P I M C O

Via Electronic Submission

July 11, 2011

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Re: Issues Arising from Margin Requirements for Covered Swap Entities as Proposed by the Prudential Regulators and Commodity Futures Trading Commission:

Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants[1]

Margin and Capital Requirements for Covered Swap Entities[2]

Dear Mr. Stawick, Mr. Walsh, Ms. Johnson, Mr. Feldman, Mr. Van Meter and Mr. Pollard:

Pacific Investment Management Company LLC ("**PIMCO**") appreciates the opportunity to comment on the CFTC's proposed rule on margin requirements for uncleared swaps (the "**CFTC Proposed Rule**") and the joint proposed rule by the OCC, Fed, FDIC, FCA and FHFA

[1] 76 Fed. Reg. 23,732 (Apr. 28, 2011).
[2] 76 Fed. Reg. 27,564 (May 11, 2011).

(together, the "**Prudential Regulators**," such proposed rule, the "**PR Proposed Rule**," and the PR Proposed Rule with the CFTC Proposed Rule, the "**Proposed Rules**").

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, 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 swap transactions. This includes the goals of moving over-the-counter derivatives to central counterparties ("**CCP**") and establishing the margin-posting requirements mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, 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 and other market participants' full efforts to comply with this goal, a significant amount of swaps will not be eligible for clearing. For this reason, we are especially concerned about the punitive nature and associated unintended consequences of the Proposed Rules on those end users who, for one reason or another, must rely on the non-cleared swaps market for risk management or other purposes. To this end, PIMCO urges the Prudential Regulators and CFTC (together, the "**Agencies**") to reconsider several aspects of the Proposed Rules, including:

- First, the Proposed Rules are overly rigid and onerous in both the amounts and types of collateral that they would require parties to post, and, as a result, are not "appropriate for the risk associated"[3] with non-cleared swaps. In their current forms, these rules would unfairly punish those long-term investors who may not have the option to engage in the cleared swaps market.

- Second, in the interest of reducing systemic risk, the Proposed Rules should allow for bi-lateral posting of margin, not simply unilateral posting of margin to swap dealers/major swap participants.

- Third, the Proposed Rules should consider more types of end users—particularly pension funds and other types of regulated funds—as "low-risk" financial end users or financial entities.

- Fourth, the Proposed Rules should allow counterparties to include swaps executed prior to the effectiveness of the Proposed Rules in initial margin calculations, but only by mutual agreement of the parties.

[3] Section 4s(e)(3)(A)(ii) of the Commodity Exchange Act, as added by Section 731 of Dodd-Frank; *see also* Section 15F(e)(3)(A)(ii) of the Securities and Exchange Act of 1934, as added by Section 764(a) of Dodd-Frank.

- Fifth, the Proposed Rules should ensure that segregation of initial margin at a third-party custodian is available for all counterparties.

- Finally, because the Proposed Rules will fundamentally affect the economics of a wide range of swaps, we urge the Agencies to delay implementation—or at least full implementation—until related elements of market infrastructure are in place.

**Recognizing that many market participants will not have the choice to transact in the cleared swaps market, the Agencies should moderate the excessive costs that the Proposed Rules impose on non-cleared swap 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, we emphasize that even in a well-established, post-Dodd-Frank market, not all swaps will be suitable for clearing. In fact, end users and even swap dealer or major swap participant (**"MSP"**) counterparties do not control which swaps will be cleared. Before a swap can be cleared, it must be accepted for clearing by a CCP.[4] While CCPs may offer clearing services for the more standardized, liquid contracts for which they can manage the risk,[5] they may be less willing to offer clearing services for many less-standardized or less-liquid swaps. These contracts will remain non-cleared—not due to the parties' own choice or riskiness of the swap, but because of the CCPs' unwillingness to clear the trades.[6]

During the time in which the market adapts to Dodd-Frank, there may be many situations in which counterparties are willing to clear their swap but no CCP is available, forcing the transaction to remain in non-cleared form. Even where a swap is acceptable to a CCP for clearing, the CFTC or SEC may not approve such swap for clearing.[7] As a result, in a mature, post-Dodd-Frank swap market, non-cleared swaps will represent a substantial and necessary portion of total swap activity.

