PIMCO

Via Electronic Submission

February 21, 2013

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants

Dear Ms. Murphy:

Pacific Investment Management Company LLC ("**PIMCO**") appreciates the opportunity to provide comment on the rule proposed by the U.S. Securities and Exchange Commission (the "**Commission**") on capital, margin and segregation requirements for uncleared security-based swaps (the "**Proposal**").[1] PIMCO is a global investment management firm that serves an array of clients and manages retirement and other assets for millions of people in the U.S. and throughout the world. Our clients include state, municipal, union and private sector pension and retirement plans, educational foundations, endowments and philanthropic and healthcare institutions, in addition to millions of individual mutual fund investors. PIMCO manages assets in a fiduciary capacity on behalf of its clients and does not invest for its own account.

In its capacity as an investment manager and fiduciary to its clients, PIMCO broadly supports improvements in risk management practices for derivative transactions. This includes the goals of moving over-the-counter derivatives to central counterparties ("**CCPs**") and establishing the margin-posting requirements mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("**Dodd-Frank**"), both of which, if properly implemented, will reduce systemic risk. In this regard, PIMCO is preparing to transition as many of its OTC derivatives positions to a clearing environment as is reasonably practicable. However, despite PIMCO's and other market participants' full efforts to comply with this goal, a significant portion of the security-based swap ("**SBS**") market may not be eligible for clearing. For this reason, we are especially concerned about the punitive nature and associated unintended consequences of the Proposal on those end users who, for one reason or another, must rely on the non-cleared SBS market for risk management or other purposes. To this end, PIMCO urges the Commission to reconsider several aspects of the Proposal, including:

- First, the Proposal is overly rigid and onerous in both the amounts and types of collateral that parties would be required to post and, as a result, is not "appropriate for the risk

[1] 77 Fed. Reg. 70214 (Nov. 23, 2012).

associated"[2] with non-cleared SBS. In its current form, the Proposal would unfairly punish those long-term investors who may not have the option to transact in the cleared SBS market.

- Second, in the interest of reducing systemic risk, the Proposal should provide for full bilateral posting of collateral.

- Third, the Proposal should distinguish among types of end user counterparties and should consider some types of end users—particularly pension funds and other types of regulated funds—as "low-risk" and subject to collateral posting thresholds.

- Fourth, the Proposal should not require SBS executed prior to the effectiveness of the Proposal to be included in margin calculations, but should allow such legacy SBS to be included in margin calculations by mutual agreement of the parties. No capital charge should be required for SBS dealers who do not collect collateral for legacy SBS.

- Fifth, the Proposal should ensure that segregation of margin collateral at a third-party custodian is available for all counterparties and should not require SBS dealers to take a capital charge as a result of third-party segregation.

- Finally, because the Proposal will fundamentally affect the economics of a wide range of SBS, we urge the Commission to delay implementation—or at least full implementation—until related elements of market infrastructure, and other regulatory regimes, are in place.

**Recognizing that many market participants will not have the choice to transact in the cleared SBS market, the Commission should moderate the excessive costs that the Proposal imposes on non-cleared SBS transactions by requiring only amounts and types of margin that are "appropriate for the risk associated" with the transactions.**

As stated above, PIMCO strongly supports central counterparty clearing. Yet, even in a well-established, post-Dodd-Frank market, not all SBS will be suitable for clearing. Neither end users nor their SBS dealer or major security-based swap participant ("**MSBSP**") counterparties control which SBS can or will be cleared. Before an SBS can be cleared, it must be accepted for clearing by a CCP.[3] While CCPs may offer clearing services for the more standardized, liquid

[2] Section 15F(e)(3)(A)(ii) of the Securities Exchange Act of 1934, as added by Section 764(a) of Dodd-Frank.

