January 18, 2010

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

Re: RIN 3038-AD99/ Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies

Dear Mr. Stawick:

The Committee on Investment of Employee Benefit Assets ("CIEBA") appreciates this opportunity to provide comments to the Commodity Futures Trading Commission (the "Commission") regarding the recently released advance notice of proposed rulemaking and request for comments ("ANPR") concerning the protection of collateral posted by customers who are clearing swaps and the implementation of the related statutory provisions enacted by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which amends the Commodity Exchange Act (the "CEA").

CIEBA represents more than 100 of the country's largest pension funds. Its members manage more than $1.4 trillion of defined benefit and defined contribution plan assets on behalf of 17 million plan participants and beneficiaries. CIEBA members are the senior corporate financial officers who individually manage and administer ERISA-governed corporate retirement plan assets.

In brief, we ask the Commission to provide plans subject to the Employee Retirement Income Security Act of 1974 ("ERISA") with an option to post collateral for cleared swaps on a segregated basis with third-party custodians. Without this option, the clearing requirement under the Dodd-Frank Act would ironically result in a marked <u>decrease</u> in security of plan assets by forcing plans to take on the "fellow-customer" default risk of hedge funds and other market participants with a wholly different risk profile. Also, as noted below, <u>based on current practices</u>, we strongly believe that the cost of providing plans with such an option will be easily manageable.

I. THE IMPORTANCE OF SWAPS TO PLANS

Swaps play a critical role for our members' plans. Pension plans use swaps to manage risk and to reduce the volatility of the funding obligations imposed on the companies maintaining the plans. If swaps were to become materially less available, to impose new risks, or to become significantly more costly to pension plans, funding volatility could increase substantially. On a national basis, this would force companies to reserve billions of additional dollars to satisfy

possible funding obligations, most of which may never need to be contributed to the plan because the risks being reserved against may not materialize. Those greater reserves would have an enormous effect on the working capital that would otherwise be available to companies to create new jobs and for other business activities that promote economic growth.

The issues we raise regarding the protection of plan collateral for cleared swaps are of great importance to our members, to the workers relying on the pension plans, and to the economy. We look forward to working with you to ensure that the new rules strengthen financial regulations in a manner that enhances workers' retirement security. It is critical that the new rules not be developed in a way that weakens such security.

II. ERISA PLANS ARE HIGHLY REGULATED AND POSE FAR LESS RISK THAN OTHER MARKET PARTICIPANTS

Congress passed the Employee Retirement Income Security Act of 1974 to strengthen ERISA plans (plans regulated under ERISA are referred to herein as "ERISA plans") and provide greater retirement security for workers. As a result, ERISA plans are subject to stringent funding requirements and are required to be prudently diversified, to have their assets held in trust, to be managed for the sole benefit of the plans' beneficiaries and to be managed by professional fiduciaries subject to the highest fiduciary standard under U.S. law. In addition, ERISA plans are financially transparent in that they are required to publicly disclose their holdings on an annual basis. ERISA plans are also subject to strict limitations on investments with affiliated persons. A fiduciary that violates ERISA in its management of plan assets can be subject to severe financial penalties.

As a direct result of this high level of regulation and the high fiduciary standards, ERISA plans are possibly the most reliable, creditworthy counterparties in the market. We are not aware (after consultation by members with many swap dealers) of a single instance since ERISA plans were created in 1974 in which an ERISA plan has ever failed to pay a counterparty on a swap, even when an ERISA plan sponsor went into bankruptcy.

III. ERISA PLANS SHOULD NOT BE FORCED TO ASSUME FELLOW-CUSTOMERS' RISK

A. Omnibus Customer Accounts Would Subject Plans to Great Risk that Plans Could Avoid Before the Dodd-Frank Act.

Today, ERISA plans are able to protect and segregate their collateral so that it is not subject to the risk of default by other less creditworthy and risk-averse market participants. By mandating clearing of many swaps, the Dodd-Frank Act certainly was not intended to make swaps transactions much less secure for plans. Yet, if plans are forced to participate in a clearing firm's commingled omnibus customer account, plans' margin would be subject to the default risk of less creditworthy and risk-averse customers of clearing firms that a plan has no way to screen or evaluate.

CIEBA believes that Congress intended to strengthen and protect ERISA plans' use of swaps under Dodd-Frank, even to the point of calling plans "Special Entities" with special protections. Consistent with that Congressional intent, the Commission should exercise its discretion under Dodd-Frank to allow ERISA plans to opt out of a clearing firm's commingled omnibus customer account. Failure to exercise discretion in this manner would result in ERISA plans having to make the untenable choice between (1) giving up a very important hedging tool that controls funding volatility and preserves company assets for job retention, and (2) retaining that tool at the cost of assuming the default risk of others ("fellow-customer risk") which the pension plan can neither monitor nor control. Accordingly, we urge the Commission to give ERISA plans the option to post collateral for cleared swaps on a segregated basis with third party custodians so as to eliminate any fellow-customer risk (as defined in the ANPR). (Third-party custodians are custodians other than the relevant derivatives clearing organization ("DCO") or futures commission merchant ("FCM")).

