin requirements to different types of market participant

Q4. Is the proposed key principle and proposed requirement for scope of applicability appropriate? Does it appropriately balance the policy goals of reducing systemic risk, promoting central clearing, and limiting liquidity impact? Are there any specific adjustments that would more appropriately balance these goals? Does the proposal pose or exacerbate systemic risks? Are there any logistical or operational considerations that would make the proposal problematic or unworkable?

MFA supports the principle set out in the Consultation Paper that market participants that are financial firms, regardless of their type, size or systemic importance, as well as systemically important non-financial entities, be required to post initial and variation margin to secure their non-cleared derivative trades. MFA believes that if the initial and variation margin required is appropriately calculated and calibrated to reflect the risk profile of a particular non-cleared derivative trade, posting bilateral margin is an appropriate and effective tool to manage and reduce systemic risk. However, MFA believes that it is important to ensure that the margin requirements applicable to non-cleared derivatives appropriately reflect the risks presented by non-cleared derivatives to the markets. Such non-cleared margin levels should allow for the proper operation of the markets in those derivatives which are not suitable for central clearing and should not impair their liquidity.

Q5. Are initial margin thresholds an appropriate tool for managing the liquidity impact of the proposed requirements? What level of initial margin threshold(s) would be effective in managing liquidity costs while, at the same time, not resulting in an unacceptable level of systemic risk or inconsistency with central clearing mandates? Is the use of thresholds inconsistent with the underlying goals of the margin requirements? Would the use of thresholds result in a significant amount of regulatory arbitrage or avoidance? If so, are there steps that can be taken to prevent or limit this possibility?

Q6. Is it appropriate for initial margin thresholds to differ across entities that are subject to the requirements? If so, what specific triggers would be used to determine if a smaller or zero threshold should apply to certain parties to a non-centrally-cleared derivative? Would the use of thresholds result in an unlevel playing field among market participants? Should the systemic risk posed by an entity be considered a primary factor? What other factors should also be considered? Can an entity's systemic risk level be meaningfully measured in a transparent fashion? Can systemic risk be measured or proxied by an entity's status in certain regulatory schemes, e.g. G-SIFIs, or by the level of an entity's non-centrally-cleared derivatives activities? Could data on an entity's derivative activities (e.g. notional amounts outstanding) be used to effectively determine an entity's systemic risk level?

MFA strongly supports the equal treatment of market participants with respect to the appropriate margining requirements. As we view initial margin thresholds as unsecured credit extensions, we believe there is a risk of unequal treatment resulting in select counterparties not

collecting any initial margin, or significantly reduced amounts of initial margin, with respect to certain of their counterparties. This unequal treatment would create or exacerbate existing market asymmetries to the detriment of buy-side firms, including MFA members, and undermine the systemic risk reduction benefits of a truly universal requirement to exchange initial margin on a bilateral basis. We believe that bilateral initial margin exchange requirements should be applied consistently, subject to appropriate minimum transfer amounts ("**MTAs**"), rather than optional thresholds that would vary by type of counterparty. Indeed, it is current market practice to use MTAs to improve the operational efficacy of variation margin exchange. Thus, the use of MTAs for both initial and variation margin exchange would not result in a significant deviation from current market practice.

Q9. What are the potential practical effects of requiring universal two-way margin on the capital and liquidity position, or the financial health generally, of market participants, such as key market participants, prudentially-regulated entities and non-prudentially regulated entities? How would universal two-way margining alter current market practices and conventions with respect to collateralising credit exposures arising from OTC derivatives? Are there practical or operational issues with respect to universal two-way margining?