[3] *See* Report of the Senate Committee on Banking, Housing, and Urban Affairs regarding the Restoring American Financial Stability Act of 2010, S. Rep. No. 111–176, at 35 (2010) ("If no clearinghouse, board of trade, exchange, or alternative swap execution facility accepts the contract for clearing or trading, then the contract must be exempt from the clearing and exchange trading requirements.").

contracts for which they can manage the risk,[4] they may be unable to offer clearing services for many less-standardized or less-liquid SBS. These contracts will remain non-cleared—not due to the parties' own choice or riskiness of the instrument, but because of the CCPs' inability to clear those SBS.[5] Even where an SBS is acceptable to a CCP for clearing, the Commission may not approve such SBS for clearing.[6]

Thus, both during the time in which the market adapts to Dodd-Frank and thereafter, there may be many situations in which counterparties are willing to clear their SBS transactions but no CCP is available to do so, forcing the transaction to remain uncleared. In a mature, post-Dodd-Frank SBS market, non-cleared SBS may represent a substantial and necessary portion of total market activity. Given that many market participants will not necessarily be able to control whether SBS in which they transact are cleared, we believe it is especially important that the Commission ensure that the collateral requirements associated with non-cleared SBS are not overly punitive. Under Section 764 of Dodd-Frank, the Commission and the Prudential Regulators must promulgate rules to address the risks of SBS that are not cleared through a CCP. Such rules must "(i) help ensure the safety and soundness of the security-based swap dealer or major security-based swap participant; and (ii) be appropriate for the risk associated with the non-cleared security-based swaps held [by] a security-based swap dealer or major security-based swap participant."[7] We believe the Proposal, however, overstates the "risk associated with non-cleared security-based swaps," and overburdens non-cleared transactions by requiring substantially higher levels of margin collateral for non-cleared SBS.

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[4] Under the Commission's final rule on this point, such a demonstration that the contract is sufficiently liquid and that the CCP has sufficient infrastructure to support the risk and terms of the contract is required for the contract to be approved for clearing at the CCP. *See* Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations, 77 Fed. Reg. 41602, 41649 (to be codified at § 240.19b–4(o)(3)(ii)(A)–(B)); *see also* Process for Review of Swaps for Mandatory Clearing, 76 Fed. Reg. 44464, 44473 (to be codified at § 39.5(b)(3)(ii)(A)–(B)) (CFTC final rule requiring a similar analysis to that required by the SEC); International Organization of Securities Commissions, *Report on Trading of OTC Derivatives* 22–24 (2011) (discussing legal and operational standardization); Anupam Chander & Randall Costa, *Clearing Credit Default Swaps: A Case Study in Global Legal Convergence*, 10 CHI. J. INT'L L. 639, 677 (2010).

[5] CCPs may choose not to clear an SBS for several reasons. Most immediately, key elements of the clearing infrastructure may not be ready to clear a particular SBS. In the longer term, CCPs may elect not to clear an SBS if its unique characteristics do not fit well with the CCP's existing menu of SBS. In particular, an SBS may be low-risk, but may not be liquid enough for central clearing. *See also* Financial Stability Board, *Implementing OTC Derivatives Markets Reforms* 19 (2010) ("[N]on-standardised bespoke products will continue to represent a portion of the OTC derivatives market," not suitable for central clearing.).

[6] *See* Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b–4 and Form 19b–4 Applicable to All Self-Regulatory Organizations, Supplementary Information Section II.A.1, § 240.19b–4(n)(2)(ii), 75 Fed. Reg. 82490, 82493, 82521 (Dec. 30, 2010); Exchange Act Section 19(b)(2)(A)(i), as amended by Section 916(a) of Dodd-Frank.

[7] Section 15F(e)(3)(A) of the Securities Exchange Act of 1934, as added by Section 764(a) of Dodd-Frank.

Higher transaction costs will lead to lower returns for the end users, including pension funds, which continue to use non-cleared SBS. Such costs will spread harm throughout the economy and could negatively affect retirees who depend on pension funds for income. A typical pension fund, for instance, that needs to hedge exposure cannot do so only through SBS that are presently cleared or likely eventually to migrate to the cleared environment. Many SBS that a typical pension fund may need to execute as part of a sound risk management program will remain uncleared. However, the collateral requirements under the Proposal will significantly increase the cost of using non-cleared SBS, penalizing end users, including the pension plans, mutual funds and other vehicles for which PIMCO serves as a fiduciary. To mitigate such costs, some pension funds may be forced to leave risks unhedged or turn to new, untested, less-effective or less-understood risk management tools. This result is ineffectual, detrimental to the economy and unintended by Dodd-Frank.

