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March 29, 2017

Christopher Kirkpatrick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: *Capital Requirements for Swap Dealers and Major Swap Participants (RIN 3038-AD54)*

Dear Mr. Kirkpatrick:

The Investment Company Institute (ICI)¹ appreciates the opportunity to comment on the recent proposal by the Commodity Futures Trading Commission (CFTC or Commission) on capital requirements for swap dealers (SDs) and major swap participants (MSPs) that are not subject to the capital rules of a prudential regulator.² We understand that the proposal's objective is to protect the safety and soundness of SDs and MSPs (counterparties to regulated funds) while taking into account the diverse nature of the entities participating in the swaps market and the other capital requirements that could apply to these firms or their corporate groups.³ The Proposal would allow an SD, depending

¹ ICI is a leading global association of regulated funds, including mutual funds, exchange-traded funds, closed-end funds, and unit investment trusts 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\$18.9 trillion in the United States, serving more than 95 million US shareholders, and US\$1.6 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

² *Capital Requirements for Swap Dealers and Major Swap Participants*, 81 FR 91252 (Dec. 16, 2016) (Proposal), available at <https://www.gpo.gov/fdsys/pkg/FR-2016-12-16/pdf/2016-29368.pdf>.

³ The prudential regulators have adopted capital requirements for SDs and MSPs subject to their jurisdiction. See *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule Margin and Capital Requirements for Covered Swap Entities*, 78 FR 62018 (Oct. 11, 2013), available at <https://www.gpo.gov/fdsys/pkg/FR-2013-10-11/pdf/2013-21653.pdf>. Broker-dealers and future commission merchants (FCMs) presently face capital requirements under rules of the SEC and CFTC, respectively, and the SEC also has proposed capital and margin requirements for security-based swap dealers (SBSDs) and major security-based swap participants. See *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers*, 77 FR 70214 (Nov. 23, 2012) (SEC Capital Proposal), available at <http://www.gpo.gov/fdsys/pkg/FR-2012-11-23/pdf/2012-26164.pdf>.

on its characteristics, to comply with a capital requirement based on: (i) existing bank holding company capital rules adopted by the Federal Reserve Board; (ii) existing capital rules for FCMs or broker-dealers; (iii) proposed capital requirements for SBSBs; or (iv) the firm's tangible net worth.⁴

We recognize that the Commission has designed the Proposal to be consistent with other capital standards, but we believe that this consistency comes with an undesirable consequence for regulated funds (counterparties to SDs) that the Commission can easily remedy. Specifically, SDs that elect to comply with the SEC Capital Proposal (which is described below) would be required to take a capital charge—similar to an SBSB—when a counterparty exercises its right under section 4s(1) of the Commodity Exchange Act (CEA) to post margin to a third-party custodian. We believe this capital charge would increase costs for regulated funds without providing any corresponding benefit, and we urge the Commission not to adopt this charge.

I. CFTC's Proposal Allows SDs to Comply with the SEC Capital Proposal

One way for SDs to comply with the CFTC's proposed capital rules would be to satisfy the SEC Capital Proposal, which would generally entail an SD being treated as an SBSB for capital purposes. The SEC Capital Proposal models capital standards for SBSBs on the broker-dealer capital standards set out in Rule 15c3-1 under the Securities Exchange Act of 1934 (Exchange Act). The SEC Capital Proposal would require an SBSB to perform two calculations: (1) a computation of the minimum amount of net capital the SBSB must maintain; and (2) a computation of the amount of net capital the SBSB is maintaining. In computing net capital, an SBSB would be required, among other things, to make certain adjustments to net worth such as deducting illiquid assets and taking other capital charges, including credit risk charges.

We have significant concern with one particular aspect of the SEC's proposed capital charges, which would disadvantage counterparties that choose to post collateral to an independent custodian, as permitted by section 3E(f) of the Exchange Act. Under Proposed Rule 18a-1 under the Exchange Act, an SBSB would incur a capital charge any time that it does not hold directly the margin collateral, including when the counterparty requires the margin collateral to be segregated. When the SEC proposed this requirement, it expressed the view that an SBSB should incur a capital charge for margin posted to an independent custodian because by not holding the collateral directly, the SBSB would not be in the physical possession or control of the collateral nor capable of liquidating the collateral promptly without the intervention of another party.⁵

⁴ Only SDs that are not predominantly engaged in financial activities could use the tangible net worth approach to satisfy their capital requirements. The CFTC proposes, however, to use a tangible net worth approach for MSP capital requirements.

⁵ See SEC Capital Proposal at 70246-47.

In our comment letter on the SEC Capital Proposal, we argued that SBSBs would have prompt access to the collateral in the event of default and explained that the proposed capital charge would increase costs to market participants that exercise their rights under section 3E(f) of the Exchange Act.⁶ This provision, added by the Dodd-Frank Act, specifically provides that for an uncleared security-based swap transaction, a counterparty of an SBSB may require any collateral posted as initial margin to be carried by an independent third-party custodian and be designated as a segregated account for and on behalf of the counterparty. This provision allows a counterparty to obtain an additional level of protection for the collateral it has posted.

II. The CFTC Should Not Impose a Capital Charge for Using an Independent Custodian

The Proposal generally would impose a capital charge on an SD that follows the SEC Capital Proposal, as if it were an SBSB, and when its counterparty elects to segregate its collateral with an independent custodian.⁷ We urge the CFTC not to incorporate this capital charge into its final rules for two reasons. First, this proposal would increase costs for counterparties that seek to use an independent custodian, making it more expensive for counterparties to obtain the important protections and operational efficiencies that independent custodians provide. Second, the proposed capital charge would not increase the safety or soundness of SDs because CFTC rules and contractual provisions ensure an SD would be able to access unilaterally and promptly any collateral held by an independent custodian.

