pension plans[17] are comparable to prudential capital requirements and pension plans must be prudently managed and diversified. If the regulators limit the availability of initial margin thresholds, under a risk-based approach, pension plans should be treated the same as or better than entities that are subject to prudential regulation.

c. Element 2 – If Pension Plans Are Treated As "Financial Entities," Subject to Initial Margin Requirements, Uncleared Swap Initial Margin Should Be A Two-Way Obligation

Element 2 would require both parties to a swap to post initial margin to one another (*i.e.*, two-way margin). We strongly believe that pension plans should be exempt from initial margin requirements. If pension plans are, however, under regulatory mandate, subject to uncleared swap initial margin requirements, initial margin should be a two-way requirement. Because of their fiduciary responsibilities, funding obligations, and the importance of their mission, pension plans are particularly attentive to counterparty risk. Pension plans pose significantly less counterparty risk to dealers than dealers do to pension plans. Moreover, as illustrated by the 2008 financial crisis and MF Global and Peregrine, pension plans can be subject to significant risks.

Accordingly, to the extent that pension plans are required to post initial margin, we support the notion that dealers also should be required to post equivalent initial margin unless the pension plan opts not to require initial margin from dealer. If pension plans are not completely exempted from uncleared swap initial margin rules, as we believe they should be, global regulators should adopt the Element 2 approach of requiring both parties to a swap to post initial margin to each other. However, a pension plan should have the option not to require the dealer to post initial margin based on the pension plan's risk analysis of the relevant dealer and potential costs.

3. Calculating And Collecting Initial Margin

a. Element 3 – Requirements For Initial Margin Models Should Be Revised

Element 3 sets forth requirements for models used to calculate initial margin. Specifically, the Consultative Document would require initial margin models to set initial margin to reflect extreme but plausible potential changes consistent with a one-tailed 99-percent confidence interval over a 10-day liquidation period. Notably, the Consultative Document does not provide any explanation for requiring a 10-day liquidation period to calculate initial margin. The Consultative Document would also require initial margin models to be approved by the dealer's prudential regulator.

We believe a 10-day liquidation period substantially overstates the risk of many uncleared swaps and will create unnecessarily high initial margin requirements,

---

[17] For example, in the U.S., ERISA plans are subject to stringent funding requirements pursuant to the Pension Protection Act of 2006. Canadian and European pension plans are similarly subject to stringent funding requirements.

particularly since models must use a 99-percent confidence interval and be calibrated to a period of financial stress.[18] Element 3 should instead require a 3 to 5 day liquidation period in initial margin models, which is sufficient to allow close-out, offset or other risk mitigation for uncleared swaps.

In addition, Element 3 would only permit initial margin models to account for diversification, hedging or risk offsets within the same asset class and covered by a single master netting agreement. We believe that initial margin models should permit risk offsets across instruments and asset classes. Common trading practices recognize the risk-reducing relationship between cash positions and derivatives on related underliers or a combination of derivative types, each targeting a different component of the individual risks presented by the cash position. The calculation of initial margin should give full recognition to the risk mitigating benefits arising from related trades across derivatives risk categories as well as across related derivatives and cash positions.

Further, Element 3 would require that initial margin models be approved by a relevant supervisory authority. Although we agree that initial margin models must be approved by the relevant regulator, initial margin models and calculations should be consistent with commonly accepted market practices and dealers should be required to disclose the methodologies, inputs and key assumptions underlying such calculations. Accordingly, the information above pertaining to initial margin models should be available for review by end-user counterparties such as pension plans upon request.[19] At more than $700 trillion notional value, the size and importance of the swaps market makes transparency critical. In addition, if regulators permit dealers to use internal margin models available for licensing by central clearing parties or third-party vendors, plans believe that those initial margin models should also be open for review by market participants in all material respects.

We note that regulators have sought centralized clearing of swaps to promote greater transparency of the swap market. We believe it would be consistent with such transparency goals to require initial margin models. Dealers will utilize initial margin models as the basis for a claim for funds from pension plans. We believe it would be consistent with regulators' market transparency goals that such initial margin models be transparent to plans' fiduciaries and auditors to ensure proper reconciliation and financial accountability. Such transparency also serves a regulatory purpose. Although regulators will approve initial margin models of dealers, regulators typically do not have the resources to monitor how such models are actually employed (e.g., accurately and consistently). Allowing transparency of such models provides greater confidence to the markets and could help avoid a crisis based on a later determination that a model which was approved by a regulator was in fact not properly employed.[20]

---

[18] *See* Consultative Document, p. 17.

