U.S. COMMODITY FUTURES TRADING COMMISSION

Three Lafayette Centre
1155 21st Street NW, Washington, DC 20581
Telephone: (202) 418-5000

Division of Swap Dealer and
Intermediary Oversight

Eileen T. Flaherty
Director

CFTC Letter No. 17-12
No-Action
February 13, 2017
Division of Swap Dealer and Intermediary Oversight

Re: Commission Regulations 23.152(b)(3) and 23.153(c): No-Action Position for Minimum Transfer Amount with respect to Separately Managed Accounts

Ladies and Gentlemen:

This letter is in response to a request for a no-action position regarding Commission Regulations 23.152(b)(3) and 23.153(c) received by the Division of Swap Dealer and Intermediary Oversight ("**DSIO**") of the Commodity Futures Trading Commission ("**Commission**") from the Securities Industry and Financial Markets Association's Asset Management Group ("**SIFMA AMG**") on behalf of its members that enter into swaps with swap dealers ("**SDs**") that are registered with the Commission and subject to the Commission's rules regarding margin requirements for uncleared swaps.[1]

Specifically, SIFMA AMG asked that DSIO provide relief that would permit SDs entering into swaps with "**Separately Managed Accounts**" (as defined below) to treat each such account as a separate counterparty for purposes of applying the minimum transfer

[1] The Commission's margin requirements for uncleared swaps apply only to SDs and major swap participants for which there is not a prudential regulator. *See* 7 U.S.C. 6s(e)(1)(B). SDs and major swap participants for which there is a prudential regulator must meet the margin requirements for uncleared swaps established by the applicable prudential regulator. 7 U.S.C. 6s(e)(1)(A). *See also* 7 U.S.C. 1a(39) (defining the term "Prudential Regulator" to include the Board of Governors of the Federal Reserve System; the Office of the Comptroller of the Currency; the Federal Deposit Insurance Corporation; the Farm Credit Administration; and the Federal Housing Finance Agency). The Prudential Regulators published final margin requirements in November 2015. *See* Margin and Capital Requirements for Covered Swap Entities, 80 FR 74840 (Nov. 30, 2015).

amount of initial and variation margin[2] permitted under Commission Regulations 23.152(b)(3) and 23.153(c),[3] despite the fact that such accounts are owned by the same legal entity.

I. Regulatory Background

Pursuant to section 4s(e) of the Commodity Exchange Act ("**CEA**")[4], the Commission is required to promulgate margin requirements for uncleared swaps applicable to each SD for which there is no Prudential Regulator.[5] The Commission published final margin requirements for such SDs in January 2016 (the "**Final Margin Rule**").[6]

As part of the Final Margin Rule, the Commission promulgated Commission Regulations 23.152 and 23.153, which require SDs to collect and post initial and variation margin with each counterparty that is an SD, major swap participant, or financial end user.[7]

---

[2] "Variation margin" is defined in Commission Regulation 23.151, 17 CFR 23.151, as:

> [C]ollateral provided by a party to its counterparty to meet the performance of its obligation under one or more uncleared swaps between the parties as a result of a change in the value of such obligations since the trade was executed or the last time such collateral was provided.

[3] 17 CFR 23.153(c). Such regulation states:

> (c) *Minimum transfer amount.* A covered swap entity is not required to collect or to post variation margin pursuant to §§ 23.150 through 23.161 with respect to a particular counterparty unless and until the combined amount of initial margin and variation margin that is required pursuant to §§ 23.150 through 23.161 to be collected or posted and that has not been collected or posted with respect to the counterparty is greater than $500,000.

A minimum transfer amount permitted by Commission Regulation 23.153(c) is hereinafter referred to as the "**MTA**."

[4] 7 U.S.C. § 1 et. seq.

[5] *See* 7 U.S.C. 6s(e)(1)(B).

[6] *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 FR 636 (Jan. 6, 2016). The Final Margin Rule, which became effective April 1, 2016, is codified in part 23 of the Commission's regulations. *See* 17 CFR §§ 23.150-159, 161.