A typical pension fund, for instance, that needs to hedge exposure cannot do so only through swaps that are presently cleared or likely eventually to migrate to the cleared

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[4] *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.").

[5] Under the CFTC and SEC proposals 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. CFTC Proposed Process for Swap Review, § 39.5(b)(3)(ii)(A)–(B); SEC Proposed Process for SB Swap Review, § 240.19b–4(o)(3)(ii)(A)–(B). *See also* IOSCO OTC Report at 22–24 (discussing legal and operational standardization); Anupam Chander & Randall Costs, *Clearing Credit Default Swaps: A Case Study in Global Legal Convergence*, 10 CHI. J. INT'L L. 639, 677 (2010).

[6] CCPs may chose not to clear a swap for several reasons. Most immediately, key elements of the clearing infrastructure may not be ready to clear a particular swap. In the longer term, CCPs may elect not to clear a swap if its unique characteristics do not fit well with the CCP's existing menu of swaps. In particular, a swap may be low-risk, but may not be liquid enough for central clearing. *See also* FSB OTC Report at 19 ("[N]on-standardised [sic] bespoke products will continue to represent a portion of the OTC derivatives market," not suitable for central clearing.).

[7] *See* Process for Review of Swaps for Mandatory Clearing, § 39.5(a)(2), 75 Fed. Reg. 67,277, 67,281 (Nov. 2, 2010) (to be codified at 17 C.F.R. 39); 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. 82,490, 82,493, 82,521 (Dec. 30, 2010); Exchange Act Section 19(b)(2)(A)(i), as amended by Section 916(a) of Dodd-Frank.

environment. Many swaps that a typical pension fund may need to execute as part of a sound risk management program will remain non-cleared. However, the margin requirements under the Proposed Rules will significantly increase the cost of using non-cleared swaps, penalizing end users, including the pension plans, mutual funds and other vehicles for which PIMCO serves as a fiduciary.

Given that many market participants will not necessarily be able to control whether swaps in which they transact are cleared, we believe it is especially important that the Agencies ensure that neither the margin nor collateral requirements associated with non-cleared swaps are overly punitive. Under Sections 731 and 764 of Dodd-Frank, the Agencies must promulgate rules to address the risks of swaps and security-based swaps that are not cleared through a derivatives clearing organization or clearing agency. Such rules must "(i) help ensure the safety and soundness of the swap dealer or major swap participant; and (ii) be appropriate for the risk associated with the non-cleared swaps held [by] a swap dealer or major swap participant."[8] We believe the Proposed Rules, however, overstate "the risk associated with non-cleared swaps," and overburden non-cleared transactions by requiring substantially higher levels of initial margin for non-cleared swaps. Higher transaction costs will, in turn, lead to lower returns for the end users that continue to use non-cleared swaps, for instance, pension funds. Such costs will spread harm throughout the economy, including to retirees who depend on pension funds for income. To mitigate such costs, 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 Proposed Rules: (1) the initial margin calculations should be based on a shorter liquidation period, and (2) the range of acceptable collateral for initial margin should be expanded.

*Liquidation period in the initial margin calculation*

By requiring parties to calculate initial margin using a liquidation period that exceeds the actual liquidation timeframe, the Proposed Rules add unnecessary costs to non-cleared swaps. While we agree that it is prudent for such period to be longer for non-cleared swaps than it is for cleared swaps, the standard currently proposed for cleared swaps is itself longer than necessary. Under both Proposed Rules, counterparties must post an amount of initial margin sufficient to cover, at a relatively high confidence level of 99 percent, the price fluctuation of the swap over a 10-day liquidation period.[9] We note that this is double the amount of time required for cleared swaps not executed on a designated contract market. Under the CFTC's proposed rule on risk management requirements for derivatives clearing organizations (the "**DCO Risk Management Proposal**"), DCOs must calculate initial margin, at a similarly high confidence level of 99

[8] Section 4s(e)(3)(A) of the Commodity Exchange Act, as added by Section 731 of Dodd-Frank; *see also* Section 15F(e)(3)(A) of the Securities and Exchange Act of 1934, as added by Section 764(a) of Dodd-Frank.

