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December 7, 2020

Mr. Christopher Kirkpatrick, Secretary  
Commodity Futures Trading Commission  
1155 21st Street, NW  
Washington, DC 20581

Ms. Vanessa A. Countryman, Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549

Re: *Portfolio Margining of Uncleared Swaps and Non-Cleared Security-Based Swaps (File No. S7-15-20; RIN 3038-AF07)*

Dear Mr. Kirkpatrick and Ms. Countryman:

The Investment Company Institute<sup>1</sup> is submitting this letter in response to the joint request for comment (“Request for Comment”) by the Commodity Futures Trading Commission (CFTC) and Securities and Exchange Commission (SEC; together with the CFTC, “Commissions”) on potential ways to implement portfolio margining of uncleared swaps and non-cleared security-based swaps (“Request for Comment”).<sup>2</sup> ICI supports the Commissions’ efforts to take a harmonized approach to portfolio margining. Our members—regulated investment companies—use derivatives to pursue their stated investment objectives, policies, and strategies. Portfolio margining in a commingled account promotes more efficient use of capital and more robust collateral management processes while mitigating against operational risks due to multiple collateral accounts. These benefits ultimately accrue

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<sup>1</sup> The [Investment Company Institute](http://www.ici.org) (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI’s members manage total assets of US\$25.8 trillion in the United States, serving more than 100 million US shareholders, and US\$8.3 trillion in assets in other jurisdictions. ICI carries out its international work through [ICI Global](http://www.ici.org), with offices in London, Hong Kong, and Washington, DC.

<sup>2</sup> 85 Fed. Reg. 70536 (Nov. 5, 2020), available at <https://www.govinfo.gov/content/pkg/FR-2020-11-05/pdf/2020-23928.pdf>.

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to regulated fund shareholders and to the markets more broadly, as a result of risk reduction and better collateral management.

Our members support the ability to engage in portfolio margining. Regulated funds and their advisers, however, are subject to strict requirements regarding the protection of fund assets that effectively limit the types of portfolio margining arrangements in which they may engage. We urge the Commissions to propose a portfolio margining regime for uncleared swaps and non-cleared security-based swaps (SBSs) that is consistent with these requirements.

Our comments below outline these requirements and discuss why regulated funds strongly favor portfolio margining in a swap account (a “Portfolio Margining Account”) held by a non-bank CFTC registered swap dealer that is also registered with the SEC as a security-based swap dealer (a “Non-Bank SD/SBSD”).<sup>3</sup> As discussed below, SBSs held in the Portfolio Margining Account should be treated for margin and all other applicable purposes as though the SBSs were swaps, subject to the rules of the CFTC.

We explain below why a Portfolio Margining Account held by a Non-Bank SD/SBSD should be subject exclusively to the margining requirements of the CFTC to margin collectively on a portfolio basis uncleared swaps and non-cleared SBSs. We recommend that transactions held in the Portfolio Margining Account be treated the same as other transactions and assets required to be carried in a CFTC-regulated swap account, and urge the Commissions to clarify the treatment of a Portfolio Margining Account upon the bankruptcy of the Non-Bank SD/SBSD carrying the account.

Finally, in light of the short comment period and the many complex legal and operational issues raised by portfolio margining, we urge the Commissions to provide further opportunities for public feedback on the important issues raised in the Request for Comment before issuing a regulatory proposal.

## I. Background

ICI’s members—including US registered investment companies (“registered funds”), such as mutual funds, ETFs, closed-end funds, and other funds that are regulated under the Investment Company Act of 1940 (“1940 Act”), and non-US regulated funds<sup>4</sup> (together with registered funds, “regulated funds”)—use derivatives in a variety of ways. Derivatives are a particularly useful portfolio management

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<sup>3</sup> A Non-Bank SD/SBSD may, in addition, also be registered as a broker-dealer, OTC derivatives dealer, or a futures commission merchant.