Current market practice. MFA welcomes the requirement for bilateral exchange of initial and variation margin in non-cleared derivatives transactions, provided that the margin requirements appropriately reflect the relevant risks associated with a particular derivative transaction. We applaud the WGMR for proposing universal two-way exchange of variation margin. In MFA's view, this requirement not only represents "best practice," but actually represents what has become standard practice, as a broad spectrum of market participants, including MFA members, currently exchange variation margin bilaterally for non-cleared derivatives. Bilateral variation margin exchange permits market participants to eliminate substantial counterparty credit risk by daily liquidating their obligations to each other arising through daily price variation of their bilateral contracts. In light of the substantial risk management benefits that the collection of variation margin offers, market participants in derivatives markets have historically exchanged bilateral variation margin and typically have in place efficient contractual arrangements and extensive operational infrastructure for such bilateral variation margin exchange. In addition, all market participants post variation margin to clearing houses when trading centrally cleared derivatives. The requirement to post bilateral variation margin for non-cleared derivatives therefore ensures such practice is consistently applied to both cleared and non-cleared derivatives. This requirement thus facilitates a more seamless transition as non-cleared derivatives that become clearing-eligible move to mandatory clearing.

Mandatory two-way exchange of variation margin reduces systemic and counterparty risk by preventing both regulated and unregulated market participants from accumulating an unlimited amount of unsecured obligations to their derivative counterparties. We believe that not requiring bilateral exchange of variation margin for non-cleared derivatives would be regressive in light of current market practice, could adversely affect market participants' counterparty and systemic risk management, and could distort the incentives for central clearing of derivatives.

We believe that the arguments above for the bilateral exchange of variation margin apply equally to the bilateral exchange of initial margin. However, if the proposals result in materially

higher initial margin requirements than under current market practice, this may severely limit the ability of market counterparties to transact in the non-cleared derivatives markets. Although it is current market practice for buy-side firms to post initial and variation margin to their counterparties, it is likely that buy-side firms will bear the bulk of the cost increases attributable to higher margin requirements and related operational costs across the market. In addition to the aggregate increase in their own trading costs, buy-side firms may also incur increased costs through adverse pricing as sell-side firms seek to pass on to their counterparties not only their increased margin and capital expenses, but also the significant costs associated with negotiating, establishing and maintaining thousands of segregated custodian accounts for counterparties as a result of the proposed initial margin requirements. In the aggregate such increased trading costs may be material and, if excessive, could limit access to the derivatives markets and therefore result in the non-cleared derivatives markets losing liquidity and depth. We therefore respectfully request that WGMR's final recommendations regarding the initial margin requirements take into account the overall cost and liquidity impact of the proposed margining requirements on buy-side firms.

Restrictions on market liquidity. Further, MFA is concerned that the universal two-way initial margin proposals may have the unintended consequence of limiting some existing sources of market liquidity. As bank/dealer counterparties do not currently post initial margin, the introduction of the new requirements to provide initial margin is likely to result in greater operational complexity and expense for those counterparties than is currently the case. This result may act as a disincentive for bank/dealer counterparties to enter into transactions that require more operational and capital resources. For example, in the case of the market for credit default swaps ("**CDS**"), most of the liquidity in the market is provided through novation of positions, and such novations are often entered into by two bank/dealer counterparties. Typically, when a CDS portfolio between original counterparties ("**Remaining Party**" and "**Party Stepping Out**") is novated to a new party ("**Party Stepping In**"), the Remaining Party and the Party Stepping In, as the novating parties, will subsequently exchange variation margin based on the new market value of the portfolio, including the market value of the novated transactions. Under the proposals set out in the Consultation Paper, the novating parties would also be required to exchange initial margin. As the initial margin will depend on the portfolio that is subject to the novation arrangements between the Remaining Party and the Party Stepping In, which portfolio may not be identical to the portfolio between the Remaining Party and the Party Stepping Out, the initial margin requirements relating to the portfolio to be novated between the Remaining Party and the Party Stepping In are likely to be different from the initial margin provided to the Remaining Party by its original counterparty, the Party Stepping Out. Initial margin requirements may also materially vary depending on the differences between the margin model used by the Remaining Party and that used by the Party Stepping In, even if both of the models used have been approved by a regulator. MFA members wish to highlight to the WGMR the risk that the resulting greater complexity of collateral management, together with a potentially significant cost increase in entering into such novation arrangements, may cause the market in novations effectively to cease. The resulting unintended consequence may be CDS unwinds becoming the sole liquidity mechanism, exerting further constraints on liquidity in the CDS markets.