[9] CFTC Proposed Rule § 23.155(b)(2)(vi), 76 Fed. Reg. 23,732, 23,746; PR Proposed Rule, § ___.8(d)(1), 76 Fed. Reg. 27,564, 27,590.

percent, based on a 5-day liquidation period for swaps not executed on a DCM and a 1-day liquidation period for all other swaps.[10]

Instead, we favor an approach suggested in the Proposed Rules, where swap entities are required to benchmark their initial margin models to yield at least as much margin as would be required for comparable cleared swaps,[11] set at levels that appropriately reflect the risk associated with such transactions. Because the 5-day period is based on market practice under the International Swaps and Derivatives Association Master Agreements,[12] it applies more appropriately to *non-cleared* swaps, while the standard for cleared swaps should be shorter, in recognition of the more orderly close-out process that would be available for cleared swaps.[13] We recommend that (a) the Proposed Rules should require that initial margin cover a 5-day liquidation period rather than a 10-day period, and (b) the DCO Risk Management Proposal should require that initial margin for cleared swaps call for a shorter liquidation period, perhaps as little as 2 days. These liquidation periods will result in initial margin calculations that are "appropriate for the risk" associated with non-cleared swaps and will not needlessly penalize those who continue to rely on non-cleared swaps for prudent risk management. Given the range of other requirements that will be imposed on non-cleared swaps, including reporting, documentation, third-party custodial arrangements and capital charges, we see no basis in Dodd-Frank for penalizing non-cleared swaps through artificially high margin requirements.

*Eligible collateral for initial margin*

We additionally believe that the range of acceptable collateral for initial margin should be expanded beyond the current requirements under the Proposed Rules to include other types of securities, given appropriate discounts or haircuts. Such additional types of securities might include high-grade corporate debt or well-understood and liquid structured credit instruments.

Even without the use of credit rating agencies, there are other, possibly even more appropriate, methods of discerning high-grade debt for use as margin. The option-adjusted spread ("**OAS**") is a theoretically sound method used widely in the market, including by PIMCO.

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[10] Risk Management Requirements for Derivatives Clearing Organizations, § 39.13(g)(2)(ii)–(iii), 76 Fed. Reg. 3,698, 3,720–21 (Jan. 20, 2011) (to be codified at 17 C.F.R. 39).

[11] CFTC Proposed Rule § 23.155(b)(2)(xiii), 76 Fed. Reg. 23,732, 23,746; PR Proposed Rule, § ___.8(d)(14), 76 Fed. Reg. 27,564, 27,591.

[12] 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). In our experience, this close-out process under the ISDA Master Agreements conservatively takes five days. Such a close-out process, however, does not take place in the more liquid, cleared market where standardization and transparency enable a more rapid unwind.

[13] Market participants have commented that the minimum five-day liquidation horizon for cleared swaps not executed on a designated contract market may be overly conservative in the cleared space. John M. Damgard, *Comment Letter submitted by the Futures Industry Association Re: RIN 3038–AC98*, at 7 (Apr. 7, 2011) (The DCO Risk Management Proposal "sets a minimum liquidation period that, over time, may prove to be excessive."); Robert Pickel, *Comment Letter submitted by the International Swaps and Derivatives Association Re: RIN 3038–AC98*, at 6 (Mar. 21, 2011) (commenting that the liquidation time will depend on "the characteristics of the relevant swap and the market that it trades in" and that "a DCO may have detailed default plans that have been put through several practical tests that demonstrate the relevant portfolio of swaps can be liquidated in a very short time."); Peter Krenkel, *Comment Letter submitted by Natural Gas Exchange Inc. Re: RIN 3038–AC98*, at 2–3 (Apr. 21, 2011) (NGX computes collateral requirements assuming a minimum liquidation period of two days and adjusts depending on the unique characteristics of products or portfolios).

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.[14] For a particular fixed 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, and 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.[15] 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)

| | **Duration (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 | | | |

Failing to include these high-grade, liquid assets as acceptable collateral will result in three adverse consequences. First, investors may be forced to hold unnecessarily low-yielding securities in relation to the transactions or portfolios hedged by the swaps. For instance, a high-yield bond fund may have to hold Treasurys and similar instruments as collateral. Doing so will create an unintended drag on performance and may result in the fund missing its benchmark. This will constitute an overall cost for investors for which they will not reap a corresponding risk reduction.