CIEBA does not believe that Congress intended ERISA plans to be put at financial risk because of their clearing of swaps through the risky swap bets made by hedge funds or other market participants with a high tolerance for risk and in most cases, lower creditworthiness. Yet that would be the result of clearing swaps, unless the Commission permits ERISA plans to fully segregate their collateral for cleared swaps. Large, speculative and leveraged hedge funds and other market participants could jeopardize the income security of ERISA plan participants if these leveraged entities are "fellow-customers" of an ERISA plan's clearing firm, default on their margin obligations and the ERISA plan's assets are used to cover the defaulting entity's margin requirements.

B. CFTC is Not Required by Dodd-Frank to Impose Fellow-Customer Risk on ERISA Plans for Cleared Swaps.

CIEBA believes Congress would not have wanted the Commission to exercise its discretion to impose a clearing system for swaps that would subject ERISA plans to greater financial risks. Congress understood that the OTC swap market is more than 20 times the size of the futures market.[1] Accordingly, Congress provided the Commission with the discretion to consider the increased risks associated with such volume and to provide for additional protections. The ANPR, with its various options, reflects a recognition that the Dodd-Frank Act gives the Commission discretion to consider different collateral arrangements than those currently used in the exchange-traded markets. We strongly support this view of the Dodd-Frank Act, and applaud the Commission for carefully considering the various models. The CEA, as amended by the Dodd-Frank Act, permits the Commission to issue two different sets of regulations, one for futures and one for swaps, and both of those regulations should address the needs of the specific

[1] A Bank for International Settlements report states that total outstanding notionals, as of June 2010, for OTC derivatives is $582 trillion and for exchange-traded derivatives is $24 trillion. Bank for International Settlements, Quarterly Review, December 2010.

market that will be subject to the regulations.[2] ERISA plans are unique users of swaps and the clearing arrangements for swaps should reflect these differences.

Until the Dodd-Frank Act, ERISA plans and other customers in the exchange-traded markets had the option of using over-the-counter swaps if the exchange-traded market posed too many risks. One of the risks of exchange-traded products considered by ERISA plans fiduciaries is the fellow-customer risk of futures clearing. Judging by the volume in the OTC swap market ($582 trillion as compared to $24 trillion for exchange-traded derivatives)[3] and our discussions with members, most ERISA plans viewed OTC swaps as more advantageous and more flexible than exchange-traded products. As swap clearing becomes mandatory, ERISA plans will not have the option of hedging in the over-the-counter market for many swaps. As a significant percentage of a nearly $600 trillion OTC swap market will be cleared, the consequence of a clearing firm's failure will be significantly larger. In addition, the collapse of a clearing firm can result in or can demonstrate (and has in the past) significant deficiencies in record-keeping by such entities which can severely impair the correct identification of customer positions and collateral.[4] These risks, the significant volume of swaps and the mandatory nature of clearing swaps strongly indicate that the Commission should consider enhancing the protections for pension plan collateral for cleared swaps.

C. The Unintended Consequence of Requiring ERISA Plans to Be Overseers of FCMs' Customer Credit Practices (as a result of fellow-customer risk) Will Lead to a Shrinkage of the Clearing Firm Market to a Few Large Banks.

ERISA plans will, as described further below, have no ability to assess the riskiness of their fellow-customers' swaps positions or the net open positions in their clearing firms' customer omnibus accounts. Accordingly, if ERISA plans are subject to fellow-customer risk for their cleared swaps, CIEBA expects that ERISA plan fiduciaries will use the size of a clearing firm's capital as an indicator of its ability to withstand the insolvency of its customers. The

---

[2] The fact-specific nature of the Commission's determinations is illustrated by Interpretive Statement No. 85-3, which permitted the commingling of customer collateral for exchange-traded contracts: it is based in part on specific practices in the exchange-traded markets and the legislative history that addresses exchange-traded contracts. Also, the language in Section 4d(a) of the CEA regarding collateral for exchange-traded derivatives is very similar to the language in Section 4d(f)(2) regarding collateral for swaps but with one critical difference, which has been widely discussed: the "missing s." In Section 4d(a) the Commission is permitted to issue regulations that allow commingling of property of an FCM customer with other property held by the FCM for "customers" (plural) while the equivalent requirement for swap collateral refers to the property of the "customer" (singular). The "missing s" further indicates that the two different sets of regulations, one for futures and one for swaps, need not be identical.

[3] Bank for International Settlements, Quarterly Review, December 2010.

[4] See, for example Linda Sadler, "*Lehman Derivatives Records a 'Mess,' Barclays Executive Says*", Bloomberg, August 30, 2010. (Barclays executive testified that in 2008, with respect to the Lehman futures business, "Lehman had 'absolutely no idea' if it had sold $2 billion more options than it had bought, or whether it owned $4 billion more than it had sold" and that "Lehman's lack of records initially prevented [Barclays] from performing 'due diligence' to discover what Lehman's and its customers' positions were.")

consequence of this approach will be that there will be increased market use of a few highly capitalized clearing firms, resulting in significantly less competition, and more concentration of risk, in the swaps clearing market.