To lower these costs and minimize unintended consequences, we suggest two changes to the Proposal: (1) model-based margin collateral calculations should be based on a shorter liquidation period and (2) the required haircuts on collateral should be adjusted to expand the range of collateral that can effectively be used.

*Liquidation period in the margin calculation*

The Proposal would allow SBS dealers to calculate margin requirements using models for all SBS other than equity SBS, for which a grid approach would be mandatory.[8] Where models are permitted, the Proposal would require the model to incorporate a 10-day liquidation period, which does not accurately reflect the typical liquidation timeline for SBS instruments.

We recommend that the final rules require that margin models cover a five-day liquidation period rather than a 10-day period. We believe that a five-day liquidation period would serve as an appropriate benchmark for non-cleared SBS, particularly because a five-day period is conservative market practice under the International Swaps and Derivatives Association ("**ISDA**") Master Agreements.[9] In our experience, the close-out process under ISDA Master Agreements rarely takes a full five days, and most transactions close out in less time. The close-out process would be even shorter for liquid, cleared products where standardization and transparency enable a more rapid unwind, which makes it appropriate for the Commission to

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[8] Proposal at 70350 (to be codified at § 240.18a-3(d)(2)). PIMCO generally supports broad availability of models to calculate margin requirements and asks the Commission to consider expanding the allowable use of models.

[9] While the 1992 and 2002 ISDA Master Agreements contain different close-out procedures, they are sufficiently similar to be discussed in the same general terms. In the case of an event of default under either of the ISDA Master Agreements, (1) the terminating party must give notice to the defaulting party of its intention to terminate all outstanding transactions under the Master Agreement, (2) the non-defaulting party then calculates the close-out amount, (3) the non-defaulting party can only then send the statement of payment calculations required by Section 6(d). PAUL HARDING, MASTERING THE ISDA MASTER AGREEMENTS (1992 and 2002) 253, 267–68 (2010).

have declined to dictate the cleared margin model liquidation periods.[10] We agree with this approach with respect to cleared SBS, and believe that, with respect to non-cleared SBS, SBS dealers required to collect margin collateral should benchmark models to collect at least as much collateral as would be required for comparable cleared SBS, but not an excessive amount.

A five-day liquidation period will result in calculations that are "appropriate for the risk" associated with non-cleared SBS and will not needlessly penalize those who continue to rely on non-cleared SBS for prudent risk management. Given the range of other requirements that will be imposed on non-cleared SBS, including reporting, documentation, third-party custodial arrangements and capital charges, we see no basis in Dodd-Frank for penalizing non-cleared SBS through artificially high collateral requirements.

*Eligible collateral*

The Proposal does not dictate the specific types of collateral that counterparties must post in order to satisfy requirements beyond a general restriction to cash, securities and money market instruments, although it seeks comment on whether a more tailored requirement would be preferable.[11] We agree with the Commission that "permitting various types of securities to count as collateral may be more practical for margin arrangements involving security-based swaps,"[12] owing at least in part to the diversity of instruments that may be held in a single customer account. As the Proposal correctly notes, however, the deductions that the collecting SBS dealers would be required to take when accounting for posted collateral[13] "would limit the types of securities and money market instruments a counterparty could provide as collateral and require a counterparty to increase the amount of collateral delivered,"[14] thereby unduly increasing the cost of uncleared SBS transactions for our clients.

We believe that the range of acceptable collateral to satisfy posting requirements should be effectively expanded by applying more appropriate discounts. Making it difficult to use high-grade, liquid assets as acceptable collateral will result in three adverse consequences:

- First, investors may be forced to hold unnecessarily low-yielding securities. For instance, a high-yield bond fund may have to hold Treasury securities and similar

[10] Clearing Agency Standards, 77 Fed. Reg. 66220, 66232–33 (Nov. 2, 2012) ("The Commission also chose not to stipulate specific requirements pertaining to the scope of historical price data, liquidity and replacement considerations, and the correlation of price risks used in calculating margin requirements, again opting for a more flexible standard. While a clearing agency may take such factors into consideration when determining margin requirements, each registered CCP should be free to develop the best margin methodology to accommodate its unique products and markets.").