<sup>4</sup> “Non-US regulated funds” refer to funds that are organized or formed outside the United States and are substantively regulated to make them eligible for sale to retail investors, such as funds domiciled in the European Union and qualified under the UCITS Directive (EU Directive 2009/65/EC, as amended), Canadian investment funds subject to National Instrument 81-102, and investment funds subject to the Hong Kong Code on Unit Trusts and Mutual Funds.

tool in that they offer regulated funds considerable flexibility in structuring their portfolios.<sup>5</sup> For example, a regulated fund may use derivatives to hedge its positions or certain risks they present, equitize cash that it cannot immediately invest in direct equity holdings, manage its cash positions, and adjust portfolio duration, all in accordance with the investment objectives stated in the fund's prospectus.

In the Request for Comment, the Commissions request detailed feedback on all aspects of the portfolio margining of uncleared swaps and non-cleared SBSs, including on the merits, benefits, and risks of portfolio margining these types of positions, and on any regulatory and operational issues associated with margining them on a portfolio basis. The Request for Comment takes into account: (1) type of registration applicable to the entity holding the collateral and standing as dealer-counterparty with respect to the regulated fund or other counterparties on the applicable uncleared swaps and non-cleared SBS (*i.e.*, BD, OTC derivatives dealer, SBSB, futures commission merchant (FCM), and swap dealer); (2) the account types (securities account, SBS account, swap account and FCM account) these registrants can maintain; and (3) the margin and segregation requirements that apply to products carried in these account types and what regime should apply in a combined asset, portfolio margined account.

## II. Benefits of Portfolio Margining Arrangements

ICI strongly supports the ability of regulated funds to portfolio margin in a commingled account uncleared swaps and non-cleared SBSs. For a number of reasons, we believe that the Portfolio Margining Account should be a swap account held by a Non-Bank SD/SBSB subject to CFTC regulation regarding such activity.

We appreciate that the Commissions previously have provided relief to permit portfolio margining of cleared credit default swaps (CDSs), including both swaps and SBSs, in a segregated account established and maintained in accordance with Section 4d(f) of the Commodity Exchange Act by an entity that is dually registered as a BD and an FCM.<sup>6</sup> We continue to support this relief, including the SEC's recent

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<sup>5</sup> Foreign regulation also contemplates use of derivatives by regulated funds. Article 51(2) of the UCITS Directive, for example, gives Member States the power to permit UCITS to employ techniques and instruments relating to transferable securities and money market instruments, including derivatives, for the purpose of "efficient portfolio management," subject to investment limits and diversification requirements set out in the UCITS Directive.

<sup>6</sup> See Order Granting Conditional Exemptions under the Securities Exchange Act of 1934 in Connection with Portfolio Margining of Swaps and Security-Based Swaps, Exchange Act Release No. 68433 (Dec. 12, 2012), 77 Fed. Reg. 75211 (Dec. 19, 2012), available at <https://www.govinfo.gov/content/pkg/FR-2012-12-19/pdf/2012-30553.pdf>; See CFTC, Order, Treatment of Funds Held in Connection with Clearing by ICE Clear Credit of Credit Default Swaps (Jan. 13, 2013), available at <https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/icecreditclearorder011413.pdf>;

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proposed order, which would supersede and replace its 2012 order.<sup>7</sup> We believe that portfolio margining of uncleared swaps and non-cleared SBSs in a Portfolio Margining Account carried by a Non-Bank SD/SBSD presents similar benefits without raising additional risks.

As the Commissions acknowledge, portfolio margining aligns margining and other costs more closely with the actual risks in a portfolio.<sup>8</sup> Maintaining two separate accounts for uncleared swaps and non-cleared SBSs is more expensive because funds must post full margin for both accounts, despite any offsetting positions in the accounts. Holding margin in separate accounts increases operational risk, because it requires the posting of multiple separate margin payments and separate withdrawals of excess collateral from the accounts. It also may reduce the ability of counterparties to net positions upon default or bankruptcy. The ability to engage in portfolio margining benefits regulated funds and their shareholders because it allows funds to efficiently meet their margin requirements, while allocating assets not required to satisfy margin requirements to more productive use in effectuating the funds' investment strategy.

