Stefan M. Gavell
Executive Vice President and Head of
Regulatory and Industry Affairs

State Street Corporation
State Street Financial Center
One Lincoln Street
Boston, MA 02111-2900

Telephone: 617.664.8673
Facsimile: 617.664.4270
smgavell@statestreet.com

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Via: http://comments.cftc.gov

Mr. David Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies; RIN No. 3038-AD99

Dear Mr. Stawick:

State Street Corporation ("**State Street**")[1] appreciates the opportunity to comment on the Commodity Futures Trading Commission's (the "**Commission**") Advance Notice of Proposed Rulemaking ("**ANPR**") regarding the protection of margin collateral posted by customers with respect to cleared swap transactions.[2]

I. Introduction

Section 724 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**") (i) prohibits the commingling of swaps customers' margin with the funds of the futures commission merchant ("**FCM**") to which the customer paid the margin, (ii) prohibits such margin from being used to margin, secure, or guarantee any trades or contracts of any other swaps customer, and (iii) allows margin of all such customers to be commingled in the same account at a bank or with a derivatives clearing

[1] With over $20 trillion of assets under custody and administration and $1.9 trillion of assets under management at September 30, 2010, State Street is a leading specialist in meeting the needs of institutional investors worldwide. Our customers include mutual funds, collective investment funds and other investment pools, corporate and public retirement plans, insurance companies, foundations, endowments and investment managers. Including the United States, we operate in 25 countries and more than 100 geographic markets worldwide.

[2] Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies, 75 FR 75162 (Dec. 2, 2010).

organization ("**DCO**"). Section 724 also provides the Commission with authority to adopt rules to require any margin that is commingled to be "separately accounted for and treated and dealt with as belonging to" the customer that paid the margin. To elicit comment from interested market participants, the Commission released the ANPR and proposed four potential models for protecting margin posted in connection with cleared swap transactions. Our comments are focused on the full physical segregation model that the Commission proposed, and, in particular, the Commission's request for comment regarding the potential use of an optional model for individual customer protection.[3]

Our comments reflect State Street's role as a service provider to a broad range of institutional buy-side market participants who are likely to become counterparties to transactions in the new cleared swaps environment. Based upon our discussions with these clients, we believe that many buy-side participants would have significant concerns with segregation rules for cleared swaps that neither increase the protection of collateral posted by a buy-side counterparty to an FCM in connection with the clearing of a swap transaction nor offer an equivalent level of protection to buy-side participants that is currently available to them on a negotiated basis in uncleared bilateral swaps. In order for the cleared swap market to be embraced by the buy-side, the focus of the regulatory framework must not be solely upon protection of members of the clearinghouse, but equally upon all parties participating in the market. If the Commission's segregation rules do not address the concerns of significant buy-side participants, there is substantial risk that the buy-side will be reluctant to participate, or may minimize its participation, in the cleared swaps market, which would adversely impact the development of the U.S. swaps market, particularly compared to non-U.S. markets. Further, if buy-side participants are not comfortable participating in the U.S. swaps market, these investors, including U.S. pension plans and mutual funds, would have reduced investment and risk management options.

To address these important concerns, the Commission should adopt rules that provide swaps customers with the option of using a tri-party custody arrangement for holding cleared swaps margin, a model that is widely used in the over-the-counter market today, and will continue to be available to market participants that trade uncleared swaps. Importantly, this model also is permitted under European regulations for futures and in the U.S. for mutual funds under specific circumstances.

Like the full segregation proposal described by the Commission, under an optional tri-party custody model, the margin of custodial customers with an FCM would be segregated both physically and legally from the margin of other customers, and would not be available to cover the losses of other customers. An optional tri-party custody model, however, provides significant advantages over full segregation. FCMs would continue to post margin for customers to an omnibus account at a DCO, and likely would charge customers electing to use tri-party custody for this financing role. Thus, unlike the full segregation model, under an optional tri-party custody model, a customer may elect to pay for additional protection without imposing additional costs on other market participants. Market participants would be comfortable with tri-party custody because, as

[3] *Id*., at 75165.

noted above, it is used today, is a required option under Dodd-Frank for uncleared swaps, and can be designed with strong controls to ensure proper maintenance of funds.

II. Discussion

Custodial arrangements to protect customer margin are common in the swaps market today. Under the customary terms used in the over-the-counter swaps market, the collateral posted by market counterparties on a bilateral basis is not subject to the risk of default of other market participants that enter into transactions with the same swap dealer. In addition, there has been increased interest in the use of tri-party arrangements in response to the global financial crisis and the bankruptcy of Lehman Brothers. In Europe, tri-party custody is used in a variety of contexts. For example, tri-party custody is used in the European futures market, and U.K. Financial Services Authority rules allow funds held with a custodian to enjoy the benefits of customer asset protections.[4] Moreover, Section 724(c) of Dodd-Frank mandates that FCMs provide customers the option of segregated margin with respect to uncleared swaps.

