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September 19, 2012

Jennifer J. Johnson. Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Re: Margin and Capital Requirements for Covered Swap Entities. Board Docket No. R-1415

Dear Madam Secretary:

We refer to our letter to the Commodity Futures Trading Commission ("CFTC") and several prudential regulatory agencies[1] jointly (the "Joint Agencies"), dated March 26, 2012 (the "March Letter"), regarding proposed rules for margin on uncleared swaps for swap dealers and major swap participants (the "Proposed Rules").[2]

The CFTC reopened the comment period with respect to its Proposed Rules, in light of a consultative document issued by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions concerning key principles and requirements relating to margin for non-centrally-cleared derivatives (the "BIS/IOSCO Proposed Requirements").[3] Considering this, we have submitted an additional letter to the CFTC, dated September 13, 2012 (the "Supplemental Letter"), to supplement our March Letter.

Because the Board was an addressee of the March Letter. and because the CFTC and several of the Joint Agencies participated in the development of the BIS/IOSCO Proposed Requirements,[4] we have enclosed a copy of the Supplemental Letter. Please treat this as part of the comment file relating to Board Docket No. R-1415.

Yours truly,

Derrell Hendrix

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[1] The prudential regulatory agencies are the Board of Governors of the Federal Reserve System ("Board"), the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), the Federal Housing Finance Agency, and the Farm Credit Administration.

[2] The Proposed Rules are included in Margin and Capital Requirements for Covered Swap Entities, Board Docket No. R-1415, Docket No. OCC-2011-0008, FDIC RIN 3064-AD79, FHFA RIN 2590-AA45, FCA RIN 3052-AC69, 76 Fed. Reg. 27564 (May 11, 2011) and Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, CFTC RIN 3038-AC97, 76 Fed. Reg. 23732 (April 28, 2011).

[3] The BIS/IOSCO Proposed Requirements are included in the consultative document entitled "Margin requirements for non-centrally-cleared derivatives," issued in July 2012 by the BIS and IOSCO for comment by September 28, 2012.

[4] *See id.* (the CFTC, the Board, the OCC and the FDIC were members of the working group that developed the BIS/IOSCO Proposed Requirements; the Board was a co-chair of such working group).

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September 13, 2012

David A. Stawick, Secretary
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, DC 20581

Re: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, CFTC RIN 3038-AC97

Dear Mr. Stawick:

We refer to our letter to the Commodity Futures Trading Commission ("CFTC") and the several prudential regulatory agencies[1] jointly (the "Joint Agencies"), dated March 26, 2012 (the attached "March Letter"), which speaks to proposed rules for margin on uncleared swaps for swap dealers and major swap participants, subject to the respective jurisdictions of the CFTC and the Joint Agencies (the "Proposed Rules").[2] We understand that the CFTC has reopened the comment period with respect to its Proposed Rules, as outlined in CFTC RIN 3038-AC97, in light of the proposals discussed in a consultative document issued by the Basel Committee on Banking Supervision ("BCBS") and the Board of the International Organization of Securities Commissions ("IOSCO") concerning key principles and requirements relating to margin for non-centrally-cleared derivatives (the "BIS/IOSCO Proposed Requirements").[3] We also understand that the CFTC and several of the Joint Agencies participated in the development of the BIS/IOSCO Proposed Requirements.[4] Therefore, we are submitting a separate letter to BCBS and IOSCO concerning the BIS/IOSCO Proposed Requirements, and we also wish to supplement our March Letter, in light of such proposed requirements, to further support the treatment of Karson Collateral's K-Notes (U.S. patent # 7,769,655) ("K-Notes") as eligible collateral under the Proposed Rules.

In response to questions raised in the CFTC and Joint Agency releases accompanying the Proposed Rules, our March Letter focused on the recognition of asset-backed or guaranteed

[1] The prudential regulatory agencies are the Board of Governors of the Federal Reserve System ("Board"), the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), the Federal Housing Finance Agency, and the Farm Credit Administration.

[2] The Proposed Rules are included in Margin and Capital Requirements for Covered Swap Entities, Board Docket No. R-1415, Docket No. OCC-2011-0008, FDIC RIN 3064-AD79, FHFA RIN 2590-AA45, FCA RIN 3052-AC69, 76 Fed. Reg. 27564 (May 11, 2011) and Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, CFTC RIN 3038-AC97, 76 Fed. Reg. 23732 (April 28, 2011).

[3] The BIS/IOSCO Proposed Requirements are included in the consultative document entitled "Margin requirements for non-centrally-cleared derivatives," issued in July 2012 by the BIS and IOSCO for comment by September 28, 2012.

[4] *See id.* (the CFTC, the Board, the OCC and the FDIC were members of the working group that developed the BIS/IOSCO Proposed Requirements; the Board was a co-chair of such working group). We are providing the Joint Agencies with copies of this letter.

securities as acceptable margin and offered fundamental criteria for such securities. The BIS/IOSCO Proposed Requirements seem to refine the asset-backed or guaranteed securities universe by specific reference to covered bonds. We believe that the BIS/IOSCO Proposed Requirements provide flexibility in a number of respects that would be welcome if integrated into the Proposed Rules. Above all, however, we urge the CFTC to endorse "high quality covered bonds" as acceptable collateral that meets all requirements of its Proposed Rules and, further, to clarify that purpose-built obligations such as K-Notes are within the ambit of "high quality covered bonds" and in fact establish a useful paradigm for such "high quality covered bonds," as described below.