Element 3: Baseline minimum amounts and methodologies for initial and variation margin

Q13. Are the proposed methodologies for calculating initial margin appropriate and practicable? With respect to internal models in particular, are the proposed parameters and prerequisite conditions appropriate? If not, what approach to the calculation of baseline initial margin would be preferable and practicable, and why?

Q14. Should the model-based initial margin calculations restrict diversification benefits to be operative within broad asset classes and not across such classes as discussed above? If not, what mitigants can be used to effectively deal with the concerns that have been raised?

MFA strongly supports the proposed requirement in the Consultation Paper that, when calculating the appropriate initial margin, market participants must make the choice between using a margin model and using the standardized margin schedule consistently in order to avoid "cherry-picking" to achieve the preferred margin outcome in a given trading scenario. MFA requests that the final requirements retain such an express requirement. Indeed, we applaud the WGMR for providing market participants a choice between using an initial margin model and using a standardized initial margin schedule.

Ten-day liquidation horizon. Under the proposals in the Consultation Paper, the initial margin models are required to set initial margin at a level that covers at least 99% of price changes over at least a ten-day liquidation time horizon. MFA understands that such requirements arguably must be equal to or greater than margin requirements for comparable centrally cleared derivatives, and that proposed margin requirements for centrally cleared derivatives under current U.S. and European Union initiatives[4] would require a five-day liquidation time horizon. However, the Consultation Paper does not explain why such a long ten-day liquidation time horizon (*i.e.*, double the liquidation time horizon for centrally cleared derivatives) is appropriate. Doubling the liquidation time horizon for cleared derivatives is, in our view, overly simplistic and disregards current market practice.

In our experience, current market practice with respect to many asset classes of non-cleared derivatives results in a liquidation time horizon that is shorter than ten days. It is market practice[5] to obtain one or more market quotations in order to terminate a non-cleared derivative position, which position is then liquidated using that valuation. Under market standard bilateral contractual arrangements, where market quotations cannot be obtained, it is possible to use a mark obtained from an alternative pricing source, such as derived from a pre-agreed model. As such market practice allows for simple liquidation rather than requiring a replacement transaction, liquidating a position in a non-cleared derivative based on the mark obtained may be completed relatively quickly, without material delay. Although the non-cleared derivatives markets may be less liquid in certain cases, as liquidation is permitted on a payment basis

[4] The mandatory clearing requirements under the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") and the European Union's European Market Infrastructure Regulation ("**EMIR**").

[5] As set out in the the market standard ISDA documentation for non-cleared derivatives.

without the need to ensure a replacement transaction, it does not necessarily follow that liquidation of a position taken in a non-cleared derivative will require more time than liquidating a position in a centrally cleared derivative. Thus, the ten-day liquidation horizon may prove to be inaccurate or unjustified. MFA therefore respectfully requests that the WGMR reconsider the appropriateness of the ten-day liquidation time horizon, *inter alia*, in light of current market practice regarding the liquidation of non-cleared derivatives.

As the derivatives markets evolve, it is probable that the baseline liquidation time horizons determined now will require adjustment over time. MFA recommends that the framework for the margining requirements for non-cleared derivatives should be sufficiently flexible to allow for periodic adjustments to the liquidation time horizon in response to developments in the liquidity of such markets.

Based on the foregoing, MFA respectfully urges the WGMR to further investigate current market practices regarding the liquidation of different classes of non-cleared derivatives in determining the appropriate liquidation time horizon. We respectfully suggest that the initial liquidation time horizon should be shortened from the proposed ten-day period, and that the framework for margining non-cleared derivatives should allow for further adjustment of the baseline liquidity horizon over time, as appropriate, in order to preserve flexibility in the framework as the non-cleared derivatives markets evolve.

