



August 8, 2011

Mr. David A. Stawick  
Secretary  
US Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st Street, NW  
Washington, DC 20581

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

Dear Mr. Stawick,

The Association of Institutional INVESTORS (the “Association”) is pleased to provide our views to the Commodity Futures Trading Commission (“CFTC” or “Commission”) regarding the appropriate model for implementing new statutory provisions relating to protection of cleared swaps customer contracts and collateral, as required under Section 724 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”). The Association supports the Commission’s efforts to safeguard market participants through rulemakings, such as the Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions (“Proposed Rule”).<sup>1</sup>

The Association of Institutional INVESTORS is an association of some of the oldest, largest, and most trusted investment advisers in the United States. Our clients are primarily institutional investment entities that serve the interests of individual investors through public and private pension plans, foundations, and registered investment companies (“RICs”). Collectively, our member firms manage ERISA pension, 401(k), mutual fund, and personal investments on behalf of more than 100 million American workers and retirees. Our clients rely on us to prudently manage participants’ retirements, savings, and investments. This reliance is built, in part, upon the fiduciary duty owed to these organizations and individuals. We recognize the significance of this role, and our comments are intended to reflect not just the concerns of the Association, but also the concerns of the companies, labor unions, municipalities, families, and individuals we ultimately serve.

## **I. Summary of Comments**

The Association supports the Complete Legal Segregation or Legally Segregated, Operationally Commingled (“LSOC”) model as the most cost effective framework to adequately protect the margin customers post to cleared swap transactions. We also support the Commission’s conclusion that in the event a futures commission merchant (“FCM”) defaults based on its inability to meet the margin obligations of one of its defaulting cleared swaps customers, the derivatives clearing organization

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<sup>1</sup> Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 76 Fed. Reg. 33818 (June 9, 2011).



(‘DCO’) should only have access to the margin of such defaulting customer to satisfy such customer’s obligations.<sup>2</sup> In so limiting access to the margin of the defaulting customer, the “fellow customer risk” presented in the futures market, whereby all customers share *pro rata* in the default of a fellow customer, is not extended to the cleared swaps market. It also effectively accounts for portability and portfolio margining interests.

The Association acknowledges that the LSOC model does not eliminate “investment risk,” or the risk that each cleared swaps customer would share *pro rata* in any losses associated with the investment by an FCM of cleared swaps customer margin.<sup>3</sup> Nor does the LSOC model eliminate the risk related to an FCM’s fraudulent activity with respect to the cleared swaps margin account where each customer would also share *pro rata* in related losses. While the Full Physical Segregation Model would address these risks, and each customer would bear the risk of loss associated with its own margin account, we believe the benefits of eliminating these risks do not outweigh the additional costs of such a model.

## II. LSOC Model

### *Overview*

Under the LSOC model, each FCM would enter, or “segregate,” in its books and records the customer margin related to cleared swaps. Such entries would be separate from entries indicating FCM obligations or the obligations of non-cleared swaps customers. Operationally, however, the FCM would be permitted to hold all cleared swaps customer margin in a single omnibus account. Full information relating to the customer cleared swaps positions and related margin would be provided by the FCM to the DCO so that the DCO can identify the defaulting customer and its margin and arrange for the porting of the non-defaulting customers’ positions and margin.<sup>4</sup> The Association believes that this model will provide appropriate customer protection with low additional costs.

The Association acknowledges that the Full Physical Segregation Model, whereby each FCM would maintain separate individual accounts for each customer’s cleared swaps margin, would provide customers with added protections in terms of both investment risk and an FCM’s fraudulent activity. The Full Physical Segregation Model is also the most similar to current practices within the swaps market, where many counterparties post margin to segregated accounts at third party custodians. Nevertheless, as reflected in the Rule Proposal, the Full Physical Segregation Model imposes considerable costs and operational burdens on funds, which costs are perceived by the Association’s members as being greatly in excess of any added benefits. Therefore, we believe that the LSOC model strikes the right balance of customer protection with minimal additional costs.

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<sup>2</sup> See *id.* at 33819.

<sup>3</sup> See *id.* at 33827.

<sup>4</sup> See *id.* at 33820.



### *Fellow Customer Risk*

The Association believes the LSOC model will achieve a number of important objectives for its members. First, by clearly stating that customer margin will not be used to satisfy the obligations of another customer, “fellow customer risk” is effectively eliminated. Second, by allowing for the commingling of margin in an omnibus account, the costs associated with establishing individually segregated accounts is avoided. Third, by requiring the FCM to provide the DCO with complete customer information including cleared swaps positions and related margin, portability of positions is enhanced. DCOs will increase the oversight of FCMs in monitoring the data provided to FCMs. As the overall pool of margin will not be available to a DCO in the event of a default, margin levels will inevitably be adjusted to more closely reflect the actual credit risk presented by a particular customer and its cleared swaps portfolio. The Association, therefore, believes this system will lead to less overall systemic risk for the system as it better reflects the actual risk posed by a customer.

