



January 18, 2011

Mr. David A. Stawick  
Secretary  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st Street, N.W.  
Washington D.C. 20581

Re: Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies (RIN 3038-AD99)

Dear Mr. Stawick:

The Asset Management Group (the “**AMG**”) of the Securities Industry and Financial Markets Association (“**SIFMA**”) is writing in response to the Advanced Notice of Proposed Rulemaking (the “**Release**”), issued on November 19, 2010 by the Commodity Futures Trading Commission (the “**CFTC**”), requesting comments regarding the appropriate model for protecting collateral posted by customers as margin for cleared swaps transactions. The AMG’s members represent U.S. asset management firms whose combined assets under management exceed \$20 trillion. The clients of AMG member firms include, among others, registered investment companies, state and local government pension funds, universities, ERISA funds, 401(k) and similar types of retirement funds, and private funds such as hedge funds and private equity funds.

In their role as asset managers, AMG member firms, on behalf of their clients, engage in transactions, including transactions for hedging and risk management purposes, that are classified as “swaps” under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“**Dodd-Frank**”) and may be subject to mandatory clearing under new CEA Section 2(h) and the CFTC’s regulations thereunder. The AMG believes that CFTC rulemaking on the protection of cleared swaps is essential to achieving the purposes of Dodd-Frank, including the statutory provisions authorizing the CFTC to implement segregation requirements for cleared swaps customer collateral enacted as part of Title VII of Dodd-Frank (“**Title VII**”), and we appreciate the opportunity to provide the CFTC with our comments and concerns.

### **Summary**

The AMG believes that protection of collateral for cleared swaps is a critical issue that will materially affect the future development of the derivatives market in the United States. AMG members act as fiduciaries for buy-side participants in swaps markets, and the major part of our clients’ derivatives transactions are bilateral over-the-counter (“**OTC**”) swaps.

The AMG recognizes that loss mutualization among clearing members of a designated clearing organization (“**DCO**”) is an inherent feature of transitioning swaps into the clearing mandate under Section 723 of Dodd-Frank. Loss mutualization among *customers*, however, if applied in the cleared swaps market, would pose new risks that the AMG believes might not be acceptable to certain clients of member firms. The AMG strongly supports the steps the CFTC is taking to explore more protective approaches and to seek input from major stakeholders. Our members have debated at length the issues and alternatives proposed in the Release and have a range of views regarding the possible outcomes of various models. AMG members generally believe that mandatory clearing should not be implemented until the CFTC develops a collateral model which seeks to achieve a limitation or elimination of fellow-customer risks in the cleared swaps market. If the current futures (“**baseline**”) model with respect to the segregation of client collateral were adopted for swaps, some members believe that some of their clients would consider exiting or significantly reducing their participation in swaps, which could adversely affect liquidity in the swaps market. At the same time, some members are concerned that certain collateral arrangements could result in an excessive increase in costs, which could also affect market participation and liquidity. The AMG believes that the CFTC’s final model will need to reflect a balancing of these three separate goals: (i) providing adequate protection for customers and their collateral by addressing fellow-customer risks; (ii) encouraging and attracting strong market participation in a robust cleared swap market; and (iii) ensuring that costs imposed on customers and the industry as a whole are not excessive.<sup>1</sup>

**I. The baseline futures model, if applied in its current form for use in all cleared swaps, would present fellow-customer risks that would be unacceptable for some clients.**

“Fellow-customer risk” encompasses both the risk of losses due to margin defaults by other customers of the same future commission merchant (“**FCM**”) and the risk of losses due to decreases in the value of other customers’ collateral.<sup>2</sup> In the OTC swaps market, which is many times larger than the exchange-traded futures market,<sup>3</sup>

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<sup>1</sup> Collateral protection, and the move to buy-side swap clearing in general, raises significant operational issues for AMG participants. The Asset Managers Forum (“**AMF**”), a group organized under the umbrella of the AMG, and solely focused on operations, has been carefully considering operational issues related to buy-side clearing of swaps, including pricing, fees and confirmations. The AMF would be pleased to discuss these issues with the Commissions.

<sup>2</sup> The AMG does not agree with recent suggestions that funds may properly mitigate or manage fellow-customer risk by themselves becoming clearing members. Not all funds engage in the volume of trading necessary to make such a registration economically feasible, and funds not registering could potentially be forced out of the cleared swap market. Moreover, it is not in end users’ interests to be forced to select investment advisors based on self-clearing membership.