Portfolio margining. MFA strongly agrees with the proposal that quantitative initial margin models may account for risk on a portfolio basis, specifically accounting for risk offsets within asset classes of derivatives that are subject to a single, legally enforceable netting agreement. MFA believes that this concept should also allow portfolio margining between cleared derivatives and non-cleared derivatives within the same asset class of derivatives in a buy-side firm's portfolio that are subject to a master netting agreement. We urge the WGMR to explicitly include in its final recommendations the principle of portfolio margining which confirms that initial margin models may take into account portfolio margining arrangements commonly referred to as "cross-product master netting agreements." Cross-product master netting agreements account for risk offsets among different types of financial instruments, rather than merely among non-cleared derivatives. For example, a cross-product master netting agreement today might include different instruments in the currency/ interest rates asset class, including U.S. Treasury futures, Eurodollar futures, non-cleared interest rate swaps, and repurchase agreements. In the future, the same cross-product master netting agreement could logically incorporate futures, centrally cleared interest rate swaps, non-cleared interest rate swap options, and repurchase agreements. Portfolio margining under cross-product master netting agreements is permitted under existing regulatory regimes and is consistent with current market practice in the derivatives markets.

MFA strongly believes that such portfolio margining arrangements would substantially mitigate the potential issue of a shortfall in eligible collateral in the wake of global regulatory reforms in the derivatives markets by allowing counterparties to recognize offsets for correlated financial instruments, including cleared and non-cleared derivatives. Such portfolio margining arrangements therefore free up excess collateral while adequately reflecting the risks of the portfolio. We applaud the WGMR for recognizing this potential shortfall, and determining that it is necessary to conduct a quantitative impact study to gauge the impact of the margin proposals,

particularly, to assess the amount of available collateral that could be used to satisfy these requirements.

Ensuring the continued viability of cross-product master netting agreements would also facilitate the transition to central clearing of derivatives by minimizing the need of market participants to post excessive collateral for portfolios that incorporate positions in both centrally cleared derivatives and non-cleared derivatives. During the transition to mandatory clearing, market participants will necessarily hold non-cleared derivative positions. Without the ability to margin correlated cleared and non-cleared positions on a portfolio basis, market participants would be unintentionally penalized during the transition to central clearing. Indeed, market participants will be forced to post redundant collateral for their cleared positions and their non-cleared positions. This unintended penalty during the transition to central clearing would act as a disincentive to market participants voluntarily moving more of their portfolios in non-cleared derivatives to be cleared by a central counterparty. The resulting bifurcation of derivatives portfolios between cleared and non-cleared derivatives is likely to have material and adverse liquidity implications in the cleared and non-cleared derivatives markets. Even after the transition of the liquid, standardized portion of the OTC derivatives markets to central clearing, portfolio margining should be available to encourage market participants to use cleared positions to offset the risk of their remaining non-cleared positions. Such cross-product portfolio margining would therefore reduce systemic risk by encouraging customers to maintain balanced and appropriately hedged portfolios as a result of the reduced aggregate margin requirements applicable when the aggregate portfolio is so hedged. Thus, counterparties would be effectively rewarded for maintaining a balanced or hedged portfolio of mutually offsetting transactions taking into account both cleared and non-cleared positions.