A. The Proposed Capital Charge Would Increase the Costs of Collateral Segregation and Undermine Its Benefits

A counterparty to a swap transaction can reduce certain risks and gain operational efficiencies by posting collateral with an independent custodian rather than posting the collateral directly with its SD counterparty. With regard to risk mitigation, tri-party collateral arrangements provide a counterparty with a realistic avenue to avoid having its collateral become part of its counterparty's bankruptcy estate. The independent custodian holding the collateral would be unaffected by the counterparty's bankruptcy and could return collateral to the non-defaulting counterparty as provided by the tri-party agreement. This would facilitate continued trading and avoid disrupting the market. The tri-party custodial structure also helps prevent fraud and misappropriation of collateral. The appointment of an independent custodian charged with maintaining custody of the collateral and effecting the transfer of funds and securities between the two parties also creates operational efficiencies—including collateral optimization and improved collateral monitoring.

⁶ See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated January 4, 2013, available at <https://www.ici.org/pdf/26967.pdf>.

⁷ See Proposal at 91262; Proposed Rule 18a-1 under the Exchange Act.

We are concerned that the CFTC's proposal to follow the SEC in imposing a capital charge on SDs with respect to the segregated collateral held at an independent custodian could increase costs for counterparties that avail themselves of the important protections provided by collateral segregation. Counterparties already pay for the protection offered by an independent custodian. A capital charge would likely raise the costs of these arrangements because SDs will seek to pass on to their counterparties the costs associated with holding extra capital. This result seems inconsistent with Congress' determination to make these protections available broadly by adding section 4s(l) to the CEA, which requires SDs and MSPs to offer their counterparties the option of segregating initial margin with an independent custodian.⁸ The Commission, in turn, has recognized that CEA section 4s(l) "indicates Congress' intent to increase the safety in the market for uncleared swaps by creating a self-effectuating requirement for the segregation of counterparty initial margin in an entity legally separate from the SD or MSP."⁹

In the case of regulated funds, the proposed capital charge would have a disproportionate and unwarranted impact. Section 17 of the Investment Company Act of 1940 (ICA) requires a regulated fund to custody its assets only with certain types of entities. In effect, this provision precludes a regulated fund from posting collateral directly to an SD covered by the Proposal. To comply with section 17 today, regulated funds rely on independent custodians to hold margin for swaps and they will continue to do so. As a result, the proposed capital charge for using an independent custodian would place an additional cost on regulated funds for complying with their obligations under the ICA, making it more expensive for these funds to use swaps to hedge their portfolios, equitize cash that they cannot immediately invest in direct securities holdings, or otherwise benefit their shareholders.¹⁰ Fund shareholders ultimately would pay for the increased costs of independent custodians through higher expense ratios or lower returns.

We believe that a regulatory capital framework should not penalize a regulated fund (and ultimately its shareholders) for complying with a statutory requirement to protect its collateral or, in the case of another counterparty, electing a protection specifically provided under the Dodd Frank Act. Regulation instead should encourage counterparties to hold collateral in a safe, efficient manner that promotes certainty and stability in the event of a default by either counterparty. The capital charge on SBSDs embedded in the SEC Capital Proposal, if adopted by the CFTC, would frustrate the Congressional and Commission objectives of providing a counterparty with extra protection of its

⁸ Specifically, the provision requires that an SD/MSP notify each counterparty that the counterparty has the right to require segregation of the funds or other property supplied to margin, guarantee or secure the counterparty's obligations and that, at the request of the counterparty, the SD/MSP segregate such funds or other property from the assets of the SD/MSP.

⁹ *Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy*, 78 FR 66621, 66632 (Nov. 6, 2013), available at <https://www.gpo.gov/fdsys/pkg/FR-2013-11-06/pdf/2013-26479.pdf>.

¹⁰ The proposed charge similarly would raise costs for other counterparties that elect to use an independent custodian.

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collateral. We request that the Commission eliminate the capital charge requirement for SDs in situations in which the counterparty elects an independent custodian.

B. SDs Would Have Prompt Access to Collateral Held at an Independent Custodian in the Event of Counterparty Default

The proposed capital charge for using an independent custodian will not increase the safety or soundness of SDs because a CFTC rule ensures that an SD will have the ability to access and liquidate promptly any collateral held by an independent custodian. CFTC Rule 23.702 requires an independent custodian to turn over collateral to an SD “promptly” following the SD’s presentation of a signed statement that the SD is entitled to the collateral. This rule ensures that tri-party agreements provide an efficient, unilateral means for the SD to obtain collateral from an independent custodian. The rule effectively gives the SD power to obtain collateral held by the independent custodian in a timely manner without the need for cooperation or consent of the counterparty and without expending significant time or effort. We note that tri-party custodial arrangements also provide contractual mechanisms that allow the secured party to control the posted collateral and provide additional assurance that an SD could access and liquidate the collateral promptly if its counterparty defaults.¹¹

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We appreciate the opportunity to comment on the Proposal. If you have any questions on our comment letter, please feel free to contact me at (202) 326-5815, Jennifer Choi, Associate General Counsel, at (202) 326-5876, or George Gilbert, Counsel, at (202) 326-5810.

Sincerely,

/s/ David W. Blass

David W. Blass
General Counsel

cc: The Honorable J. Christopher Giancarlo, Acting Chairman
The Honorable Sharon Y. Bowen, Commissioner

Eileen T. Flaherty, Director, Division of Swap Dealer and Intermediary Oversight

¹¹ See Letter from Karrie McMillan, *supra* note 6, at 7. See also Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC, dated December 5, 2013 at 5-8 and 12-14, *available at* <https://www.ici.org/pdf/27742.pdf>.