July 11, 2011

Ms. Jennifer J. Johnson
Secretary
Federal Reserve System Board of Governors
20th Street & Constitution Avenue, N.W.
Washington, D.C. 20551

Mr. Michael Sullivan,
Market RAD
Office of the Comptroller of Currency
250 E Street, S.W.
Washington D.C. 20219

Mr. Robert E. Feldman
Secretary
Federal Deposit Insurance Corporation
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Mr. Gary Van Meter
Acting Director of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive
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Mr. Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
1700 G Street, N.W.
Washington, D.C. 20552

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

Re: Margin and Capital Requirements for Covered Swap Entities (RIN 1557-AD43; RIN 7100-AD74; RIN 2064-AD79; RIN 3052-AC69; RIN 2590-AA45); Margin Requirements for Uncleared Swap Dealers and Major Swap Participants (RIN 3038-AC97)

Dear Ms. Johnson, et al.:

The Association of Institutional INVESTORS (the "Association") appreciates the opportunity to provide comments related to proposed rules on margin and capital requirements required under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] On April 28, 2011, the Commodity Futures Trading Commission ("CFTC") published a proposal titled "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, Proposed Rules."[2] Shortly thereafter, a collection of U.S. prudential regulators[3] jointly issued their proposed requirements, titled "Margin and Capital Requirements for Covered Swap Entities."[4] This letter expresses the Association's general concerns regarding the margin requirements for uncleared swaps put forth in these two proposals.

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[1] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (2010).
[2] *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23,732 (April 28, 2011).
[3] The prudential regulators included: the Federal Reserve, Farm Credit Administration, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, and Office of the Comptroller of the Currency.
[4] *See* Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27,564 (May 11, 2011).

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

I. SUMMARY OF MARGIN REQUIREMENT ISSUES

We appreciate the efforts undertaken by each agency to ensure the safety of our financial system. However, we would like to share certain concerns we have regarding the recent proposals on margin issued by the prudential regulators and the CFTC, respectively (collectively referred to as the "regulators"). As explained in greater detail below, the Association's key issues and recommendations are as follows:

- Neither proposal requires swap dealers or major swap participants (MSPs) to post collateral for uncleared swaps when transacting with financial end-users. By not requiring the posting of collateral, the proposals may disincentivize the use of clearing by swap dealers and MSPs, and increase risks for financial end-users.

- Regulators should adopt an initial margin calculation model based upon a 5-day liquidation horizon, as opposed to the 10-day liquidation horizon being proposed. A liquidation horizon of 5-days would be sufficient in times of distress, as demonstrated during the recent Lehman Brothers collapse.

- The scope of acceptable collateral should be widened to include other high quality fixed income instruments.

- RICs, ERISA accounts, and government benefit plans should be treated as low-risk financial end-users, regardless of how these entities utilize swaps.

- The effective date for any final rulemakings on margin requirements should be only after the clearing requirements take effect and all parties have the ability to clear.

- The margin rules should be harmonized with both: (1) other domestic regulations, and (2) international regulations, to ensure that these requirements are consistent across borders and among all entities.

II. KEY CONCERNS

a. Bi-Lateral Margin Requirements

Both the prudential regulators' and the CFTC's proposals set forth the margin requirements for swap dealers and MSPs, referred to collectively as covered swap entities ("CSEs"). While these requirements involve set standards for the collection of margin, they do not require CSEs to *post* margin for uncleared swaps when transacting with financial end-users.[5] Without this posting requirement, financial end-user counterparties would face increased risks if a dealer defaults because neither the counterparty nor a third-party custodian will actually have possession of the collateral. We understand that the rationale provided for not requiring CSEs to post margin in such transactions may be that these entities are subject to existing prudential capital requirements, which already take into account the risk arising from derivatives transactions.[6] We note, however, that these liabilities will be present regardless of an entity's capital requirements. There is no reason why CSEs should not have to collateralize their obligations to end-users when end-users are required to collateralize their obligations to CSEs. In addition, by not requiring CSEs to post margin, there is the risk that CSEs may take on more exposure than they otherwise would if margin was required.