One of the clear benefits provided by portfolio margining—whether in the cleared or uncleared context—is the ability to offset risks on correlated swap and SBS positions. For example, portfolio margining of a group of single name SBSs together with a swap entered into by the same counterparties on an index of CDSs is more efficient from a netting and valuation perspective because the single name SBSs would be single components of the index and, as a result, if combined, would create the exposure or delivery obligation under the index swap. Similarly, a group of single name SBSs comprising the CDSs underlying a CDS index entered into on one side of the market would offset a CDS index swap on the other side of the market entered into with the same counterparty. By combining the positions in a Portfolio Margining Account, both counterparties benefit from offsetting the positions.

Netting in this manner likewise can reduce systemic risk by reducing overall leverage and counterparty risk. In addition, subjecting swaps and SBSs to uniform margining schedules, levels, and portfolio

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CFTC, Order, Treatment of Funds Held in Connection with Clearing by ICE Clear Europe of Credit Default Swaps (Apr. 9, 2013), *available at* <https://www.cftc.gov/sites/default/files/idc/groups/public/@requestsandactions/documents/ifdocs/iceclear europe4dfcds040913.pdf>. ICI submitted a comment letter in 2012 on ICE Clear Credit's application. *See* Letter to Mr. David A. Stawick, Secretary, Commodity Futures Trading Commission, and Ms. Elizabeth Murphy, Secretary, Securities and Exchange Commission, from Dorothy Donohue, Deputy General Counsel, ICI, dated April 9, 2012, *available at* <https://www.ici.org/pdf/26027.pdf>.

<sup>7</sup> Proposed Order Granting Conditional Exemptions Under the Securities Exchange Act of 1934 in Connection With the Portfolio Margining of Swaps and Security-Based Swaps That Are Credit Default Swaps, 85 Fed. Reg. 70657 (Nov. 5, 2020), *available at* <https://www.govinfo.gov/content/pkg/FR-2020-11-05/pdf/2020-24612.pdf> ("Proposed Order"). For ICI's letter on the Proposed Order, please see Letter to Ms. Vanessa A. Countryman, Secretary, Securities and Exchange Commission, from Sarah A. Bessin, Associate General Counsel, Investment Company Institute, dated Dec. 7, 2020.

<sup>8</sup> Request for Comment at 70537.

reconciliation procedures in a commingled account mitigates against operational risk and allows counterparties and dealers to respond more quickly to margin call or default situations because they have the ability to view exposures holistically. Finally, portfolio margining of uncleared positions, as well as portfolio margining of cleared positions, promotes uniform treatment of positions in bankruptcy.<sup>9</sup>

### III. Regulatory Restrictions Limit Permitted Portfolio Margining Arrangements for Funds

Regulated funds and their advisers are subject to unique regulatory requirements regarding the protection of fund assets. These requirements effectively limit the types of portfolio margining arrangements in which regulated funds may engage. For example, as fiduciaries to their clients, advisers to regulated funds require strong protections for fund collateral when funds trade in the derivatives markets and generally require counterparties to post collateral to the regulated funds in order to protect shareholders against counterparty risk.<sup>10</sup> Registered funds must ensure that their collateral arrangements satisfy the custody restrictions of the 1940 Act, which require that funds maintain their assets on a segregated basis with a third-party custodian, typically a bank.<sup>11</sup> Because of the 1940 Act's custody restrictions, registered funds may not permit their collateral to be rehypothecated.<sup>12</sup> UCITS

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<sup>9</sup> For example, under the SEC's 2012 order on portfolio margining of cleared swaps and SBSs that are CDSs, counterparties are subject to the bankruptcy regime applicable to the FCM and expressly waive their rights to claim against the bankrupt estate of the dually-registered BD. Under the Proposed Order, however, this waiver would be modified to allow counterparties not to waive their limited right to lodge claims against the estate of the BD counterparty with respect to general creditor claims. *See* Proposed Order at 70661.