<sup>3</sup> Recent statistical studies have estimated the notional size of the exchange-traded futures market at \$22.7 trillion as compared to the derivatives market size of \$635 trillion. *See* Annex Table 23A: Derivative financial instruments traded on organised exchanges, BIS Quarterly Review A126 (2010) (“**BIS Study**”) (calculating the notional principle for all futures in all markets as \$22.751 trillion as of June 2010 and calculating the notional principle for all options in all markets as \$52.708 trillion as of June 2010); *and* Annex Table 19: Amounts outstanding of over-the-counter (OTC) derivatives, BIS Study A121 (calculating the notional amounts outstanding for all OTC derivatives in all markets as \$582.655 trillion as of June 2010).

some clients (including US mutual funds where segregation of collateral is required under applicable law) have the ability to choose a structure where its collateral secures its own, and only its own, obligations. Thus, in the existing OTC swaps market, there is the ability for some clients not to lose any of their collateral as a result of defaults by other customers of the same FCM. It should be noted, however, that this ability to fully segregate collateral does not eliminate mutualization of unsecured mark-to-market exposure to a counterparty. These clients may not be willing to participate in a cleared-swaps system that requires them to no longer have the option of these added protections. Further, fellow-customer risk is a type of risk that our members and their customers have little ability to manage or evaluate; customers have access to information about their FCM's own capitalization, but not about the creditworthiness of the FCM's other customers or the risks associated with other customers' positions.

The AMG recognizes that the baseline model has operated uneventfully in the futures context; however, in the cleared swaps context, the prospect of bearing the risk of another client's default causes significant concern for some members given the greater size of the swaps market and inherent differences between swaps and futures. Futures risks and related margin determination are well understood by the market, whereas swaps represent a much wider range in types of transactions, tenor and the nature and degree of risks presented. Further, certain end users who have been unwilling to bear the possibility of fellow-customer risks to their collateral have been able to transact in the OTC swaps market rather than the futures market, an option that would be foreclosed if the baseline model was also applied in the cleared swaps market. Therefore, the AMG believes that, in seeking to adopt the appropriate model for cleared swaps, the CFTC should regard the reduction of fellow-customer risks as a primary goal.

The CFTC may also wish to consider whether an approach that mutualizes margin default risk creates an effective subsidy of higher-risk participants by lower-risk participants. To the extent higher-risk participants do not bear the full cost of the risk they contribute to the system, the baseline model may create incentives that contribute to overall systemic risk, particularly if applied in the cleared swaps context where a wider range of risks is presented.

## **II. The AMG recognizes that more protective collateral models may entail higher costs.**

In striving for these goals, the CFTC must of course balance any additional customer protection with consequent effects on both costs and liquidity. Some DCOs and FCMs have stated that any change away from the baseline futures model will result in increased and excessive costs depending on the model chosen, in addition to costs passed on to the customer to compensate for the loss of cross-collateralization.<sup>4</sup> The AMG believes, however, that it would be premature at this point to rule out more protective collateral models because of concerns about potential costs. Some participants are

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<sup>4</sup> The AMG is aware that DCOs and FCMs have claimed that a change in models will result in cost increases of required collateral to margin customer positions by 60%, but the AMG believes that these entities should support these claims with actual cost figures and the methodologies used in computing such cost increases. *See* Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies (Advanced Notice of Proposed Rulemaking), Federal Register 75: 231 (Dec. 2, 2010) p. 75163.

willing to pay for full segregation of their collateral in the bilateral market. DCOs and FCMs who believe that certain models will result in excessive costs need to demonstrate and explain these costs more clearly. The decision whether to adopt a more protective model for customer collateral is a cost-benefit analysis that needs to be properly weighed and the only way to achieve that is through a comprehensive study of such costs. Similarly, better information concerning costs is necessary to understand how costs would be allocated under a new model. The AMG encourages DCOs and FCMs to provide more detail on why and by how much costs would be expected to increase to give the industry an opportunity to comment on ways to better assess the costs and benefits of any model.

**III. The AMG believes that it is important for protection of customer collateral in any model, and in related DCO and FCM regulation, that the CFTC adopt requirements and oversight systems to ensure the integrity of client collateral records.**

In addition to these fellow-customer risks, under the current baseline model for futures, customers are dependent on the records of the FCM to verify their positions and associated margin. This exposes customers to the risk that FCM customer recordkeeping may not be sufficient to allow for an orderly transfer or distribution of customer property.<sup>5</sup> Historically, failing firms have been subject to strains that resulted in erratic recordkeeping or compliance practices in the periods preceding their bankruptcy and, after bankruptcy, have not had the human resources or access to systems required to locate and reconcile customer and account records. Improved recordkeeping standards would facilitate portability in the event of a failure of the FCM by providing enhanced visibility to the DCO, the trustee and the CFTC into individual customer positions and associated margin, including timely identification of any customer accounts in deficit.