Second, the securities that investors will be forced to hold as margin may be out of step with the transactions or portfolios hedged by the swap or the portfolio benchmark, thereby creating undesirable basis[16] and running counter to clients' desire to match benchmark composition.[17] Forcing the manager to hold an out-of-benchmark instrument as margin 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 choose to enter into repurchase transactions or use prime brokerage arrangements to raise the cash or liquid securities

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

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

[16] We use the term "basis" here to mean a mismatch between the instrument being hedged and the hedge instrument. *See* FRANK J. FABOZZI, THE HANDBOOK OF FIXED INCOME SECURITIES 1312–13 (7th ed. 2005).

[17] As an example, a fixed-income fund manager may wish to enter into a swap to hedge some of the fund's interest rate risk and could do so by exchanging fixed interest rate exposure for floating rate exposure by entering into a swap. The best collateral to use for this swap is likely to be the fixed rate bond or bonds whose interest rates are being swapped for floating rate return. But the Proposed Rules may require the manager to hold as margin securities that have no relation to the portfolio.

needed as initial margin. 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.

**Following appropriate risk management practices in the bilateral swap market, the Proposed Rules should allow for bilateral posting of margin, not simply posting of margin to swap dealers and MSPs, as end users will often pose less credit risk than the swap entity.**

Under both Proposed Rules, the covered swap entity must collect both initial and variation margin from its counterparty; however, the Proposed Rules neither require nor accommodate the possibility of bilateral exchanges of margin between swap counterparties. We are encouraged that the CFTC questions this approach in its release and specifically seeks comment on this point, providing numerous arguments in favor of two-way margin posting.[18]

We agree with many of the CFTC's arguments in support of two-way margin posting for three main reasons. First, such practice would follow what are currently considered to be best practices in collateral and credit risk management in the OTC market. Perhaps most importantly, as the CFTC notes in its release, two-way payment of variation margin prevents exposures from accumulating.[19] Second, in many cases, the counterparty to a covered swap entity may be a more stable and secure entity than the covered swap entity itself.[20] Third, the covered swap entity that is not required to post initial margin under the Proposed Rules has an incentive to keep the swap in the non-cleared market. This runs counter to Dodd-Frank's purpose to bring more swaps into the cleared market.

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

**The Proposed Rules should consider a broader range of regulatory structures in determining which end users can benefit from margin thresholds.**

The Proposed Rules should expand the criteria that establish whether end users are eligible for margin thresholds. Under the PR Proposed Rule, a covered swap entity may apply a threshold to both initial and variation margin if its counterparty is a "low-risk financial end user"—a financial end user that is "subject to capital requirements established by a prudential

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[18] CFTC Proposed Rule, Supplementary Information Section II.C.3, 76 Fed. Reg. 23,732, 23,736.

[19] *Id.* ("Unchecked accumulation of such exposures was one of the characteristics of the financial crisis which, in turn, led to the enactment of the Dodd-Frank Act.").

[20] For instance, an ERISA plan may in many cases be a "better" credit than a covered swap entity, but the Proposed Rules presently do not contemplate the ERISA plan calling for margin from a covered swap entity to reflect the risk that the covered swap entity may pose to the ERISA plan as a counterparty.

regulator or state insurance regulator," among other requirements.[21] Under the CFTC Proposed Rule, a covered swap entity is permitted to set a threshold for both initial and variation margin if its counterparty is a financial entity that represents that it is, among other things, "subject to capital requirements established by a prudential regulator or State insurance regulator."[22]

We believe this definition in the PR Proposed Rule, and accommodation in the CFTC Proposed Rule, should take account of other regulatory regimes beyond that of a prudential regulator or state insurance regulator where such other regulatory regime effectively limits the leverage or riskiness of the counterparty.[23] Accordingly, the definition of "low-risk financial end user" in the PR Proposed Rule, and the availability of margin thresholds for certain financial entities in the CFTC Proposed Rule, should also accommodate entities that are subject to oversight by the Securities and Exchange Commission under the Investment Advisers Act of 1940, Department of Labor under the Employee Retirement Income and Security Act of 1974, or other comparable regulatory regime, where such regulation has the effect of limiting the leverage of the regulated entity.