<sup>10</sup> Margin requirements for swaps, both in the United States and abroad, require dealers to post to regulated fund counterparties both variation margin and, subject to an ongoing transition period, initial margin. The US prudential regulators similarly require SBSs to post to, as well as to collect from, regulated fund counterparties, both variation and initial margin against SBSs. The SEC's margin rules for SBSs do not require SBSs (other than bank SBSs, which are not subject to the rules) to post margin to counterparties. Although we contemplate that regulated funds and their investment advisers may seek contractually to require SBSs to post variation and initial margin to the funds, it is not certain that such SBS counterparty will agree to do so.

<sup>11</sup> Under the 1940 Act, registered funds are required to custody their assets in accordance with Section 17 of the 1940 Act. The SEC has adopted separate custody rules governing different types of assets. Although Rule 17f-1 under the 1940 Act permits registered funds to use a BD custodian, the rule imposes conditions that are difficult in practice to satisfy. Non-US regulated funds, such as UCITS, are similarly subject to requirements regarding the safekeeping of their assets. *See* EU Directive 2009/65/EC, as amended.

<sup>12</sup> Rule 17f-1, for example, provides that a BD custodian must physically segregate fund assets from other assets held by the BD and mark such assets to identify them as the fund's property. The rule prohibits the BD from having any power to assign, hypothecate, pledge, or otherwise dispose of the fund's assets, except at the fund's direction and for its account. Furthermore, the fund's assets cannot be subject to a lien or charge of any kind in favor of the BD. Rule 17f-6 under the 1940 Act permits registered funds to maintain initial margin with an FCM in connection with the fund's cleared futures and options transactions (and, pursuant to no-action relief, swap transactions), subject to strict conditions intended to safeguard fund assets, including a requirement that the FCM comply with the CFTC's segregation rules. While Rule 17f-6

funds are also subject to regulatory restrictions regarding posting of collateral and maintenance of assets with a designated custodian.<sup>13</sup>

These restrictions collectively limit the ability of regulated funds to engage in portfolio margining arrangements in a securities account or an SBS account. First, because BDs, OTC derivatives dealers and stand-alone SBSs that are not banks (“Non-Bank Stand-Alone SBSs”) are not required to post margin to regulated funds, a regulated fund may prefer to limit potential risk to the fund by instead trading with a bank SBS, which is required to post margin.<sup>14</sup> Second, SBSs (other than bank SBSs) are permitted under the SEC margin rules to rehypothecate counterparty collateral. Rehypothecation of fund assets, however, generally is inconsistent with the requirements applicable to regulated funds.<sup>15</sup>

In addition, advisers to regulated funds may consider BD/SBSs, as well as OTC derivatives dealers and Non-Bank Stand-Alone SBSs, to be less favorable counterparties for SBS transactions because they may expose funds to greater risk in the event of the counterparty’s insolvency. BD/SBSs are subject to administration in bankruptcy under the Securities Investor Protection Act of 1970 (SIPA), which imposes a stay that would prevent operation of close-out netting upon bankruptcy of the BD until the stay is lifted.<sup>16</sup> In addition, customer claims relating to securities, including SBSs, carried by a broker-dealer, are mutualized under SIPA so that, unlike a bank insolvency, claims of customers are reduced based on losses in the accounts of other customers. Similarly, insolvencies of OTC derivatives dealers that are also registered as SBSs and Non-Bank Stand-Alone SBSs are subject to the stockbroker liquidation provisions of the US Bankruptcy Code, which also contemplate mutualization

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permits the FCM, under certain circumstances, to place the fund’s assets with another FCM, clearing organization, or bank, the FCM may do so only in compliance with CFTC requirements, including obtaining an acknowledgement that the assets are held on behalf of the FCM’s customers in accordance with the Commodity Exchange Act.

<sup>13</sup> Article 22 of the UCITS Directive states that assets held in custody by the depositary shall not be reused for its own account by the depositary or by any third party to whom custody has been delegated, subject to an exception for fully collateralized, client directed, securities lending.

<sup>14</sup> Although the SEC rules allow SBSs to comply with CFTC margin requirements with respect to SBSs in limited circumstances under the SEC’s “alternative compliance mechanism,” there are a number of conditions to reliance on that provision and it is not clear whether SBSs will be able to do so as a practical matter. *See* Rule 18a-10 under the Securities Exchange Act of 1934 (“1934 Act”) (alternative compliance mechanism for SBSs that are registered as swap dealers and have limited SBS activities).