[11] Proposal at 70269, Questions 1 and 2.

[12] *Id.* at 70264.

[13] *See id.* at 70349 (to be codified at § 240.18a-3(c)(3)).

[14] *Id.* at 70264.

instruments as collateral. Doing so will create an unintended drag on performance and may result in lower returns for the fund's investors. This will constitute an overall cost for investors for which they will not necessarily reap a corresponding risk reduction.

- Second, the securities that investors will be forced to hold as collateral may be different from the transactions or portfolios hedged by the SBS, thereby creating undesirable basis risk[15] and running counter to clients' desire to match benchmark composition. Forcing the manager to hold an out-of-benchmark instrument as collateral may throw off the manager's ability to match or outperform a benchmark whose return is sought by the manager's client, and in general may disturb the desired risk/return balance determined according to the client's investment profile and manager's investment strategy.

- Third, investors seeking to avoid this unnecessary cost or basis may look to "collateral transformation" schemes to convert holdings to assets that satisfy the posting requirements. These collateral transformations will typically include haircuts on securities that will create additional costs for the funding component of the transformation. Further, these arrangements will have an unintended and equally undesirable consequence for the investor, namely, creating unsecured exposure to the repo counterparty or prime broker, possibly increasing the sort of systemic risk that Dodd-Frank is intended to reduce.

As stated above, we believe that the range of acceptable collateral to satisfy posting requirements should be effectively expanded by applying more appropriate discounts. Specifically, we believe that the deductions applicable to high-grade corporate debt or well-understood and liquid structured credit instruments should be altered to better account for the value of these instruments. In our comment letter to the Prudential Regulators and the CFTC on their proposed rules for margining uncleared swaps and SBS,[16] we advocated the use of the option-adjusted spread ("**OAS**") to determine the haircuts applicable to collateral for swaps. We believe this method would be appropriate for determining the haircuts applicable to non-cleared SBS collateral for nonbank counterparties under this Proposal as well and urge the Commission to adopt this approach.

OAS is a theoretically sound method used widely in the market, including by PIMCO. OAS generally measures a debt instrument's risk premium over benchmark rates covering a variety of risks and net of any embedded options in the instrument.[17] For a particular fixed

[15] *See* FRANK J. FABOZZI, THE HANDBOOK OF FIXED INCOME SECURITIES 1312–13 (7th ed. 2005).

[16] Letter to the Prudential Regulators and the CFTC on the Proposed Margin and Capital Requirements for Covered Swap Entities (July 11, 2011), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47757&Search Text=.

[17] FRANK J. FABOZZI, THE HANDBOOK OF FIXED INCOME SECURITIES 908–09 (7th ed. 2005).

income instrument, the OAS reflects the credit and liquidity risk net of any spread due to option features in the instrument and associated option risk. Because OAS can be calculated in a consistent manner for any fixed income instrument relative to its benchmark rates, this method allows for comparison of fixed income instruments across asset classes.[18] The OAS thresholds and associated haircuts for high-grade fixed income instruments can be determined in accordance with an approved method. For instance, we recommend the following as one possible schedule:

**Margin Value for High-Grade Debt or Credit Instruments Used as Collateral (% of market value)**

| | **Maturity (years)** | | | |
|---|---|---|---|---|
| **OAS Value (basis points)** | **0–2** | **2–5** | **5–11** | **11+** |
| ≤ 50 | 96 | 95 | 94 | 93 |
| > 50 but ≤ 100 | 92 | 91 | 90 | 89 |
| > 100 but ≤ 150 | 90 | 89 | 88 | 87 |
| > 150 but ≤ 200 | 82 | 81 | 80 | 79 |
| > 200 but ≤ 250 | 78 | 77 | 76 | 75 |
| > 250 | Instrument not acceptable as collateral | | | |

While we understand why the Commission would choose to base collateral haircuts for SBS dealers' capital on broker-dealer capital haircuts, we do not believe that these same haircuts should be applicable to collateral collected from counterparties. Unlike haircuts applied to assets held to meet capital requirements, which do not directly affect third parties, haircuts applied to collateral collected from counterparties directly dictate the amount of collateral that the counterparty must post. As a result, haircuts applied to amounts collected as collateral must be simple and consistent with the way in which the end user values the collateral. Allowing end user counterparties to calculate the haircuts applicable to their collateral using OAS would permit these counterparties to assess accurately their posting obligations without requiring the analysis and application of a large portion of broker-dealer regulation that would otherwise be irrelevant to their operations.

