

**Meeting between Prudential Regulators and  
Representatives of the American Benefits Council and  
Committee on Investment of Employee Benefit Assets  
March 1, 2012**

**Participants:** Sean Campbell, Anna Harrington, and Christopher Paridon  
(Federal Reserve Board)

Jan Jacobson (American Benefits Council); Stacey Dion (Boeing);  
Deborah Forbes (Committee on Investment of Employee Benefit Assets);  
Kent Mason (Davis Harmon); James Harshaw (General Motors Investment  
Management Company); Bob Shepler (Lockheed Martin); Bella Sanevich  
(NISA); Brian Duncan and Maureen Donley (Skadden, Arps); Chris Condeluci  
(Venable); Frederick Miller (Weyerhaeuser); and Edwin Egee (Xerox).

**Summary:** Staff of the Federal Reserve Board and prudential regulators met with representatives and members of the American Benefits Council (“ABC”) and the Committee on Investment of Employee Benefit Assets (“CIEBA”) to discuss issues related to the proposed rule of the Board and other prudential regulators on margin and capital requirements for covered swap entities under Title VII of the Dodd-Frank Act.

The ABC and CIEBA representatives suggested that ERISA plans should be excluded from the proposed rule’s requirements in light of the fact that ERISA plans are safe and highly regulated counterparties that are minimally leveraged and hold liquid assets that are required by law to be prudentially diversified. The CIEBA representatives requested that, in the alternative and assuming that ERISA plans are not excluded as noted above, ERISA plans be treated as low-risk financial end users under the proposed rule and made a number of suggestions on various aspects of the proposed rule. A copy of the discussion document provided by the CIEBA representatives is attached.

## **Prudential Regulators: Proposed Changes To Uncleared Swap Margin Rules**

### **Proposed Changes To Definition Of Low-Risk Financial End User:**

ERISA plans are highly credit-worthy, minimally leveraged (if at all), heavily regulated, and prudently managed counterparties to Covered Swap Entities (CSEs). As such, ERISA plans should be completely excluded from mandatory initial margin requirements for uncleared swaps and security-based swaps. We request that, for purposes of the uncleared margin rules, ERISA plans not be treated like other financial end users.

Alternatively, we request that ERISA plans be considered “low-risk financial end users.” The Agencies explain in the preamble to the proposed rules that the proposed definition of low-risk financial end user is based upon the MSP and MSSP definitions.<sup>1</sup> In defining MSP and MSSP, Dodd-Frank §§ 721(a)(16) and 761(a)(5) exclude swaps and security-based swaps used by an ERISA plan “for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan.” Although we cannot know with complete certainty until the MSP and MSSP definitions are finalized, because ERISA plans use swaps and security-based swaps primarily for hedging purposes, we do not believe that any ERISA plan will ever be an MSP or MSSP. The statutory language demonstrates that Congress intended ERISA plans not to be subject to the onerous regulations placed on MSPs and MSSPs. The reasons for functionally excluding ERISA plans from the definitions of MSP and MSSP -- because ERISA plans present little counterparty risk and use swaps and security-based swaps predominately for hedging or mitigating plan risks -- apply equally here.

The Agencies departed from the MSP and MSSP approach here by not excluding ERISA plans from the requirement to post margin for uncleared positions to the extent such plans use swaps and security-based swaps predominately to hedge or mitigate plan risks. There is no more reason to consider ERISA plans riskier in the uncleared margin context than in the MSP or MSSP context. Accordingly, we suggest below two alternative modifications to proposed rule § \_\_.2(n) to make the treatment of ERISA plans consistent with the MSP and MSSP definitions. In addition, although we believe it is not necessary for the Agencies to set maximum limits on margin thresholds, to the extent the Agencies impose such limits, we believe those limits should be in the \$100 million - \$150 million range.

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<sup>1</sup> “With respect to the first criterion, the definition of ‘significant swaps exposure’ under the proposed rule is very similar to the definition of ‘substantial counterparty exposure’ proposed by the CFTC and SEC for purposes of establishing what level of swap and security-based swap counterparty exposure would require a person to register as a major swap participant or major security-based swap participant under the Commodity Exchange Act or the Securities Exchange Act, respectively...” 76 Fed. Reg. at 27,571.

“The second criterion . . . generally mirrors the description of hedging-related swaps and security-based swaps that are excluded for purposes of determining whether a person maintains a substantial position in swaps or security-based swaps and therefore meets the definition of major swap participant or major security-based swap participant under the Commodity Exchange Act and Securities Exchange Act, respectively.” 76 Fed. Reg. at 27,571-72.

### Alternative 1

“§ \_\_.2(n) Low-risk financial end user means a counterparty that is a financial end user and either is an employee benefit plan subject to Title I of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) or makes the following representations to a covered swap entity in connection with entering into a swap or security-based swap with the covered swap entity...”