**IV. Although the AMG cannot yet advocate for the adoption of a single model (or optionality to choose between models) without additional information concerning each model's cost implications and effects on fellow-customer risk, AMG members have expressed views on the segregation models.**

*Current futures model.* As discussed, AMG members believe that the baseline model, which has operated efficiently in the futures context, may not be acceptable for everyone as applied to cleared swaps, particularly because customers cannot manage fellow-customer risks due to a lack of visibility into other customers of the FCMs. Members' concerns about fellow-customer risk are exacerbated by the placement of fellow-customer margin ahead of the capital of the DCO and the default fund contributions of other FCMs in the waterfall.

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<sup>5</sup> See e.g., Linda Sandler, *Lehman Derivatives Records a "Mess," Barclays Executive Says*, BLOOMBERG NEWS, August 30, 2010, <http://www.bloomberg.com/news/2010-08-30/lehman-derivatives-records-a-mess-barclays-executive-says.html>. When Barclays Capital took over Lehman Brothers' derivatives trades in 2008, a director of Barclays' futures business stated that "Lehman's books were in such a mess that I don't think they knew where they [their futures] were." The condition of the records prevented the director from performing any kind of initial due diligence to "discover what Lehman's and its customers' positions were, where Lehman kept its bank accounts, and who its brokers were."

***Omnibus model with a change in the waterfall.*** If the current futures model or another omnibus model were to be adopted, the AMG would request that customers be moved to the back of or removed from the waterfall, so that, at a minimum, non-defaulting client margin is behind the capital of the DCO and the default fund contributions of other FCMs. This change in the waterfall lessens the impact of fellow-customer risk and makes sense as a matter of both fairness and efficiency. The DCO is in a much better position to assume and manage the risk of an FCM default. Each DCO can examine the records of, and impose requirements on, member FCMs. The DCO also has visibility into the full book of customer trades of its member FCMs.

***Full physical segregation.*** Some AMG members believe that it is essential for them to have the right to elect, on behalf of certain clients, that their collateral be maintained in a segregated account at the relevant DCO. These members believe the full physical segregation model (“**full physical segregation**”) is an important elective right for customers who are not willing to allow their assets to be used by a DCO to cover defaults by other customers of the relevant clearing member. Member support for this model may depend on the potential impact of increased costs (for which data is not yet available). If this model were adopted, it would not require the delivery of duplicative collateral at the custodian or FCM levels as all required collateral would be ultimately posted with, and held by, the applicable DCO.

***LSOC.*** Some AMG members support the principles behind the legally separate but operationally commingled model (“**LSOC**”), but believe a variety of issues would need to be adequately addressed to clarify how the model could work in practice, including: (i) how the LSOC model would reduce risk mutualization among customers without unduly imposing additional costs; (ii) whether adequate recordkeeping systems can be developed to protect against possible errors or losses due to physical commingling of collateral; and (iii) bankruptcy considerations.

***Optionality.*** Furthermore, some AMG members believe that the CFTC should provide customers with the option between full physical segregation (if full physical segregation is adopted) and one of the other proposed models.

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The AMG thanks the CFTC for the opportunity to comment in advance of their rulemaking on the model for the protection of cleared swaps customer collateral under Title VII. The AMG's members would appreciate the opportunity to further comment on these topics, as well as other rulemakings the CFTC will undertake under Title VII of the Dodd-Frank Act. If you have any questions, please do not hesitate to call the undersigned at 212-313-1389.

Respectfully submitted,

A handwritten signature in black ink, appearing to be 'T. Cameron', with a long horizontal line extending to the right.

Timothy W. Cameron, Esq.  
Managing Director, Asset Management Group  
Securities Industry and Financial Markets Association

cc: Chairman Gary Gensler, CFTC  
Commissioner Bart Chilton, CFTC  
Commissioner Michael Dunn, CFTC  
Commissioner Scott D. O'Malia, CFTC  
Commissioner Jill E. Sommers, CFTC  
Chairman Mary L. Schapiro, SEC  
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