[7] *See e.g.*, Commission Regulation 23.153(a) and (b), 17 CFR § 23.153(a) and (b), stating:

> (a) *Initial obligation.* On or before the business day after the day of execution of an uncleared swap between a covered swap entity and a counterparty that is a swap entity or a financial end user, the covered swap entity shall collect the variation margin amount from the counterparty when the amount is positive, or post the variation margin amount with the counterparty when the amount is negative as calculated pursuant to § 23.155 and in a form that complies with § 23.156.

Commission Regulations 23.152(b)(3) and 23.153(c) permit (but do not require) an SD to apply an MTA of up to $500,000 to transfers of initial and variation margin to "alleviate the operational burdens associated with making de minimis margin transfers."[8]

Pursuant to Commission Regulation 23.161, compliance dates for the Final Margin Rule are staggered such that SDs must come into compliance in a series of phases over four years. The first phase affected SDs and their counterparties, each with the largest outstanding notional amounts of uncleared swaps. These SDs began complying with both the initial and variation margin requirements of the Final Margin Rule on September 1, 2016.[9] The second phase begins March 1, 2017, and requires SDs to comply with the variation margin requirements of Commission Regulation 23.153 with all relevant counterparties not covered in the first phase.

II. Summary of Request for No-Action Position

As represented by SIFMA AMG, its members represent U.S. and multinational asset management firms. The clients of these firms include numerous individual investors, registered investment companies, endowments, public and private pension funds, UCITS, hedge funds, private equity funds, and many others. Large institutional clients, like pension plans and endowments, often hire multiple asset managers in addition to managing funds internally. This approach achieves diversity of investment objectives and asset allocations for the invested assets. These institutional clients will typically hire the asset manager to exercise investment discretion over only a portion of the client's assets (referred to as assets under management or "**AUM**") for management in separate accounts.

The separately managed account relationship between the client and each asset manager is established by an investment management agreement ("**IMA**"). The IMA, among other things, sets forth the account parameters and the scope of the asset manager's authority, which will be limited to the specified AUM. Through the IMA, the asset manager is given authority to open accounts at financial institutions and establish trading relationships for derivatives, if derivatives are utilized as part of the overall investment strategy (each account managed by an asset manager and governed by an IMA that grants an asset manager authority with respect to a specified AUM is hereinafter referred to as a "**Separately Managed Account**" or "**SMA**").

> (b) *Continuing obligation*. The covered swap entity shall continue to collect the variation margin amount from, or to post the variation margin amount with, the counterparty as calculated each business day pursuant to § 23.155 and in a form that complies with § 23.156 each business day until such uncleared swap is terminated or expires.

[8] Final Margin Rule, 81 FR at 653.

[9] *See* Commission Regulation 23.161(a)(1), 17 CFR § 23.161(a)(1).

As a swap counterparty to an SMA, an SD will likely face the same SMA owner through multiple SMAs of multiple asset managers. For uncleared swaps executed by asset managers for SMAs, the asset manager will typically execute swap transactions as an agent for the SMA on behalf of the owner and will often (but not always) limit any liability under the swap trading relationship documentation to that SMA's AUM. SIFMA AMG estimates that large pension funds, endowments, or other institutional investors may have dozens of asset managers with SMAs.

Each SMA that trades uncleared derivatives will typically have its own payment netting set corresponding to each ISDA master agreement and credit support annex ("**CSA**") used by the relevant asset manager.[10] As a result, collateral movements for initial or variation margin are not netted across the SMAs of a particular owner, including SMAs with different investment strategies handled by the same asset manager. Although the owner could post less collateral by netting across all SMAs handled be a particular asset manager when facing a particular SD, separation is needed to allow asset managers to execute effectively on the investment strategy and to track the profits and losses for each strategy (in turn allowing the owner the ability to measure the effectiveness of each strategy and asset manager).