[19] Recent events involving large multi-national banks, such as the London Interbank Offered Rate situation, highlight the need for transparency. *See*, *e.g.*, *In re Barclays PLC*, CFTC Docket No. 12-25 (June 27, 2012).

[20] *Id*.

b. Element 3 – The Initial Margin Look-Up Table Is An Appropriate Alternative To An Initial Margin Model

Element 3 provides an alternative method for calculating initial margin that uses a look-up table based upon the notional value of a swap.[21] We believe that the look-up table is a far better than other approaches that would far overstate the risks of many uncleared swaps and be unworkable because dealers will have a difficult time identifying a "similar" futures contract or cleared swap.[22]

We also support that dealers "should not be allowed to switch between model- and schedule-based margin calculations in an effort to 'cherry pick' the most favorable initial margin terms."[23] Dealers should be required to take a consistent approach over time.

c. Element 3 –Parties Should Be Permitted a Commercially Reasonable Time After Executing a Swap Before Posting Initial and Variation Margin

Element 3 provides that "[i]nitial margin should be collected at the outset of a transaction."[24] This collection timeframe is too aggressive and will lead to significant operational disruptions, errors and costs as a result of industry-wide collateral operational limitations. Any standard that requires dealers to collect margin "on or before the date it enters into" a swap cannot even be effectuated in a simpler, highly mature derivatives marketplace such as futures markets. Initial margin is never called by a dealer until T+1.

Pension plans, like other parties, need a commercially reasonable time to operationally move money to a new counterparty or a new third party custodian. Under all proposed approaches, a pension plan may have to establish new arrangements with new counterparties or custodians and set aside collateral several days before the plan even knows with certainty that the swap will be executed. This will tie up funds that otherwise could be used to generate income for retirees. We suggest that the regulators permit a commercially reasonable time of two local business days after entering into a swap before requiring initial margin to be posted. For the same reasons, we also suggest that parties not be required to make variation margin calls until the local business day after the swap is executed and not be required to post variation margin until two local business days after the swap is entered into.

4. Element 4 – The Definition Of Eligible Collateral Is Appropriately Broad

Element 4 would define eligible collateral and provide other guidelines regarding haircuts and diversification.[25] The Consultative Document lists as eligible collateral cash,

---

21 *See* Consultative Document, pp. 18-19, App. A.

22 As a general matter, a main reason that an uncleared swap will not be cleared is because it is not similar to any cleared product.

23 Consultative Document, p. 19.

24 *Id.*

25 *See* Consultative Document, p. 22.

high quality government and central bank securities, high quality corporate bonds, high quality covered bonds, equities included in major stock indices, and gold. Although the list in the Consultative Document is not intended to be exclusive, we recommend adding to the list interests in money market mutual funds and certificates of deposit.

We strongly favor the approach in the Consultative Document of expanding the types of permitted collateral. We believe the types of permitted collateral should be broad enough to ensure that there is sufficient eligible collateral available to all market participants. We are also concerned that a more narrow menu of collateral choices ultimately would decrease diversification in pension plans' investment portfolios and could serve to increase overall funding risks.

5. Element 5 – Plans Believe That Collateral Should Be Held By A Third Party Custodian, Be Bankruptcy Remote From A Defaulting Counterparty, And Not Be Rehypothecated Or Reused

Element 5 would require parties to exchange gross margin and sets out three principles for uncleared swaps: 1) initial margin must be individually segregated; 2) initial margin should be held in a way that fully protects the posting party from the bankruptcy of a defaulting counterparty; and 3) collateral cannot be rehypothecated or reused.[26] Plans strongly support these margin protecting principles, if requested by a client, and also recommend that such protections be expanded to variation margin.

The Consultative Document makes clear that existing collateral protections available in over-the-counter swap markets should not go away. These existing protections include segregation of both initial and variation margin with a third party custodian and restrictions on rehypothecation and reuse of collateral. These types of collateral arrangements protect investors, reduce systemic risk, and aid regulators in overseeing the liquidation of a dealer because collateral can be identified faster and with greater certainty in a dealer bankruptcy.[27] The benefits of these arrangements have been recognized by the European Union in its rules for cleared swaps that require central clearing parties and clearing members to offer segregation of margin to their customers.[28] The Consultative Document is also consistent with provisions in Dodd-Frank that provides non-dealer counterparties the option to elect to have their initial margin held by a third-party custodian.[29]

---

[26] *See* Consultative Document, p. 25.