IV. THE HIGH COST ASSERTIONS AND THE FACTS

There have been extensive discussions of the costs that would be associated with permitting swaps customers to have their margin segregated. It is not entirely clear to us what costs are being described by opponents of segregation – is it operational costs, increased margin, or some other costs? We ask that the Commission publish the arguments and supporting data that are being made in relation to costs and that ERISA plans (and others) be given thirty days to review the information and respond.

In that regard, we have a few observations about costs. First, in the existing swaps market, dealers commonly charge nothing or minimal fees to ERISA plans for segregating posted collateral with a third-party custodian. Fees of third-party custodians are limited and may be less than $30,000 per year per account. Second, for centrally cleared swaps, we believe that DCOs, dealers and third party custodians could adopt systems similar to those used for uncleared swaps on commercially reasonable terms or at no cost to the customer. Also, we understand that LCH.Clearnet ("LCH") intends to offer a service for its swap clearing system, Swapclear, which will segregate swap collateral on a customer-by-customer basis. Although the fees that LCH will charge for this are not publicly available, LCH must believe it can offer this segregation at a commercially viable rate. We also note that there may be significant differences between what a clearing firm or DCO will suggest in terms of increased costs, be it higher margin or fees, and what the market will accept as a business matter, particularly if there is healthy competition. Accordingly, we see no reason why the Commission should not require clearing firms to provide pension plans[5] with the right to require that their margin be segregated with a third party custodian and not be subject to fellow-customer risk and let competitive forces determine whether clearing firms will be able to pass on any costs of providing collateral segregation to clients or whether clearing firms will consider all or part of such costs a necessary expense of their business.

---

[5] We note that a significant amount of assets of defined contribution and defined benefit pension plans are invested in U.S. registered investment companies, bank collective investment funds and similar arrangements that also require their swap collateral to be held with third-party custodians. Accordingly, consistent with Congressional intent to protect pension plans and retirement security, we believe that such entities should also be given the right to require that their collateral be segregated and held at a third-party custodian and not be subject to fellow-customer risk.

V. DEBUNKING MORAL HAZARD - ERISA PLANS DO NOT HAVE THE NECESSARY INFORMATION TO ASSESS FELLOW-CUSTOMER RISK OR THE NECESSARY TOOLS TO CONTROL THE RISK NOR ARE THEY SET UP TO ASSESS THE RISK

The ANPR asks: if collateral is fully segregated, would ERISA plans pay less attention to potential risks of their clearing firms?

As noted, most ERISA plans' derivative positions are in OTC swaps as compared to exchange-traded products. A significant amount of ERISA plans' swap collateral is fully segregated or is otherwise protected from dealer default. Despite these protections, ERISA plans carefully screen their dealers and assess their creditworthiness. The high standard of care imposed upon ERISA fiduciaries combined with the very negative consequences of a failure by a dealer or FCM will result (as it has in the past) in ERISA plans continuing to scrutinize FCMs and dealers carefully even if their collateral is fully segregated.[6] A failure by a dealer or FCM may not trigger material losses if margin is segregated, but the expense, confusion, transaction costs and costly delays involved in going through a bankruptcy is a major problem that no plan wants to endure. See, e.g., footnote 4 above.

While ERISA plans should and do monitor their dealers and clearing firms, ERISA plans and their fiduciaries should not, nor are they set up to, make credit judgments of clearing firms' customers. Yet those credit judgments are made every day by clearing firms. ERISA plans do not have the control, information or expertise over clearing firms' customer exposures that clearing firms have by design and necessity. It is inconceivable that Congress had any intent that, as a result of Dodd-Frank, ERISA plans or other end-users would be responsible for monitoring a clearing firm's customer credit practices. Nor has the clearing firm or DCO community ever suggested that it would provide the real-time transparency into their available credit lines, maximum exposures to any particular client (and whether they have made or could make exceptions), customer credit profiles, product exposures, leverage and other information that would be necessary for any meaningful risk analysis by a pension plan of an FCM's customers.

. . .

It is critical that our members' plans continue to be able to use swaps as efficiently as possible to continue to provide retirement security and health benefits to millions of Americans across the country. For the reasons stated above, we believe the Commission has the discretion under the Act to provide for greater protection for the collateral of ERISA plans than exists today in the exchange-traded market and that such additional protection is both consistent with Congressional

[6] However, as shown by Lehman Brothers, AIG and Bear Stearns, even the most diligent ERISA plan fiduciary may not have all the necessary information to avoid a defaulting dealer. Segregation of collateral with third-party custodians (among other protections implemented by ERISA fiduciaries) protected ERISA plans from material losses from these types of defaults.

intent and needed to adequately protect America's retirement assets. Accordingly, we urge the Commission to give ERISA plans the option to post collateral for cleared swaps on a segregated basis with third-party custodians so as to eliminate fellow-customer risk. We would hope that the Commission would not mandate clearing until this critical issue is resolved.

We thank the Commission for the opportunity to comment on its ANPR on customer collateral for cleared swaps. If you have any questions, please do not hesitate to call James Harshaw, at (212) 418-6162.

THE COMMITTEE ON INVESTMENT OF EMPLOYEE BENEFIT ASSETS