Further, initial margin models that account for cross-product master netting agreements are consistent with the proposals set out in the Consultation Paper,[6] as they are not intended to lower margin standards that may already exist, but rather, are intended to produce appropriate risk assessments of counterparties' potential future exposure with a view to promoting robust margin requirements. Allowing for risk offsets across centrally cleared derivatives and non-centrally cleared derivatives within the same cross-product master netting agreement would not alter the amount of, or compromise relevant parties' rights to, the margin posted to a central counterparty in connection with any cleared derivatives. This result is evidenced by the existing market practice of including cleared futures contracts in cross-product master netting agreements that also include non-cleared derivatives. MFA wishes to emphasize that initial margin models that permit cross-product master netting agreements would continue to be subject to the WGMR's additional proposed requirements applicable to quantitative initial margin models, including only accounting for offsets that may be reliably quantified, receiving regulatory approval prior to applying the model, and the model being subject to the internal approval and governance process of the counterparty proposing to use the same.

We therefore respectfully request that the WGMR include in the final policy proposals the following statement, or a substantially similar statement: "Quantitative initial margin models that account for risk on a portfolio basis may also take into account all products that are

[6] *Id.* at 17.

approved for model use and that are subject to a single legally enforceable cross-product master netting agreement." As an additional requirement, the WGMR could also specify that the regulated party intending to use an initial margin model that recognizes a cross-product master netting agreement should obtain a legal opinion verifying the validity and enforceability of the cross-product master netting agreement under the applicable law of each relevant jurisdiction.[7]

Transparency and objectivity of models. MFA urges the WGMR to require that margin models be sufficiently replicable in order to allow both parties to a non-cleared derivative contract to determine independently the applicable margin. The buy-side's ability to access and replicate initial margin models would enable them to anticipate how margin might change over the life of the derivative contract and how much they should hold in reserve. Such replicability is fundamental to conducting capital planning and underlies a buy-side market participant's ability or inability to devote its resources strategically to other investments or obligations. MFA is concerned that, without a requirement for reasonable transparency, sell-side firms may alter their baseline models to produce different initial margin requirements for different counterparties without an objectively justifiable basis. Therefore, MFA respectfully recommends that the WGMR require the basic functionality and baseline assumptions of proprietary initial margin models to be made available to counterparties to allow for model replication of initial margin determinations.

Without a right of access to basic functionality information regarding the margin model, the buy-side will lack adequate transparency into their current and future initial margin requirements. The ability of buy-side firms to replicate initial margin determinations is critical to such firms' capacity to anticipate and adjust to changes in their obligations. In MFA's view, replicability should be a condition to regulatory approval of any initial margin model. Without the information necessary to predict with reasonable certainty potential changes in initial margin requirements, market participants may hold excess capital to account for an unanticipated initial margin change, or may not have sufficient capital reserves, potentially resulting either in inefficient use of capital and reduced market liquidity, or in a series of defaults with potential pro-cyclical effects. Requiring transparency with respect to initial margin requirements would therefore allow customers to model for and anticipate margin changes and to avoid capital inefficiencies and capital shortages.

Further, initial margin models should generally be objective (*i.e.*, a model should arrive at the same initial margin amount for identical swaps regardless of the counterparty's identity) so that the initial margin requirements are predictable. Therefore, we request that the guidelines prohibit the variation of the initial margin models based solely on the identity of a counterparty, other than to clearly reflect the creditworthiness of its counterparty. We believe such a prohibition is necessary to prevent discriminatory distortions in derivatives markets and eliminate unfair competitive advantages among market participants.

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[7] Such requirement would be consistent with the requirement in the definition of "Qualifying cross-product master netting agreement" in the U.S. prudential regulators' proposed "Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule", 77 Fed. Reg. 52978 (Aug. 30, 2012), at §___.101(b) on p. 53004.

Q15. With respect to the standardised schedule, are the parameters and methodologies appropriate? Are the initial margin levels prescribed in the proposed standardised schedule appropriately calibrated? Are they appropriately risk sensitive? Are there additional dimensions of risk that could be considered for inclusion in the schedule on a systematic basis?