Furthermore, many SBS end user counterparties will face both bank SBS dealers, who will be subject to the Prudential Regulators' collateral rules, as well as nonbank SBS dealers, who will be subject to the Proposal. For ease of application and consistency of treatment across instruments, as well as to minimize the opportunity for regulatory arbitrage, we believe that the haircuts applicable to SBS under the Proposal should be aligned with haircuts applicable to SBS as determined by the Prudential Regulators. We believe that this would best be accomplished through an OAS-based approach.

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[18] *See* FRANK J. FABOZZI, FIXED INCOME ANALYSIS FOR THE CHARTERED FINANCIAL ANALYST PROGRAM 350–53 (2000).

**The Proposal should provide for bilateral posting of collateral.**

Under the Proposal, an SBS dealer must collect collateral to protect against both current exposure and potential future exposure to its counterparties. For each counterparty, the SBS dealer must calculate the "equity" in the counterparty's account on a daily basis by taking the total market value of all securities held by the SBS dealer, plus credits owed to and minus debits owed from the dealer. To protect against current counterparty exposure, an account held by an SBS dealer may not have a negative equity value, and sufficient collateral to offset any negative equity must be posted by noon of the business day following the calculation resulting in a negative amount. In addition, the Proposal requires that accounts held by SBS dealers must have sufficient positive value to protect against potential future exposure, via a daily "margin amount" calculation. The amount of positive value in each account held by an SBS counterparty must be equal to the calculated margin amount, with limited exceptions.[19]

On the other hand, under the Proposal, MSBSPs must collect or post collateral to address current exposure only. Consequently, at the end of each day, an MSBSP must calculate the equity in its SBS counterparties' accounts, as described above, and by noon of the next business day collect sufficient collateral to offset any negative equity values. If the account's equity value is positive, the MSBSP must deliver collateral to its counterparty equal to the account's equity surplus by noon of the following business day.[20] MSBSPs are not required to collect collateral to protect against potential future exposure and therefore are not required to calculate or collect a positive equity margin amount.

As a result, an end user counterparty to an MSBSP, but not an end user counterparty to an SBS dealer, is protected from the default of its SBS counterparty. In contrast, we believe that an end user counterparty to any SBS dealer[21] should be protected against its counterparty's default in the same way that the SBS dealer is protected from the end user's default. In fact, in many cases, non-leveraged, real-money end users will pose less counterparty risk than a potentially leveraged bank that is an SBS dealer. As a result, we believe that an SBS dealer should be required to post collateral to its counterparties to protect against both current exposure and potential future exposure at the option of its counterparty.

We believe that the option to require full two-way collateral posting is appropriate for three main reasons. First, such practice would follow what are currently considered to be best

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[19] Proposal at 70270, Questions 12–18.

[20] *Id.* at 70348–50 (to be codified at 17 C.F.R. § 240.18a–3(b)–(d)).

[21] As we expect some of PIMCO's SBS counterparties to be SBS dealers, but not MSBSPs, we focus throughout this letter on the Proposal's treatment of SBS dealers. Where applicable, we would have the same recommendations with respect to MSBSP rules.

practices in collateral and credit risk management in the SBS market.[22] Second, in many cases, the counterparty to an SBS dealer may be a more stable and secure entity than the SBS dealer itself.[23] Third, the SBS dealer that is not required to post collateral under the Proposal has an incentive to keep the SBS in the non-cleared market. This runs counter to Dodd-Frank's purpose to bring more SBS into the cleared market.

While we understand that the Commission may be responding to the language of Dodd-Frank requiring regulators to promulgate rules to address risks to SBS dealers, we believe this requirement must be read in the context of the larger goals of the statute to reduce systemic risk, improve transparency and otherwise improve the safety of the financial markets. We believe a set of rules that calls only for one-way posting of collateral to SBS dealers would tend to *increase* systemic risk relative to the current system of risk management in the non-cleared SBS market.