SIFMA AMG represents that application of the MTA at the owner (*i.e.*, legal entity) level presents significant practical challenges for SMAs. Because the assets for each SMA of a particular owner managed by a particular asset manager are held, transferred, and returned separately at the SMA level, asset managers cannot collectively calculate MTA across the SMAs of a single owner and cannot move collateral in aggregate across such accounts. Rather, each SMA must calculate and post or collect collateral separately as per its applicable master netting agreement.

SIFMA AMG believes that the only workable solution to this problem would be to set the MTA at zero, which would frustrate the very purpose of permitting a $500,000 MTA in the first place. Although third-party offerings could provide for consolidated *calculations*, collateral *transfers* cannot be similarly consolidated so owners of multiple SMAs will still end up having to move small amounts of collateral. Likewise, SIFMA AMG does not believe that SDs can dynamically calculate and manage MTA across a SMA owner's separate eligible master netting agreements for several reasons, including timing, additional regulatory risk, and confidentiality. Even if SDs could take on this responsibly, asset managers would still have to transfer funds due for each SMA separately. Further, splitting the MTA (*e.g.,* giving $50,000 "shares" of MTA to ten separately

[10] In other words, the asset manager may have a single master netting agreement with a particular SD, but the swaps of a particular SMA are treated as if such swaps were governed by a separate master netting agreement. This arrangement allows an asset manager to have multiple SMAs governed by the same terms and conditions of a master netting agreement with an SD without the operational burden of executing dozens if not hundreds of individual agreements.

managed accounts) creates regulatory risk in ensuring that such a split is not being applied to more accounts than would be permitted by the $500,000 MTA limit. In addition, given that SMA owners may have dozens of relationships, this solution would only meaningfully cover a subset that have a maximum of ten accounts.

If SMAs are left with no choice but to set MTA to zero at the account level, this consequence negatively impacts SMA owners, imposing burdens that SIFMA AMG argues are not necessary to achieve the objectives of the uncleared swap margin requirements. Based upon a review of some asset managers' current and anticipated collateral movements, SIFMA AMG estimates that a shift from an MTA of $500,000 to an MTA of zero would increase daily collateral movements by many multiples, thereby resulting in increased operational risk and significant costs.

III. DSIO No-Action Position re: Commission Regulation 23.152(b)(3) and 23.153(c).

Based on the foregoing, DSIO believes that a no-action position is warranted. Accordingly, DSIO will not recommend an enforcement action against an SD that does not comply with the MTA requirements of Commission Regulations 23.152(b)(3) or 23.153(c) with respect to one or more swaps with any legal entity that is the owner of more than one SMA, subject to the following conditions:

(1) Any such swaps are entered into with the SD by an asset manager on behalf of an SMA owned by the legal entity pursuant to authority granted under an IMA;

(2) The swaps of such SMA are subject to a master netting agreement that does not permit netting of initial or variation margin obligations across SMAs of the legal entity that have swaps outstanding with the SD; and

(3) The SD applies an MTA no greater than $50,000 to the initial and variation margin collection and posting obligations required pursuant to Commission Regulations of such SMA.

This letter, and the positions taken herein, represent the views of DSIO and do not necessarily represent the positions or views of the Commission or of any other office or division of the Commission. The relief issued by this letter does not excuse persons relying on it from compliance with any other applicable requirements contained in the CEA or in the Regulations issued thereunder. This letter does not create or confer any rights or obligations on any person or persons subject to compliance with the CEA that bind the Commission or any of its other offices or divisions. As with all no-action letters,

DSIO retains the authority to condition further, modify, suspend, terminate, or otherwise restrict the terms of the no-action relief provided herein, at its discretion.

Should you have any questions, please contact me at (202) 418-5326 or Frank Fisanich, Chief Counsel, at (202) 418-5949.

Very truly yours,

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

Cc: Regina Thoele, Compliance
National Futures Association, Chicago

Jamila A. Piracci, OTC Derivatives
National Futures Association, New York