Improving the Initial Margin Schedule. MFA endorses the optionality embedded in the proposals regarding the basis for determining margin requirements and commends the provision of two alternative methods for calculating initial margin. We acknowledge that the wide spectrum of market participants in the non-cleared derivatives markets merits the provision of a standardized approach, such as provided by the initial margin schedule in Appendix A of the Consultation Paper ("**IM Schedule**"). We appreciate the simplicity and predictability of the IM Schedule and its usefulness to some market participants. However, we are concerned that the IM Schedule does not properly account for the diversity and risk characteristics of derivatives products that, in some cases, could create inappropriate market asymmetries. We have included as an annex to this letter a proposed sample of an amended IM Schedule that provides some additional granularity. The amended IM Schedule annexed hereto is not an exhaustive revision and does not propose to address all concerns relating to the IM Schedule, but seeks to enhance the usefulness and reliability of the IM Schedule for non-cleared derivatives with embedded optionality, as described below.

More specifically, where the buyer and seller have asymmetric risk/reward profiles under products with embedded optionality, such as CDS, the margin requirements for those products should be more granular to avoid over-posting or under-posting of initial margin. More granularity would be consistent with existing market practice that reflects differences in the risk profile between the party acquiring protection from the debtor's default under the terms of a CDS, for example, and the party providing protection. In the case of a CDS transaction, the risk profile of the protection buyer is lower than the risk profile of the seller given its contingent payout obligation if a credit event is triggered. The prospective default of a buyer therefore presents a lower systemic risk than the prospective default of a seller, and a buyer should accordingly be subject to lower margin requirements. For example, the buyer of a CDS should be subject to an initial margin requirement which is a lower proportion of the notional exposure compared to the seller, while the seller should be subject to an initial margin requirement that is a higher proportion of the notional exposure.

Similarly, the IM Schedule currently sets out a single category for equity derivatives, which would place a call option on a highly liquid equity security in the same category as a total return swap on an illiquid security. In this example, the equity option and the total return swap would each be subject to an initial margin requirement of at least 15% of notional exposure, which would be a high initial margin requirement for the equity option (given the payment of premium and lack of continuing credit exposure), but a potentially appropriate initial margin requirement for the total return swap.

MFA therefore recommends that, where appropriate, the IM Schedule should differentiate between the risk profiles of parties buying protection under a derivative contract (lower risk) and parties selling such protection (higher risk). Further, the IM Schedule should reflect the differences in the risks presented by a derivative transaction where the underlying is, for example, a currency of, or equity issued by, an issuer established in one of the G7 or G20

countries (lower risk), and where the underlying is currency of, or equity issued by, an issuer established in a country with an unstable or a new currency (higher risk). Accordingly, we request that the WGMR revise the IM Schedule to properly account for the variety of derivatives and the risk profiles of the parties by: (i) increasing the number of subcategories in the asset classes and assigning appropriate initial margin ranges and alternative initial margin calculation bases to such subcategories; and (ii) considering the asymmetric risk profiles of a buying/selling party in each relevant asset class or subcategory and appropriately reflecting risk profile differences in the initial margin amounts.

Element 4: Eligible Collateral

Q21. Should concrete diversification requirements, such as concentration limits, be included as a condition of collateral eligibility? If so, what types of specific requirements would be effective? Are the standardised haircuts prescribed in the proposed standardised haircut schedule sufficiently conservative? Are they appropriately risk sensitive? Are they appropriate in light of their potential liquidity impact? Are there additional assets that should be considered in the schedule of standardised haircuts?

While MFA appreciates the simplicity of the proposed standardized haircut schedule set out in Appendix B of the Consultation Paper ("**Haircut Schedule**"), we are concerned that the proposed haircuts in the Haircut Schedule are static and there is no adjustment mechanism to reflect changes in market conditions. We respectfully suggest that the standardized haircuts in the Haircut Schedule more dynamically reflect current collateral financing markets of such assets, as necessary, and that the standardized haircuts are revised periodically to ensure that the Haircut Schedule does not significantly deviate from observable market levels. Accordingly, MFA recommends that the WGMR consider using the haircut levels available in the repurchase market for the relevant collateral asset as the basis for the standardized haircuts. Haircuts should also be subject to regular review and, where appropriate, revision and adjustment. We believe these recommendations would allow the parties to a non-cleared derivative trade to agree and apply more objective, current and accurate haircuts reflecting actual market values of the collateral assets at the relevant time.