Furthermore, the Association believes the proposals may actually discourage the use of clearing, since CSEs will be required to post margin for cleared swaps but not for uncleared swaps when transacting with financial end-users. Thus, these proposed rules appear inconsistent with efforts to promote the use of clearing.

b. RICs and ERISA Accounts as "Low Risk Financial End-Users"

The proposal put forth by the prudential regulators distinguishes among four types of derivatives counterparties: (i) counterparties that are themselves covered swap entities; (ii) counterparties that are high-risk financial end-users of derivatives; (iii) counterparties that are low-risk financial end-users of derivatives; and (iv) counter parties that are nonfinancial end-users of derivatives (commonly known as "commercial end-users").[7] In general, the CFTC's proposed margin requirements effectively recognize the same distinctions.[8] The margin collection requirements vary depending on which category an entity falls into, and require more stringent margin collection requirements for financial end-users deemed "high-risk" over those deemed "low-risk."[9]

While the Association agrees with the principle behind this approach, we are concerned regarding the distinction between "low-risk financial end-users" and "high-risk financial end-users." To be deemed "low-risk," the proposal requires a financial end-user to meet all of the follow criteria: (i) its swaps exposure falls below significant swaps exposure threshold; (ii) it predominantly uses swaps to hedge or mitigate its business risks; and (iii) it is subject to the capital requirements for a prudential regulator or state insurance regulator.[10] The Association believes that the proposed criteria for "low-

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[5] *See* 76 Fed. Reg. 27,567; *see also* 76 Fed Reg. 23,736.
[6] *See* 76 Fed. Reg. 27,568.
[7] *See* 76 Fed. Reg. 27, 567; *see also* 76 Fed. Reg. 23,736.
[8] *See* 76 Fed. Reg. 23,736.
[9] *See* 76 Fed. Reg. 27,571.
[10] *See* 76 Fed. Reg. 27, 567; *see also* 76 Fed. Reg. 23,736.

risk financial end-users" should be modified to include RICs, ERISA accounts, and government benefit plans; irrespective of whether they are transacting in swaps solely for hedging purposes or not. We suggest that the criteria for factor three should be expanded to include entities subject to the Securities and Exchange Commission (SEC), Department of Labor, or CFTC oversight, such as RICs, ERISA accounts and government pension plans. The "low-risk" designation is warranted because these entities are subject to comprehensive regulation and pose less risk than other counterparties. RICs are subject to the Investment Company Act of 1940 and other regulatory requirements that impose substantial compliance requirements, including: limitations on leverage, diversification requirements, and liquidity standards.[11] Similarly, ERISA accounts have regulatory requirements governing leverage and diversification.[12] Government benefit plans are subject to many of the same requirements and constraints as ERISA accounts and, therefore, should be afforded the same treatment. Moreover, these entities demonstrated themselves as being "low-risk" during the 2008 financial crisis by satisfying counterparty obligations even in times of serve economic distress. Finally, with the application of the specified swap exposure threshold, it should not be necessary to distinguish whether these swaps are used for hedging activity.

c. Calculation of Initial Margin

Both proposed rules share a similar model for calculating initial margin, which generally requires enough margin to cover at least 99% of price changes by product and portfolio over a 10-day holding period, referred to by the CFTC as a 10-day "liquidation horizon."[13] The 10-day holding period is excessively long, and would unnecessarily require additional margin while doing little, if anything, in terms of increasing the actual protection of counterparties. A holding period of 5-days has been proven effective in previous default events, such as the 2008 Lehman Brothers crisis. Moreover, it is also consistent with current market practices, as market participants and clearinghouses generally use a 3-5 day window.