The Association has a number of thoughts to enhance the protections afforded by the LSOC model and, in particular, notes the points raised by the Commission at footnote 185 of the Proposed Rule.<sup>5</sup> Specific recommendations as to drafting improvements are as follows:

### *Recordkeeping.*

Fundamental to the efficacy of the LSOC model, the avoidance of “fellow customer risk” and the portability of non-defaulting customer positions and margin is the provision of customer records from the FCM to the DCO. It is essential that such records are accurate and complete and, as noted at the CFTC Staff Roundtable to Discuss Protection of Cleared Swaps Customer Collateral, there are concerns that such recordkeeping needs to be robust, especially as an FCM experiences financial stress.<sup>6</sup>

In that light, stringent and enforceable recordkeeping standards are critical and should be incorporated into the proposed rules. Specifically, proposed Rule 22.11(e) should be amended to provide specific and concrete examples of steps a DCO must take to confirm such information is accurate, complete and produced on a timely basis, including the performance of regular or random independent audits of such records.<sup>7</sup> The phrase “appropriate steps” should be replaced with the phrase “all steps necessary.”

In addition, the current drafting, which requires FCMs to send DCOs requisite information “at least once each business day,” should be replaced with, “as frequently as technologically feasible.”<sup>8</sup> Such a

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<sup>5</sup> See *id.* at 33848.

<sup>6</sup> A transcript of the Roundtable is available at:

[http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission6\\_060311-transcri.pdf](http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission6_060311-transcri.pdf).

<sup>7</sup> See Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 76 Fed. Reg. at 33855.

<sup>8</sup> See *id.* at 33854.



timeframe would be consistent with the timeframe for the reporting of swaps data more generally as specified in other Rule Proposals, and minimizes the risk that a DCO would not have the complete records of all trading and margin positions.

#### *Disposition of Customer Property*

The LSOC model is also dependent on the language confirming that one customer's property cannot be used to meet the obligations of either the FCM or the FCM's other customers. The Association has several recommendations to clarify the proposed drafting so that there is a clear distinction between the approach applied to futures accounts and that applicable to cleared swaps accounts.

Proposed Rule 22.2(f)(4) addresses the FCM's segregation requirements<sup>9</sup> and it would be helpful if the Commission required the FCM to identify when the FCM has used its own capital to meet a customer's margin obligation and whether such FCM's capital may be used by the DCO to cure a defaulting customer's margin obligations.

Proposed Rule 22.14 outlines the sequence of events applicable upon an FCM default and should be clarified to address simultaneous defaults in both the futures and cleared swaps account.<sup>10</sup> Particularly with respect to the application of FCM and DCO resources, it should clarify how such resources will be allocated across such accounts.

Proposed Rule 22.15 clarifies that neither the DCO nor the FCM may use the property of one customer to cure the default of another customer.<sup>11</sup> The Association recognizes the complexity of this goal, especially with respect to the most recent cleared swaps positions and margin transfers. Notwithstanding our proposal that the FCM must provide relevant information to the DCO "as frequently as technologically feasible," it should be clarified that any initial misallocation related to delayed recordkeeping must be rectified as promptly as possible with property of the non-defaulting parties to be fully restored.

#### *Investment Risk*

The Association acknowledges that the LSOC model permits cleared swaps customers to share *pro rata* in any decline in value of FCM investments of cleared swaps customer collateral. We believe that despite this risk, the system provides appropriate customer protection and effectively mitigates costs. However, the Association urges the Commission to ensure that swaps customers may direct the investments in which initial margin is invested, as is done today through bilateral agreements with dealer counterparties. Control is essential for many swap customers to ensure that they maintain the specific risk profile detailed in their individualized and distinct investment mandates.

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<sup>9</sup> See *id.* at 33852.

<sup>10</sup> See *id.* at 33855.

<sup>11</sup> See *id.* at 33856.



### III. Additional Models

Among the alternatives suggested by the Commission, the Association believes the LSOC model is the most cost effective model that also adequately protects the margin customers post to cleared swap transactions. We note, however, that collateral solutions developed for the listed futures market may not necessarily adequately address related costs and liquidity issues as additional trades enter this market. We therefore believe that the Commission should consider the potential for alternative, less costly solutions to collateralization in the FCM clearing context. We believe alternatives should be permitted as long as they adequately address collateral return risk, ease market-wide liquidity burden, and do not increase risk. We are currently examining such alternatives and would welcome the opportunity to discuss these with the Commission. In particular, alternatives in which registered clearing agencies<sup>12</sup> intermediate the collateral pledge and return processes may provide means of protecting pledged assets without the need for physical segregation of collateral.

### IV. Conclusion

The Association recognizes the challenge facing the Commission to effectively protect customers while limiting costs on the marketplace. We support complete legal segregation and the LSOC model because they meet the Commission's goals while also providing customers with appropriate protection at the lowest possible cost. The Association thanks the Commission for the opportunity to comment on these proposed rules. Please feel free to contact me with any questions you may have regarding our comments at (617) 748-1748 or [jgidman@loomissayles.com](mailto:jgidman@loomissayles.com).

On behalf of the Association of Institutional INVESTORS,



John R. Gidman

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

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<sup>12</sup> As defined in the Securities Exchange Act of 1934, as amended.