Element 5: Treatment of Provided Margin

Q22. Are the proposed requirements with respect to the treatment of provided margin appropriate? If not, what alternative approach would be preferable, and why? Should the margin requirements provide greater specificity with respect to how margin must be protected? Is the proposed key principle and proposed requirement adequate to protect and preserve the utility of margin as a loss mitigants in all cases?

Q23. Is the requirement that initial margin be exchanged on a gross, rather than net basis, appropriate? Would the requirement result in large amounts of initial margin being held by a potentially small number of custodian banks and thus creating concentration risk?

Q24. Should collateral be allowed to be re-hypothecated or re-used by the collecting party? Are there circumstances and conditions, such as requiring the pledgee to segregate the

re-hypothecated assets from its proprietary assets and treating the assets as customer assets, and/or ensuring that the insolvency regime provides the pledger with a first priority claim on the assets that are re-hypothecated in the event of a pledgee's bankruptcy, under which re-hypothecation could be permitted without in any way compromising the full integrity and purpose of the key principle? What would be the systemic risk consequences of allowing re-hypothecation or re-use?

MFA respectfully requests that the WGMR consider the requirements under the Dodd-Frank Act regarding the segregation of collateral.[8] Under the Dodd-Frank Act, regulated entities[9] must offer their counterparties the opportunity to segregate with an independent third-party custodian any collateral that does not constitute variation margin that is posted in connection with non-cleared derivative transactions. The counterparty therefore has the option to elect full third-party segregation of its initial margin, but is not mandated to do so. We respectfully urge the WGMR to provide for such similar optionality by a counterparty regarding the segregation of its posted initial margin in the final margining requirements. In addition, we further suggest that collateral providers should have the option to permit the collateral recipient to re-hypothecate all or a proportion of the posted initial margin. We believe that such optionality would allow for necessary cost mitigation to avoid excessive disruption in the non-cleared derivatives markets without compromising the overall benefits of the enhanced margining requirements set out in the Consultation Paper.

Element 7: Interaction of National Regimes in Cross-Border Transactions

Q27. Is the proposed approach with respect to the interaction of national regimes in cross-border transactions appropriate? If not, what alternative approach would be preferable, and why?

MFA supports the clarification of the jurisdiction over market participants proposed in the Consultation Paper, *i.e.*, that the margin requirements in a particular jurisdiction should generally be applied to legal entities established in that local jurisdiction. We also agree with the limited exception to this principle as set out in the Consultation Paper. In order to achieve a more stable and effectively regulated market environment for non-centrally cleared derivatives, maximum harmonization of regulatory requirements is necessary and desirable. Given the close integration of the non-centrally cleared derivatives markets across geographies and jurisdictions, we are conscious of the potentially serious impact that even a relatively minor divergence in substantive regulatory requirements could have in the operation of the non-centrally cleared derivatives markets and on the business of the market participants. Inability to ensure that both parties to transactions are able to meet their respective regulatory obligations at all times could

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[8] *See* Dodd-Frank Act, Section 724(c), available at: http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf. Section 724(c) of the Dodd-Frank Act, enacting Section 4s(l) of the 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."

[9] Under Section 724(c) of the Dodd-Frank Act and the proposed rulemaking by the U.S. Commodity Futures Trading Commission on protection of collateral for uncleared swaps, the obligation to offer initial margin segregation to counterparties applies to "swap dealers" and "major swap participants". *See* 75 Fed. Reg. 75432.

result in disruption of business and inadvertent or unavoidable breach of regulatory requirements. Given the potentially significant consequences of divergent regulatory requirements in the non-cleared derivatives markets, to the extent that maximum harmonization is not possible, we respectfully urge the WGMR to propose a fallback mechanism to reconcile conflicts in regulatory requirements of different jurisdictions.