**The Proposal should allow for margin thresholds that depend on the risk posed by the SBS counterparty.**

The Commission requires SBS dealers to collect positive margin amounts on SBS to protect the SBS dealer against the potential future exposure posed by its counterparty. Based on this logic, we believe that the amount of margin that must be collected should depend on the risk posed by the counterparty in question. For example, entities such as registered investment companies, ERISA funds, and foreign pension plans that are subject to comprehensive regulatory regimes are minimally risky SBS counterparties. These low-risk financial end users should be allowed an uncollateralized threshold of $100 million. Threshold rates for other counterparties should be calibrated using this threshold. We note that allowing an unsecured threshold would be in line with the proposals of the Prudential Regulators, the CFTC and the Basel Committee on Banking Supervision and International Organization of Securities Commissions,[24] which would all allow a covered swap entity to apply a threshold to both initial and variation margin in certain cases.

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[22] We note that bilateral posting of collateral is standard market practice for cleared derivatives. Given that uncleared derivatives are generally considered to pose more risk, we would be surprised if the Commission intended for the uncleared market to be less collateralized than the cleared market.

[23] For instance, an ERISA plan may in many cases be a "better" credit than an SBS dealer, but the Proposal presently does not contemplate the ERISA plan calling collateral to protect against potential future exposure from an SBS dealer to reflect the risk that the SBS dealer may pose to the ERISA plan as a counterparty.

[24] Second Consultative Document issued by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions on Margin requirements for non-centrally-cleared derivatives, *available at* http://www.bis.org/publ/bcbs242.pdf.

**The Proposal should allow counterparties to include SBS executed prior to the effectiveness of the Proposal in margin calculations, but only by mutual agreement of the parties. No capital charge should be required for legacy SBS not included in collateral calculations.**

The Proposal does not require SBS dealers to collect collateral to protect against exposure arising from "legacy accounts"—accounts that contain only SBS entered into prior to the effectiveness of the rules.[25] We agree with this exclusion of legacy accounts from the calculation requirements for SBS dealers. We do not agree, however, with the requirement that SBS dealers must take a capital charge equal to the margin amount minus the positive equity in the account.[26] The costs of this requirement will ultimately flow back to the counterparties, penalizing all counterparties who trade with any affected SBS dealer. Further, the retroactive effect of such a requirement—which effectively requires SBS dealers to revise the price terms of pre-effective SBS—is contrary to the prospective nature of the rest of Dodd-Frank's Title VII.[27]

As a result, we believe that it would be more appropriate for the Commission to exclude legacy SBS from all collateral calculations, unless both parties agree that the transactions should be included. We believe that parties should be able to mutually benefit from lower collateral requirements that may result from the inclusion of legacy SBS in collateral calculations, and that the requirement for mutual agreement would be more consistent with general principles of contract law. If, however, the transactions are included in collateral calculations, no capital charge should be required, so as not to retroactively penalize SBS dealers for their previous transactions or create additional price burdens for these dealers' counterparties prospectively.

**The Proposal should require segregation of the margin amount at a third-party custodian for all counterparties and not subject such segregation to pricing penalties through a capital charge.**

Because segregation is central to risk management, we believe that the Proposal should require an SBS dealer to segregate any collateral posted to satisfy the margin amount with an independent custodian. Absent an actual requirement to segregate initial margin, cost considerations will lead SBS dealers to pressure counterparties not to elect segregation, which is contrary to Dodd-Frank's goals. We believe that a requirement to segregate margin amounts will impose discipline on the market in a way that will encourage increased protection against systemic risk.

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[25] Proposal at 70249 (to be codified at § 240.18a-3(c)(1)(iii)(D), (c)(2)(iii)(C)).

[26] *Id.* at 70336 (to be codified at § 240.18a-1(c)(1)(viii)(B)(3)).

[27] *See* Dodd-Frank § 712(f). Note also there may be grounds for challenging this approach. *See* Bowen v. Georgetown Univ. Hosp., 488 U.S. 204, 208 (1988) ("[A] statutory grant of legislative rulemaking authority will not, as a general matter, be understood to encompass the power to promulgate retroactive rules unless that power is conveyed by Congress in express terms.").