**The Proposed Rules should allow counterparties to include swaps executed prior to the effectiveness of the Proposed Rules in initial margin calculations, but only by mutual agreement of the parties.**

The PR Proposed Rule allows covered swap entities to incorporate swaps whose execution predates the effectiveness of the rules into a portfolio initial margin model[24] while the CFTC Proposed Rule does not. We urge the Prudential Regulators and CFTC to consider two points in relation to parties' ability to include pre-effective swaps in initial margin calculations.

First, we understand that the PR Proposed Rule allows parties to include pre-effective swaps in initial margin calculations only by the parties' mutual agreement. PIMCO would appreciate clarification to this effect in the PR Proposed Rule. We are concerned that the PR Proposed Rule's treatment of pre-effective swaps may be construed by covered swap entities as a free option to be applied in all cases to the benefit of the covered swap entity, which may, in turn, harm its counterparty and distort the market.[25] Additionally, the retroactive effect of such a provision—which effectively allows covered swap entities to revise the collateral terms of pre-effective swaps at their option—is contrary to the prospective nature of the rest of Dodd-Frank's

[21] *Id.* § ____.2(n)(3), 76 Fed. Reg. 27,564, 27,587.

[22] CFTC Proposed Rule §§ 23.153(c)(1)(i), 76 Fed. Reg. 23,732, 23,745; *see also id.* Supplementary Information Section II.C.3, 76 Fed. Reg. 23,732, 23,736 & n.11.

[23] For instance, regulated investment companies are subject to extensive regulation by the Securities and Exchange Commission, in particular under the Investment Advisers Act of 1940, that has the effect of limiting their leverage and the discretion of the investment companies' asset managers. Similarly, employee benefit plans falling under paragraphs (3) and (32) of Section 3 of the Employee Retirement Income and Security Act of 1974 are subject to supervision by the Department of Labor which subjects those plans to a restrictive set of investment rules. Such regulatory oversight diminishes the risk that such regulated entities pose as end users in swap transactions, and we believe this risk mitigating effect should be recognized under the PR Proposed Rules.

[24] PR Proposed Rule, § ____.8(b)(1)–(2), 76 Fed. Reg. 27,564, 27,590.

[25] Under the PR Proposed Rule, the covered swap entity can choose to calculate initial margin "[w]ith respect to only those swaps and/or security-based swaps transactions entered into on and after the effective date," or alternatively, "[w]ith respect to all swaps and/or security-based swaps transactions governed by such qualifying master netting agreement, regardless of whether they were entered into before, on, or after the effective date." PR Proposed Rule, § ____.8(b)(1)–(2), 76 Fed. Reg. 27,564, 27,590. If this is interpreted to allow covered swap entities this sort of free option, the margin requirement for the same swap could vary solely based on whether the covered swap entity chooses to include pre-effective swaps in the calculation.

Title VII[26] and to the general principles of contract law whereby a party to a contract cannot unilaterally change contract terms.

Second, we agree that parties should be able to benefit from lower initial margin amounts that result from the inclusion of pre-effective swaps in the initial margin calculation. We believe the treatment of pre-effective swaps under both the PR Proposed Rule and CFTC Proposed Rule should be consistent, and recommend that the CFTC adopt a rule provision allowing parties to include pre-effective swaps in initial margin calculations, similar to the provision in the PR Proposed Rule.[27] As with our recommendation regarding the PR Proposed Rule, assuming the CFTC includes a provision allowing parties to use pre-effective swaps in initial margin calculations, we would ask the CFTC to make clear that parties may only use pre-effective swaps in initial margin calculations by mutual agreement.

**The Proposed Rules should ensure that segregation of initial margin at a third-party custodian is available for all counterparties.**

Because segregation is central to risk management, we believe the Proposed Rules should require a covered swap entity to segregate initial margin with an independent custodian. At present, whether the Proposed Rules require segregation depends on whether a covered swap entity's counterparty is a swap dealer or MSP. The CFTC Proposed Rule requires that each covered swap entity hold initial margin at an independent third-party custodian when it receives initial margin from a counterparty that is an swap dealer or MSP,[28] and both Proposed Rules require that each swap entity hold margin at an independent third-party custodian when it receives margin from a covered swap entity.[29] The CFTC Proposed Rule additionally requires each covered swap entity to provide each of its counterparties the opportunity to select an independent custodian to hold initial margin.[30] The PR Proposed Rule does not contain a similar notification requirement.