In addition, we generally support the prudential regulators proposal to allow for the calculation of initial margin on a portfolio basis. While the CFTC does not directly address this in its proposal, we encourage the Commission to adopt a similar approach. Furthermore, we encourage the regulators to allow for offsetting positions and hedging benefits to be recognized *across* risk categories.[14] We believe this is a better approach, as opposed to restricting portfolio netting to within a particular risk category (e.g. commodity, credit, equity, foreign exchange/interest rate), as the prudential regulators' proposal does. Allowing for netting across asset classes better reflects a portfolio's overall exposure, and recognizes the benefits of diversification across products.

d. High Quality Fixed Income Instruments as Collateral

The scope of acceptable collateral should be widened to include other high quality fixed income instruments, including those denominated in foreign currencies. The Association appreciates the

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[11] *See generally* 15 U.S.C. § 80-1 *et seq.;* 17 C.F.R. § 230.482; Section 17(a)(3), 15 U.S.C. § 77q(a)(3); 10-b, 17 C.F.R § 240.10b-5; and 15 U.S.C. § 80b-6.
[12] *Id.*
[13] *See* 76 Fed. Reg. 23,746; *see also* 76 Fed. Reg. 27,590.
[14] *See* 76 Fed. Reg. 27,590.

CFTC and prudential regulators' concern regarding the quality of collateral. However, by restricting collateral to only cash and government-backed instruments,[15] the proposals will limit investment strategies and ignore the value counterparties place in other high-quality fixed income instruments. These limitations may unintentionally impact the market for the limited type of instruments designated as acceptable collateral, allowing regulatory requirements rather than actual fundamental market forces shape the market. Moreover, the limits on acceptable collateral will restrict investment strategies, diminishing the returns for mutual funds and benefit plans and their investors.

e. Effective Date for Margin Requirements

Regulators should implement clearing standards prior to implementing margin requirements for uncleared swaps. By first requiring clearing and ensuring all market participants have the ability to clear, regulators will further encourage the use of cleared instruments. Furthermore, the Association firmly believes that adequate time must be provided to allow for the revision of client documentation to reflect the new margin requirements. To avoid the risk of significant market disruption, these margin requirements must be implemented in a manner that allows market participants to make necessary adjustments.

f. Harmonization of Rules

Domestic and international regulators should harmonize margin rules to ensure that these requirements are consistent across borders and entities. There should be consistency, to the fullest extent practicable, between the prudential regulators' proposal and the CFTC's proposal. To the extent that one set of regulations is more favorable than the other, it creates an artificial incentive for market participants to choose certain dealers over others. Thus, jurisdictional concerns would replace creditworthiness and price as the determinative factor in choosing a counterparty. Particular areas where consistency is essential include methodology for calculating initial margin and the determination of "low-risk" financial entities. Furthermore, while the SEC has yet to propose its margin rules, we urge the CFTC and the prudential regulators to work collaboratively with the SEC to ensure consistency among these rules.

III. CONCLUSION

The Association recognizes the challenges regulators face in setting appropriate margin requirements that ensure the protection of market participants, while not imposing limitations on investment strategy or diminishing market liquidity. The Association thanks the CFTC and the prudential regulators for the opportunity to comment on these proposed rules. Please feel free to contact me with any questions you may have on our comments at jgidman@loomissayles.com or (617) 748-1748.

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[15] *See* 76 Fed. Reg. 23,738; *see also* 76 Fed. Reg. 23,738.

On behalf of the Association of
Institutional INVESTORS,

John R. Gidman

cc: **Gary Gensler, Chairman**
Bart Chilton, Commissioner
Michael Dunn, Commissioner
Scott O'Malia Commissioner
Jill E. Sommers, Commissioner
Commodity Futures Trading Commission

Ben Bernanke, Chairman
Federal Reserve System Board of Governors

John Walsh, Acting Comptroller of the Currency
Department of Treasury

Martin Gruenberg, Acting Chairman
Federal Deposit Insurance Corporation

Leland Strom, Chairman
Farm Credit Administration

Edward DeMarco, Acting Director
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