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MFA thanks the WGMR for the opportunity to provide comments regarding the proposals in the Consultation Paper and we would welcome the opportunity to discuss our views in greater detail. Please do not hesitate to contact Laura Harper or the undersigned at +1 (202) 730-2600 with any questions the WGMR or any member of the WGMR might have regarding this letter.

Respectfully submitted,

Stuart J. Kaswell

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

cc: Mr. Michael Gibson, Board of Governors of the Federal Reserve System
Mr. Bobby Bean, Federal Deposit Insurance Corporation
Mr. Sean Campbell, Federal Reserve Board
Mr. Nicolas Gauthier, European Commission
Mr. John Lawton, U.S. Commodity Futures Trading Commission
Mr. Thomas McGowan, U.S. Securities and Exchange Commission
Ms. Heather Pilley, UK Financial Services Authority
Ms. Roopa Sharma, UK Financial Services Authority
Mr. Graham Young, Bank of England
Mr. Kurt Wilhelm, Office of the Comptroller of the Currency

The Hon. Gary Gensler, Chairman, U.S. Commodity Futures Trading Commission
The Hon. Jill E. Sommers, Commissioner
The Hon. Bart Chilton, Commissioner
The Hon. Scott D. O'Malia, Commissioner
The Hon. Mark P. Wetjen, Commissioner

The Hon. Mary L. Schapiro, Chairman, U.S. Securities and Exchange Commission
The Hon. Elisse B. Walter, Commissioner
The Hon. Luis A. Aguilar, Commissioner
The Hon. Troy A. Paredes, Commissioner
The Hon. Daniel M. Gallagher, Commissioner

Annex

SAMPLE INITIAL MARGIN SCHEDULE

Product Category	**Initial Margin Calculation Basis**
Equities	Options: • X% of the premium paid on the derivative contract; or • X% of the notional value of the derivative contract; or • X% of the premium premium paid on the derivative contract *multiplied by* delta Swaps: • X% of the notional value of the derivative contract Other Factors: • Higher % where the underlier is an equity security by a non-G7 issuer
Interest Rates	Options: • X% of the premium paid on the derivative contract; or • X% of the notional value of the derivative contract; or • X% of the premium premium paid on the derivative contract *multiplied by* delta Swaps: • X% of the notional value of the derivative contract Other Factors: • Higher % where the underlier relates to non-G7 countries • Higher % where the underlier relates to emerging markets
Credit Default Swaps	For Buyer of Protection: Nil, or, if agreed between the parties, X% of the notional value of the derivative contract, graduated % possibly reflecting CDS spreads (*i.e.*, lower % for tighter spreads), for example, on the basis of the following spread tiers: • 0 – 250 bps • 251 – 500 bps • 500 – 1050 bps / 0 – 20 points upfront • 1050 – 2500 bps / 21 – 50 points upfront • 2500 bps / > 50 points upfront

Product Category	**Initial Margin Calculation Basis**
	For sold protection: • X% of the notional value of the derivative contract
FX	Options: • X% of the premium paid on the derivative contract; or • X% of the notional value of the derivative contract; or • X% of the premium paid on the derivative contract *multiplied by* delta Swaps: • X% of the notional value of the derivative contract Other Factors: • Higher % where the underlier is a currency of a non-G7 country Higher % where the underlier is a currency of a non-G21 country • Higher % where the underlier is a currency of an emerging markets country
Commodities	Options: • X% of the premium paid on the derivative contract; or • X% of the notional value of the derivative contract; or • X% of the premium paid on the derivative contract *multiplied by* delta; or • standardized portfolio of risk (SPAN) margin for the nearest futures or options contract + X% Swaps: • X% of the notional value of the derivative contract