### Alternative 2

“§ \_\_.2(n) Low-risk financial end user means a counterparty that is a financial end user and makes the following representations to a covered swap entity in connection with entering into a swap or security-based swap with the covered swap entity –

- (1) The counterparty does not have a significant swaps or security-based swaps exposure;
- (2) The counterparty predominately uses swaps or security-based swaps to hedge or mitigate ~~the risks of~~ its business, operational, investment, or liability risks-activities, including balance sheet, interest rate, or other risks arising from the ~~business-operations~~ of the counterparty; and
- (3) The counterparty is subject to capital requirements established by a prudential regulator or state insurance regulator, or is an employee benefit plan subject to Title I of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002).”

## **Expand Permissible Collateral:**

It is essential to ERISA plans that the types of collateral that may be posted as margin for uncleared swaps and security-based swaps be expanded beyond what the Agencies originally proposed (cash, U.S. Treasuries, and, for initial margin only, senior debt obligations of certain GSEs). Permitting additional types of collateral (subject to appropriate haircuts) is particularly important to plans, which typically have cash balances only to the extent necessary to pay pensioners and make other required distributions. The restrictive approach proposed by the Agencies would require plans to increase the amount of cash and U.S. Treasuries they hold, which will decrease investment returns and lead to greater benefit security risks for participants.<sup>2</sup>

The types of collateral acceptable for uncleared swaps and security-based swaps should not be more restrictive than the types of collateral acceptable for cleared swaps and security-based swaps. The Agencies should permit CSEs to accept the same types of collateral that derivatives clearing organizations (DCOs) registered with the CFTC accept for cleared swaps. Similarly, any haircuts applied to the value of collateral accepted by a CSE should be the same as the largest haircut applied by one or more DCOs to the same collateral. This approach will permit dealers, major swap participants, and major security-based swap participants to piggy-back off of the risk management practices of DCOs that are embodied in DCOs' rules approved by the CFTC. Although we believe this approach is the best course, at a minimum, the Agencies should include as eligible collateral high quality municipal securities, certificates of deposit, commercial paper, corporate bonds, and interests in money market mutual funds.

We suggest the following language to replace proposed rules § \_\_.6(a) and (b) in their entirety.

“§ \_\_.6           Eligible Collateral

(a) A covered swap entity shall collect as initial margin and variation margin required pursuant to this part only the types of collateral accepted for cleared swaps by a derivatives clearing organization registered with the Commodity Futures Trading Commission.

(b) The value of any eligible collateral described in paragraph (a) of this section, for purposes of satisfying the initial margin or variation margin requirements of this part, shall be subject to, and limited by, the highest discount applied by one or more derivatives clearing organizations registered with the Commodity Futures Trading Commission to the same type of eligible collateral.

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<sup>2</sup> In addition, in some cases, cash or U.S. Treasuries can be riskier than other forms of collateral. For example, if a party sells a covered call option on an illiquid security, it would be less risky for the party to post (and a CSE to accept) the underlying security as collateral instead of cash.

**Pre-Enactment Swaps Should Only Be Included In Portfolio Margin By Agreement Of The CSE And Counterparty**

Proposed rule § \_\_.8(b)(2) may be read to permit a CSE unilaterally to include pre-enactment swaps in initial margin calculations for swap or security-based swap portfolios. The inclusion of pre-enactment swaps could result in an exorbitant margin call for a counterparty that has a large pre-existing portfolio with a CSE and did not previously post initial margin.

We understand that the Agencies may not have intended that CSEs have unilateral authority to include pre-enactment swaps. Because of the magnitude of the potential consequences, it is critical that the rule unambiguously permit inclusion of pre-enactment swaps only by mutual agreement of the CSE and its counterparty.

We suggest the following clarification to proposed rule § \_\_.8(b). (We understand that the Agencies proposed an all-or-none approach in § \_\_.8(b)(2) with respect to the inclusion of pre-enactment swaps in order to prevent a CSE from selectively incorporating only certain pre-enactment swaps in portfolio margin calculations. 76 Fed. Reg. at 27,569, n. 34. As reflected in the suggested change below, we believe that permitting inclusion of some, but not necessarily all, pre-enactment swaps based upon mutual agreement of the parties should alleviate the concern that a CSE might cherry-pick certain pre-enactment swaps in order to increase the amount of margin it collects.)

“§ \_\_.8 Initial Margin Models.