<sup>15</sup> *See* Rule 15c3-3 (p)(1)(ii) under the 1934 Act.

<sup>16</sup> BD liquidations are subject to SIPA and, unlike bankruptcies under the US Bankruptcy Code, creditors may not close out derivatives contracts outside of the bankruptcy stay.

of customer positions in securities and, because SBSs are “securities,” the mutualization provisions are expected to apply.<sup>17</sup>

#### IV. Recommendations for a Portfolio Margining Regime for Uncleared Swaps and Non-Cleared SBSs

ICI urges the Commissions to propose a portfolio margining regime for uncleared swaps and non-cleared SBSs that reflects the regulatory requirements to which regulated funds are subject. Such a portfolio margining regime should allow regulated funds to carry uncleared swaps and non-cleared SBS positions in a Portfolio Margining Account at a Non-Bank SD/SBSD. Both uncleared swap and non-cleared SBS positions in the Portfolio Margining Account should be margined solely in accordance with CFTC margin rules, without additionally imposing SEC or FINRA margining requirements applicable to SBSs.

We discuss below recommendations that are critical to the ability of regulated funds to engage in portfolio margining in a Portfolio Margining Account. We urge the Commissions to address these issues in any proposed portfolio margining regime.

##### A. Confirm Applicability of CFTC Regulations

We recommend that positions and transactions held in the Portfolio Margining Account be treated the same as other transactions and assets required to be carried in a swap account.<sup>18</sup> Thus, both swaps and SBSs in the Portfolio Margining Account would be subject to the margin and other applicable regulations of the CFTC, such as recordkeeping requirements, in the same manner as if such assets were required to be carried in such account.<sup>19</sup>

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<sup>17</sup> Request for Comment at 70539 and 70542 (suggesting that the stockbroker liquidation regime should be applicable in the event of the insolvency of an SBSD other than a bank). Although these provisions do allow for limited close-out rights and netting of securities contracts, there is less certainty regarding how the provisions would operate in practice than is the case for bankruptcies involving broad close-out rights under master netting agreements, as authorized under the US Bankruptcy Code with respect to swaps and SBSs and the rules regarding transfer and unwind of customer custodial accounts upon a bank insolvency. Given that SBS collateral for cleared SBSs is treated differently from securities collateral, SBS counterparties also face uncertainty regarding treatment of the two types of collateral in a SIPA proceeding.

<sup>18</sup> Our recommendation is analogous to the CFTC’s approach of applying “home field” rules to portfolio margined accounts in its recent proposed amendments to its Part 190 bankruptcy regulations. *See* proposed 17 CFR 190.00(e).

<sup>19</sup> Such treatment would be consistent with the approach of the CFTC staff in Letter 16-71, which permits a covered swap entity to apply the CFTC’s margin rules for uncleared swaps on a portfolio basis to both swaps and SBSs subject to a series of conditions, including that the SBSs be treated as if they were swaps for purposes of applying the CFTC’s margin rules. CFTC Letter 16-71 (Aug. 23, 2016), *available at* <https://www.cftc.gov/csl/16-71/download>.

For the reasons discussed above, regulated funds are limited in their ability to engage in portfolio margining in a securities account or an SBS account. When a Non-Bank SD/SBSD portfolio margins commingled swaps and SBSs in a swap account, it is critical that a single margining regime apply—that of the CFTC, consistent with the status of the Portfolio Margining Account as a swap account. If the SEC’s margin rules for non-cleared SBSs (or FINRA margining rules) could apply to transactions in the Portfolio Margining Account in addition to the CFTC’s rules, market participants would face unnecessary uncertainty, and legal and operational challenges, in determining how to apply multiple margining requirements within a single account.<sup>20</sup>

## B. Confirm Treatment in Bankruptcy

A prerequisite for an effective portfolio margining regime is clarity regarding how transactions and margin that are portfolio margined in the same account would be treated in the event that the swap counterparty were to become insolvent. A US-domiciled Non-Bank SD/SBSD would be subject to the commodity broker provisions of the US Bankruptcy Code<sup>21</sup> and either the securities stockbroker liquidation provisions of the US Bankruptcy Code<sup>22</sup> or SIPA (if the Non-Bank SD/SBSD is a BD). If the Non-Bank SD/SBSD is a non-US entity, it would be subject to applicable foreign law in the event of insolvency. Protection of fund assets is of paramount concern to regulated funds and their advisers. It therefore is critical that the Commissions provide clarity, as part of any proposed portfolio margining regime, regarding the treatment in bankruptcy of a Portfolio Margining Account.