The BIS/IOSCO Proposed Requirements have identified "high quality covered bonds," among other types of assets, as an example of eligible collateral that satisfies the key principles of (i) high liquidity, (ii) the ability to hold value in times of financial stress after accounting for risk-appropriate haircuts to mitigate credit, market and FX risks, and (iii) protection against "wrong way risk," the susceptibility of an asset pool to adverse correlation with a counterparty's credit risk (each a "Key Principle" and together the "Key Principles"). Generally speaking, covered bonds are debt securities that offer dual recourse. Bondholders not only have recourse to the issuer of the bonds, but they also have full, first priority recourse to a "cover pool" of assets that are subject to haircuts. These assets are commonly in the form of mortgage loans or public sector loans, and are in some instances held by a bankruptcy-remote special purpose entity. Thus, from a credit evaluation perspective,[5] the quality of a covered bond depends in large part on the quality of its cover pool, but because of the dual recourse nature of covered bonds, the issuer's creditworthiness is also relevant. Together, both of these factors are a proxy for the ultimate assessment as to the bondholder's probability of recovery in the event of the issuer's default.

Although it is clear that a higher probability of recovery equates to a high quality covered bond, the BIS/IOSCO Proposed Requirements are not specific with respect to the definition of "high quality covered bonds." Presumably, in jurisdictions with established statutory frameworks in respect of covered bonds,[6] covered bonds satisfying such statutory requirements are implicitly of high quality. However, in jurisdictions where covered bond issuances are non-regulated and contractually based (such as the U.S.), the determination of high quality will need more guidance.[7] We therefore will request BIS and IOSCO to include in their final requirements guidelines for what constitute "high quality covered bonds," whether or not subject to a statutory program. K-Notes should fall within such guidelines.

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[5] *See, e.g.*, the "Purposes and Procedures Manual" of the National Association of Insurance Commissioners Securities Valuation Office.

[6] In these jurisdictions, the legal frameworks governing the issuance of covered bonds spell out several requirements, such as the type of institutions allowed to issue covered bonds, the types of assets eligible for cover pools, and the priority rights of covered bondholders against such assets in the event of issuer insolvency. FITCH RATINGS, ABCs OF U.S. COVERED BONDS 1, 5 (Sept. 3, 2008).

[7] In the U.S., where no statutory framework for covered bonds exists, the Department of Treasury issued a Best Practices Guide in July 2008 that offers recommended guidelines for the issuance of residential mortgage covered bonds. These guidelines, despite having no effect of law, offer insight into what types of covered bonds are considered high quality. Although other non-statutory jurisdictions may not have similar guidance, the Treasury guide may provide useful general insights.

A K-Note matches our covered bond description and, more importantly, satisfies the Key Principles. K-Notes are issued by a bankruptcy-remote trust on behalf of a party requesting the issuance of such K-Notes for collateral purposes. Like covered bonds, K-Notes offer more than one means of recourse to their holders. K-Notes are supported by a first lien on a portfolio of readily marketable securities that are subject to standardized haircuts, daily margining, and asset pool adjustment—similar to the "cover pools" of covered bonds. This asset pool of securities from which K-Notes may draw is just as, if not more, liquid than the asset pools of covered bonds, which are generally comprised of loans. In addition, holders of K-Notes have full recourse to not only the K-Note issuer (the "K-Note Sponsor"),[8] but also to two or more independent qualifying financial institutions[9] that assume joint and several unconditional payment obligations in respect of the K-Notes in the event that the counterparty fails to pay and its margined securities (which are subject to a haircut) prove inadequate upon liquidation to satisfy the beneficiary's claim. This is superior to a covered bondholder's recourse to only the issuer of such covered bonds and the covered bond issuer's portfolio of, typically, relatively illiquid loan assets. The K-Note Sponsor and the supporting qualifying financial institutions would be legally obligated to make payment to the noteholder in satisfaction of a demand for redemption no later (following such demand) than the end of a normal settlement cycle for the pledged securities supporting the K-Note.[10]

Reviewing the criteria offered by the BIS/IOSCO Proposed Requirements, the unconditional payment obligations of qualifying financial institutions, along with the first lien on the pool of marketable securities and rapid settlement, satisfy the first Key Principle of high liquidity. The dual recourse nature of K-Notes, standardized haircuts, daily margining procedures, and the bankruptcy-remote status of the issuer satisfy the second Key Principle of holding value in times of financial stress. The third Key Principle, avoiding adverse correlation, is met by program rules requiring that qualifying financial institutions must be unrelated to the client who is required to put up the collateral. For these reasons, we ask the CFTC to endorse the view that obligations of structures like the K-Note program qualify as eligible collateral under the BIS/IOSCO Proposed Requirements (as a "high quality covered bond"), as well as under any final implementing rules that the CFTC might adopt.[11]

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[8] The K-Note Sponsor will in all cases be guaranteed by the counterparty in question and in many cases guaranteed by a highly rated affiliate or the parent of the counterparty.

[9] Karson proposes that any of the following be recognized as a qualifying financial institution: an entity authorized by its relevant regulator to undertake the proposed activity that is a bank, as defined in Section 3(a)(6) of the Securities Exchange Act of 1934 (the "Exchange Act"), a banking institution organized under the laws of a non-U.S. jurisdiction that maintains at least US$1 billion of regulatory capital, or an insurance or reinsurance company that is subject to supervision as such by the insurance commission (or similar regulatory authority or agency) of a State of the United States, by the United States or an agency or instrumentality thereof or by a financial services regulatory authority of a G20 member government.

[10] Market participants would, of course, be free to stipulate a shorter payment timeframe, which K-Notes could be structured to accommodate.

[11] As in our March Letter, we note the need for complementary capital treatment as part of this endorsement. March Letter, at 3-4.

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As always, we would be delighted to have the opportunity to answer any questions that the CFTC may have about the K-Note program. Please contact our counsel, Joshua Cohn or Curtis Doty of Mayer Brown LLP (212-506-2500), to arrange such a discussion.

Yours truly,

Derrell Hendrix

cc: Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
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