(b) . . . To the extent that a qualifying master netting agreement between a covered swap entity and its counterparty governs swaps or security-based swaps that were entered into before, on, and after the effective date, the covered swap entity may use its initial margin model to calculate the amount of initial margin required to be collected pursuant to section \_\_.3 either –

(1) With respect to only those swaps and/or security-based swaps transactions entered into on and after the effective date; or

(2) With respect to those pre-enactment all-swaps and/or security-based swaps transactions for which the parties agree, ~~governed by such qualifying master netting agreement, regardless of whether they were entered into before, on, or after the effective date.~~

### **Variation Margin Should Be Segregated At An End User's Option:**

As noted in the preamble to the proposed rules, Dodd-Frank §§ 724(c) (adding CEA § 4s(1)) and 764 (adding Securities Exchange Act § 3E(f)) explicitly require that CSEs notify their counterparties of the right to have initial margin segregated with an independent, third-party custodian. *See* 76 Fed. Reg. at 27,568, n. 24. The Agencies should also permit a CSE's counterparty the right to elect to require the CSE to segregate variation margin with a third party custodian. Such segregation will ensure the safety of variation margin posted by an ERISA plan. We suggest the following addition to proposed rule § \_\_.7, which makes clear that a CSE must offer its counterparty the right to require segregation of all initial and variation margin:

“(e) *Optional Segregation of Collateral.* A covered swap entity shall offer each counterparty the opportunity to select a third-party custodian that is independent of the covered swap entity and the counterparty to hold all collateral posted as initial and/or variation margin subject to the same restrictions in paragraphs (b), (c), and (d) of this section.”

### **Excess Variation Margin Should Be Promptly Returned By A CSE:**

Although the proposed definition of “variation margin amount” appears to contemplate that variation margin can be returned to a counterparty, the proposed rules describing variation margin create ambiguity. We suggest the following clarification to § \_\_.4 Variation Margin:

“(a) General. On or after the date on which a covered swap entity enters into a non-cleared swap or non-cleared security-based swap, the covered swap entity shall,

(1) to the extent the variation margin amount for such swap or security-based swap is positive, collect variation margin from the counterparty to such swap or security-based swap in an amount that is no less than the greater of—

~~(a)~~ (a) Zero; or

~~(b)~~ (b) The variation margin amount for such swap or security-based swap less the variation margin threshold amount for the counterparty (not including any portion of the variation margin threshold amount being applied to other swaps or security-based swaps with the counterparty), as applicable; or

(2) to the extent the variation margin amount for such swap or security-based swap is negative, at the option of the counterparty, return variation margin to the counterparty in an amount required to make the variation margin amount equal to zero.”

### **Parties Should Have A Commercially Reasonable Time To Post Initial Margin:**

The proposed rules require CSEs to collect initial margin “on or before the date it enters into” a swap or security-based swap and collect variation margin on the date it enters into a swap or security-based swap. Proposed Rules § \_\_.3(b) and § \_\_.4(a). As proposed, the rules would require counterparties to set aside collateral several days before entering into a swap or security-based swap with a new counterparty (or when using a new third-party custodian), even before the counterparty knows with certainty that the swap or security-based swap will be executed. Counterparties to a swap or security-based swap need a commercially reasonable amount of time to operationally move money to a new counterparty or third-party custodian. The Agencies should permit a commercially reasonable time of two days after entering into a swap or security-based swap before requiring initial or variation margin to be posted. We suggest the following changes § \_\_.3 and § \_\_.4:

“§ \_\_.3(b) Timing. A covered swap entity shall, with respect to any non-cleared swap or non-cleared security-based swap to which it is a party, comply with the initial margin requirements described in paragraph (a) for a period beginning on or before two days after the date it enters into such swap or security-based swap and ending on the date the non-cleared swap or non-cleared security-based swap is terminated or expires.”

“§ \_\_.4(a) General. Beginning no later than two days ~~On-and~~-after the date on which a covered swap entity enters into a non-cleared swap or non-cleared security-based swap, the covered swap entity shall...”

## **Uncleared Margin Rules Should Only Be Effective After Clearing Rules Are Effective and Internal Margin Models Have Been Approved**

The CFTC and SEC are still in the process of proposing and finalizing rules creating the infrastructure for clearing and exchange trading swaps and security-based swaps. It is not clear when the CFTC and SEC will finalize all of the requisite rules. The proposed uncleared margin rules are designed to create higher initial margin requirements than the requirements that will apply for cleared swaps and security-based swaps, particularly where a CSE does not use an initial margin model. Until such time that the clearing infrastructure is in place, for risk management strategies that cannot be efficiently executed using futures contracts, ERISA plans (and other market participants) will have no choice but to use uncleared swaps. Further, until such time that the exchange trading infrastructure is in place (*i.e.*, until swap execution facilities and security-based swap execution facilities are operational) and the trading mandate in the Dodd-Frank Act is effective, cleared swaps markets may not have sufficient depth and liquidity to provide a reasonable alternative for ERISA plans (and other market participants).

The Agencies should not penalize the use of uncleared swaps and security-based swaps prior to the time that cleared swaps and security-based swaps are readily available and liquid electronic markets have been established, and prior to the time that the Agencies have approved CSE initial margin models. Thus, the Agencies should delay implementation of the uncleared margin rules until the later of the date that the Agencies have approved initial margin models for at least the five largest CSEs or 180 days after the effective date of all CFTC and SEC rules necessary to implement both the clearing and trading mandates for ERISA plans and their fiduciaries. A delay of 180 days after these rules are effective for ERISA plans and their fiduciaries will allow time for cleared swaps and security-based swaps markets to develop at least some depth and liquidity.