In contrast, in the U.S. futures market, an FCM posts customer margin to an omnibus account at the DCO, and the DCO can access all funds in the customer omnibus account upon the default of any of the FCM's customers. Thus, customers of a particular FCM are exposed to the risk of each other's default. Under an optional tri-party custody regime for swaps, a customer would be able to avoid this "fellow customer" risk. The customer would post margin assets to the custodian that are at least equal to the margin required to be posted by the FCM to the clearinghouse. Upon a default of the customer, the FCM would have full access to the margin posted to the custodian, but the margin could not be used to cover the default of any other customer. As discussed below, an FCM would likely charge a customer for this extra protection, but the cost would not be incurred by other market participants.

To facilitate the development of a robust cleared swaps market, the Commission's segregation rules should provide market participants with the option of obtaining the same level of protection as is available today in the over-the-counter market in both the United States and in Europe, and that will continue to be available for uncleared swaps under Dodd-Frank. This consistency would provide buy-side market participants that operate globally the same level of protection across jurisdictions.

Segregation rules that provide for a tri-party custody option would isolate any additional costs associated with segregation to those market participants that elect to use it. Specifically, if a customer elects to use tri-party custody, the customer's FCM still will be required to post margin to an omnibus account at the clearinghouse, and therefore the total pool of margin available to the clearinghouse would remain unchanged. The FCM may charge the customer that elects to use tri-party custody a fee to account for this financing role, but this cost would not otherwise be incurred by non-electing market

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[4] ISDA, Managed Funds Association, and SIFMA, Independent Amounts White Paper 9 (Oct. 2009) (citing relevant Financial Services Authority rules), *available at* http://www.isda.org/c_and_a/pdf/Independent-Amount-WhitePaper-Final.pdf.

participants. In addition, this financing function likely will only be offered by FCMs that are financially strong. The widespread use of tri-party arrangements globally today demonstrates that certain market participants are likely to be willing to bear this potential additional cost in order to benefit from the additional protections of legal and physical segregation.

Moreover, Commission rules could be designed to help ensure that tri-party custody arrangements do not present risks to the FCMs or the swaps clearinghouse, which have previously been a concern for the Commission.[5] There have been significant changes in the market since the Commission expressed its prior concerns regarding the use of custodial accounts. In fact, the Commission addressed its prior concerns in its proposal for segregation of margin for uncleared swaps.[6] The Commission could adopt a similar approach for optional tri-party customer arrangements for cleared swaps and require, for example, that:

- the FCM be permitted to access margin under pre-agreed circumstances, such as the default of the customer and upon submitting a written statement under the penalty of perjury that the FCM is entitled to the margin;[7]
- margin funds must be invested consistent with the standards for investment of customer funds that the Commission applies to exchange-traded futures;[8]
- customers not be permitted to withdraw or access margin without the prior consent of the FCM;
- the custody account be in the name of the FCM for the benefit of the customer;
- the custodian be financially liable to the FCM for breaches of the tri-party custody agreement; and
- the custodian provide a daily report to the FCM of all assets held in the account.

These protections would help ensure that, when necessary, customer margin would be available and the FCM could access it without delay. At the same time, customers would benefit from the protections afforded by full physical segregation and consistency with the way markets operate today and, in the case of uncleared swaps, will be required to operate under Dodd-Frank.

[5] *See* Commodity Futures Trading Commission, Amendment of Financial and Segregation Interpretation No. 10, 70 FR 24768 (May 22, 2005) (withdrawing an interpretation that permitted the conditional use of custodial accounts for futures).
[6] *See* Proposed Rule, Protection of Collateral of Counterparties to Uncleared Swaps, 75 FR 75432 (Dec. 3, 2010).
[7] *Id*., at 75434 (proposing that custody accounts for uncleared swaps margin require a written statement signed under the penalty of perjury to release funds to a party to the tri-party arrangement).
[8] *Id.* (proposing a similar requirement for uncleared swaps margin).

III. Conclusion

For the reasons discussed above, to facilitate a robust cleared swaps markets, the Commission's margin segregation rules should provide market participants with the option to use tri-party custody arrangements.

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We would be happy to discuss the foregoing at your convenience.

Sincerely,

Stefan M. Gavell

cc: Jeffrey N. Carp, State Street Corporation, EVP and Chief Legal Officer
David C. Phelan, State Street Corporation, EVP and General Counsel