[27] The U.S. SEC also notes that requiring segregation with a third-party custodian "may impose a disproportionate impact on U.S. SEC-registered broker-dealers in comparison to banks, as a result of the differences in regulatory capital treatment of the initial margin deposited with third party custodians." Consultative Document, p. 26. We believe that uncleared swap margin requirements must be designed to protect the counterparties to a transaction. If broker-dealers are disadvantaged relative to banks, then the SEC should consider other relief for its broker-dealers. It would not be appropriate to attempt to mitigate such disproportionate impact at the expense of the very market participants that the uncleared swap margin rules are designed to protect.

[28] Regulation (EU) No 648/2012 of the European Parliament of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, Article 39.

[29] Dodd-Frank §§ 724 and 764.

7. Element 7 – International Rules Must Be Consistent

Element 7 proposes a framework whereby entities would only be subject to margin requirements of their home jurisdiction and market participants would not be subject to duplicative requirements where margin requirements between jurisdictions are comparable.[30] We believe this proposed Element highlights the importance of consistent international regulation to avoid flight to the most appealing jurisdiction. However, only the uncleared margin rules of the jurisdiction where a transaction occurs should apply and there should be clarity and consistency as to where a transaction is deemed to have occurred. Importantly, we believe that (i) there should only be a single jurisdiction for each transaction; (ii) such jurisdiction's regulations should be the only one that applies to such transaction; (iii) regulators should be consistent and clear how such jurisdiction is determined; and (iv) parties to a transaction should be able to contractually agree as to what is the jurisdiction of such transaction, provided it is a jurisdiction of one of the counterparties and provided that such jurisdiction is recognized by the regulator of the other counterparty.

By ensuring that there is a single jurisdiction for each transaction, regulators will be supplying market participants with legal certainty as compared to an unintended consequence of legal risk. Legal risk is part of systemic risk and regulators could inadvertently contribute to systemic risk by adopting conflicting regulations from different jurisdictions which apply to a single transaction. For example, pension plans are concerned about being placed in a situation where they may pay margin based on one jurisdiction’s rules only to be later told by their dealer counterparty that they need to collect additional margin as a result of another jurisdiction’s rules. Had the relevant pension plan known before the transaction that there would additional margin requirements imposed on it, it may not have done the transaction. If international regulations are consistent, applying the law of a single jurisdiction will provide legal certainty and greatly reduce pension plans’ compliance burden and, accordingly, transaction costs.

If international regulations are not consistent, we believe that pension plans should be able to avail themselves of the best protections that exist globally and should not be limited by the rules of their home jurisdiction where those rules provide less protection than another jurisdiction. For example, if a U.S. pension plan desires to avail itself of collateral protections that are offered only in Europe and enters in a transaction in Europe with a counterparty to avail itself of such protections, local European regulation should prevail and the U.S. pension plan should not lose such protections solely because they are not offered in the U.S.

8. Uncleared Margin Rules Should Only Take Effect After The Clearing System Is In Place And Initial Margin Models Have Been Approved

---

[30] *See* Consultative Document, pp. 28-30.

Question 1 in the Consultative Document asks what would be an appropriate phase-in period for uncleared swap margin requirements.[31] The framework in the Consultative Document will create higher initial margin requirements for uncleared swaps than those applicable for cleared swaps, particularly where initial margin is not calculated using an initial margin model. It will take some time for the clearing requirements to be implemented. If uncleared swap margin requirements take effect before the clearing infrastructure is in place, pension plans will have no option but to pay the higher margin requirements under the uncleared swap rules until cleared swaps are available. Similarly, if the uncleared swap margin rules take effect before initial margin models are approved, which timeframe is highly uncertain given the various regulators' resource constraints, pension plans will be forced to post initial margin in accordance with the look-up table, which is expected to impose higher margin requirements than initial margin models.

We recommend that implementation of all uncleared swap margin rules be delayed to coordinate with the clearing system and the approval of internal margin models by global regulators. We also ask that uncleared swap margin rules be phased in to permit market participants time to put in place the necessary arrangements once the rules are final. We suggest, at a minimum, a delay of at least 180 days after the clearing rules take effect before uncleared swap margin rules take effect. Our strong hope, however, is that the global regulators will exempt pension plans from initial margin requirements for uncleared swaps for the reasons stated herein.

* * * *

We appreciate your consideration of our views.

American Benefits Council
Committee on Investment of Employee Benefit Assets
European Federation for Retirement Provision
The European Association of Paritarian Institutions
The National Coordinating Committee for Multiemployer Plans
The Pension Investment Association of Canada

---

[31] Consultative Document, p. 5.

EXHIBIT A

Below is a summary of some of the key reasons U.S.-regulated ERISA plans present virtually no counterparty risk.