The Commission also should clarify that the beneficial owner of a Portfolio Margining Account would be a “counterparty” with respect to its derivatives positions. Language in the Request for Comment suggests that an entity that enters into an SBS with an SBSB would be a “customer” of the SBSB. The Request for Comment further explains that Section 16 of SIPA defines the term “customer” to “include a person that has a claim for futures and options on futures . . .”<sup>23</sup> We believe it is more accurate to refer to funds and others that engage in derivatives transactions with these entities as “counterparties.”

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<sup>20</sup> For example, the implementation dates of the CFTC’s margin rules for uncleared swaps and the SEC’s margin rules for non-cleared SBSs differ. The CFTC’s margin rules require initial margin and variation margin to be posted and collected by swap dealers, major swap participants, and other entities with “material swaps exposure” (MSE), which is defined as an average daily aggregate notional amount of uncleared swaps with all counterparties above \$8 billion. The SEC’s rules do not provide for phased implementation, and require compliance beginning on October 6, 2021. If a Non-Bank SD/SBSD were subject to both sets of rules with respect to transactions in the Portfolio Margining Account, it may be unclear whether a regulated fund would need to be in-scope under both the CFTC’s and the SEC’s rules before it could engage in portfolio margining of uncleared swaps and non-cleared SBSs in such an account. It also would raise significant operational challenges if MSE were below \$8 billion, and thus the swaps in the account were not subject to the CFTC’s margin rules for uncleared swaps, yet the SEC’s margin rules for non-cleared SBSs were applicable to the SBSs in the account.

<sup>21</sup> Subchapter IV of Chapter 7 of Title 11 of the US Bankruptcy Code.

<sup>22</sup> 11 U.S.C. 741.

<sup>23</sup> Request for Comment at 70540.



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Treating them as customers creates substantial uncertainty regarding the bankruptcy regime applicable to SBSs traded by an SEC-regulated SBS. If the SEC is not willing to clarify the status of an SBS counterparty generally, we respectfully request that it do so in the context of any proposed portfolio margining regime for uncleared swaps and non-cleared SBSs. Given that a fund or other entity would face a Non-Bank SD/SBSD with respect to its uncleared swaps and non-cleared SBS positions held in a Portfolio Margining Account, we believe that fund or other entity should be treated as a counterparty.

V. The Commissions Should Provide Further Opportunities for Public Feedback

We appreciate the opportunity to provide feedback on the Request for Comment. Given the short comment period and the many complex legal and operational issues raised by portfolio margining, we urge the Commissions to provide further opportunities for public feedback on the important issues raised in the Request for Comment before issuing a regulatory proposal. We believe the Commissions, as well as market participants, would benefit from a more fulsome public discussion of these issues, perhaps through a joint Commission roundtable or similar forum. We encourage the Commissions to explore, as part of further public dialogue, the potential benefits of extending portfolio margining to instruments beyond swaps and SBSs, including a discussion of the regulatory and operational considerations that may be relevant.

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If you have any questions on our comment letter, please feel free to contact me at (202) 326-5835.

Sincerely,

/s/ Sarah A. Bessin

Sarah A. Bessin  
Associate General Counsel

cc: The Honorable Jay Clayton, Chairman  
The Honorable Hester M. Peirce  
The Honorable Elad L. Roisman  
The Honorable Allison Herren Lee  
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Securities and Exchange Commission

The Honorable Heath P. Tarbert, Chairman  
The Honorable Brian Quintenz  
The Honorable Rostin Behnam  
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