For a similar reason, we believe that it is inappropriate, and contrary to Dodd-Frank's goals, to require an SBS dealer to take a capital charge in the event that counterparty collateral is segregated.[28] Specifically, the Commission would require an SBS dealer to take a capital charge equal to the margin amount minus any positive equity in the account for any counterparty that elects to segregate margin collateral at an independent third-party custodian.[29] This will significantly increase the cost of such an election to the SBS dealer, which cost will be directly passed on to the end user counterparty. Though it is in the best interest of the system to encourage independent third-party segregation of margin amounts, many end users faced with a higher cost per swap if segregation is elected will, understandably, waive the segregation requirement. Requiring SBS dealers to take a capital charge will inappropriately penalize parties that wish to exercise their statutory right to require segregation. We believe that imposing an effective penalty on counterparties that wish to exercise this statutory right is contrary to the consumer-protection spirit of Dodd-Frank.

**Implementation of the Proposal must be coordinated among U.S. and international regulators and with the development of market infrastructure, including the development of clearinghouses and custodial arrangements.**

We strongly believe that the effective dates for the Proposal should be harmonized with the effective dates for margin requirements for uncleared swaps, promulgated by the CFTC, Prudential Regulators and international regulators. Without such coordination, market participants may face uncertainty as to the rules and associated margin calculation methodology applicable to SBS, depending on the counterparty. Further, market distortions may occur if the rules applicable to SBS do not become effective until well after the rules applicable to swaps. Uncertainty would lead to confusion in the marketplace, possibly even undermining the price transparency goals of Dodd-Frank. The Commission, Prudential Regulators and CFTC (and, to the extent possible, international regulators) can avoid these problems by aligning the effective dates of their respective rules.

More significantly, however, we urge regulators to impose their respective rules in a manner that is sensitive to the development of key aspects of market architecture. In our view, there are at least two areas of operational and contractual infrastructure that need to be in place, without which implementation of the regulators' respective rules could lead to unintended consequences contrary to the goals of Dodd-Frank.

First, the infrastructure for clearing SBS must be sufficiently established at the CCPs and accessible to market participants so that parties willing to clear transactions can do so. This will be particularly important if the Proposal requires higher levels of collateral for non-cleared SBS than for cleared SBS—implementing the Proposal prior to widespread use of clearing would tend to amplify the costs of the Proposal on SBS transactions. The chilling effect on SBS transaction

[28] Proposal at 70247, Questions 9 and 10.

[29] Proposal at 70336 (to be codified at § 240.18a-1(c)(1)(viii)(B)(2)).

activity or the attendant costs of continuing to enter into SBS transactions would likely lead to adverse risk management consequences. We therefore urge the Commission to consider the state of development of the operational infrastructure, account structures, contractual arrangements and applicable rules of self-regulatory organizations that are the subject of other rulemakings under Dodd-Frank before imposing these onerous collateral rules.

Second, the infrastructure of custodial accounts for segregated collateral must be finalized and implemented before the Proposal can be effective. Establishing the independent custodial accounts permitted under the Proposal will take time. The marketplace has not settled on standard terms for these arrangements, and we expect the independent custodian community to wait until relevant rulemaking has progressed further before doing so. If an SBS dealer's counterparty is unable to avail itself of segregation at an independent custodian because the tri-party custodial agreement or account infrastructure is not yet in place, collateral held at SBS dealers may increase systemic risk to counterparties rather than reduce it, as an end user will face counterparty default risk where an SBS dealer directly holds collateral. We thus urge the Commission to be mindful of this required infrastructure in determining the effective dates of the Proposal.

The modifications to the Proposal outlined in this letter will further our shared objective of reducing systemic risk arising from the SBS market while reducing the likelihood of unintended and adverse market impacts.

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PIMCO thanks the Commission for giving it the opportunity to comment on the Proposal and for the Commission's consideration of PIMCO's views on the subject. If you have any questions, please do not hesitate to call me at (949) 720-6000.

Sincerely,

Douglas M. Hodge
Managing Director, Chief Operating Officer
Pacific Investment Management Company LLC