- ERISA plans are required to be prudently diversified. In entering into swaps for plans, ERISA requires that plan fiduciaries act solely in the interest of the plan's participants and beneficiaries and with the care, skill, prudence, and diligence that a prudent person familiar with such matters would use.[32]
- "Investment managers" for ERISA plans are required to be regulated entities (registered investment advisers, banks, or insurance companies) that are (1) subject to the highest standard of care under US law, (2) liable for significant financial penalties for failure to comply with relevant provisions of ERISA, and (3) liable in many instances for the acts of other fiduciaries.[33]
- ERISA plan assets are required to be held in trust for future payment, subject to the oversight of a trustee which is typically a US regulated bank or, in the case of a multiemployer plan, an independent trust jointly managed and subject to specified fiduciary rules.[34]
- Because of the regulatory structure that applies to ERISA plans, ERISA plans typically have minimal (if any) leverage.
- ERISA plans are subject to stringent funding requirements pursuant to the Pension Protection Act of 2006.
- ERISA plans are financially transparent; they typically have third-party custodians report their net asset value to dealers on a monthly basis and are required by law to report their holdings annually to the Department of Labor.[35]
- ERISA plans are not operating entities subject to business-line risks and competitive challenges.
- There is no provision under any law for ERISA plans to file for bankruptcy or reorganization to avoid their financial obligations to counterparties. Even the filing of bankruptcy by an ERISA plan sponsor or the involuntary termination of the plan does not relieve a plan of its financial obligations to counterparties since the plan is transferred to the Pension Benefit Guaranty Corporation.
- ERISA plans are typically (and correctly) not treated the same as unregulated investment entities in CFTC regulations. For example, Rule 4.5 excludes certain ERISA plans from the definition of a "commodity pool" and operators of most ERISA plans from the definition of "commodity pool operator." The CFTC has relied on ERISA's "pervasive" regulation of plans and plan fiduciaries as a reason

---

[32] ERISA section 404(a)(1)(B).

[33] ERISA sections 3(38) (investment manager requirements), 404(a) (fiduciary standards), 405 (co-fiduciary liability), 409 (fiduciary liability), 502 (ERISA enforcement).

[34] ERISA section 403(a).

[35] *See* Form 5500.

EXHIBIT C

Below is a summary of some of the key reasons pension plans established in a European Union member state present virtually no counterparty risk.

European pension funds are subject to regulation and extensive regulatory oversight, including the IORP Directive[44] and the national Pension acts of their home countries. Article 18 of the IORP Directive imposes broad investment regulations on pension plans that are intended to assure the security and affordability of occupational pensions. These regulations are designed to enable pension plans to meet their obligations to beneficiaries and creditors.

European pension funds are also subject to an extensive set of rules regarding their solvency and liability coverage ratio. The regulatory framework ensures that pension funds' coverage ratios do not fall below certain minimum levels. European pension plans are therefore conservatively managed and very creditworthy.

European pension funds are users of long dated interest rate and currency and inflation swaps for purposes of limiting investment risk. Their liabilities (*i.e.*, the pension cash flows) are hedged against inflation and interest rate risks, to offer protection for - ultimately the pension beneficiaries. European pension funds are constrained by regulation to use swaps solely for risk management purposes. Article 18(d) of the European IORP Directive (2003/41/EC) restricts pension funds from using OTC derivatives for any purpose other than to manage risks associated with their long-term liabilities. European pension funds do <u>not</u> speculate with derivatives and are not allowed to do so.

The policy of pension funds is usually determined by a board of trustees, consisting of an equal representation of employers and employees. Pension funds are structured as foundations or similar entities, with key characteristics being that these are <u>not-for-profit</u> and <u>independent</u> entities, without shareholders. Mandatory participation typically is an inherent feature of many pension funds in EU countries. This implies that an employer, or a group of employers, has the requirement to offer a pension scheme to its employees. For employees, participation in such a pension scheme is compulsory. This compulsory system for pension funds works on the basis of solidarity and risk sharing among participants. Any return on investment will be to the sole benefit of the future pensioners.

Due to the compulsory nature of pension funds in combination with their conservative long-term investment strategy, the theoretical risk of a bankruptcy of a pension funds is very remote. The pension fund can mitigate such risk, for instance, by (i) increasing the premiums (ii) no indexation and/or (iii) decreasing payments to the pensioners.

---

[44] Directive 2003/41/EC, Jun. 3, 2003, on the activities and supervision of the institutions for occupational retirement provision, OJL 235, 23/9/2003, (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:235:0010:0021:EN:PDF).