We first recommend that the Proposed Rules require a covered swap entity to hold initial margin received from its counterparty at an independent custodian. Such a provision is in line with the statutory requirement for covered swap entities to notify each counterparty of that counterparty's right to have initial margin held in a segregated account at an independent third-party custodian.[31] We would further encourage the Agencies to ensure that a covered swap entity does not unduly delay the establishment of tri-party custodial agreements, and that if it does not execute such agreements within a reasonable time for segregation by the covered swap entity's counterparty, the covered swap entity must hold its counterparty's collateral in a segregated client account on its own books and records.

[26] *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.").

[27] PR Proposed Rule, § ___.8(b)(1)–(2), 76 Fed. Reg. 27,564, 27,590.

[28] CFTC Proposed Rule, § 23.158(a)(3), 76 Fed. Reg. 23,732, 23,748.

[29] *Id.*; PR Proposed Rule, § ___.7(a), 76 Fed. Reg. 27,564, 27,589. In the case of the CFTC Proposed Rule, this requirement applies to covered swap entities when they post margin to swap dealers or MSPs. CFTC Proposed Rule, § 23.158(a)(4), 76 Fed. Reg. 23,732, 23,748.

[30] CFTC Proposed Rule, § 23.158(a)(2), 76 Fed. Reg. 23,732, 23,748.

[31] *See* Section 4s(l)(1)(A) of the CEA, as added by Section 724 of Dodd-Frank; *see also* Section 3E(f)(1)(A) of the Exchange Act, as added by Section 763(d) of Dodd-Frank.

**Implementation of the Proposed Rules must be coordinated—among the Agencies and with respect to other aspects of market infrastructure, such as clearing houses and custodial arrangements.**

As a basic aspect of inter-agency coordination, the effective dates for the Proposed Rules should be harmonized. Without such coordination, market participants will face uncertainty as to the margin rules and associated margin calculation methodology applicable to swaps depending on the counterparty. Uncertainty would lead to confusion in the marketplace, possibly even undermining the price transparency goals of Dodd-Frank. The Prudential Regulators and CFTC can avoid these problems by aligning the effective dates of their respective rules.

More significantly, however, we urge regulators to impose the Proposed 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 Proposed Rules could lead to unintended consequences contrary to the goals of Dodd-Frank.

First, the infrastructure for clearing swaps must be sufficiently established at the derivatives clearing organizations and clearing agencies, and accessible to market participants so that parties willing to clear transactions can do so. This will be particularly important if the Proposed Rules continue to require higher levels of margin for non-cleared swaps than for cleared swaps—implementing the Proposed Rules prior to widespread use of clearing would tend to amplify the costs of the Proposed Rules on swap transactions. The chilling effect on swap transaction activity or the attendant costs of continuing to enter into swap transactions would likely lead to adverse risk management consequences. We therefore urge the Agencies 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 rulemaking under Dodd-Frank before imposing these more onerous margin rules.

Second, the account infrastructure of custodial accounts for segregated margin must be set up to allow for compliance with the Proposed Rules. Establishing the independent custodial accounts required under the Proposed Rules 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.

This lag in establishing account infrastructure may have unintended consequences. Particularly in relation to the CFTC Proposed Rule, a covered swap entity's counterparty may be unable to avail itself of margin segregation at an independent custodian because the tri-party custodial agreement or account infrastructure is not yet in place. If the necessary custodial account infrastructure is not ready to accommodate these parts of the Proposed Rules, initial margin held at covered swap entities may increase systemic risk to counterparties rather than reducing it. We thus urge the Agencies to be mindful of this required infrastructure in determining the effective dates of the Proposed Rules.

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

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PIMCO thanks the Agencies for giving it the opportunity to comment on the Proposed Rules related to margin for non-cleared swap transactions and for the Agencies' 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

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