BLACKROCK

August 8, 2011

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

RE: Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions; RIN Number 3038–AC99

Dear Mr. Stawick:

BlackRock, Inc.[1] is pleased to respond to the Commodity Futures Trading Commission's request for comments on the Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 76 Fed. Reg. 33832 (the "Proposal"). This issue has generated vigorous debate among industry participants, and we support the Commission's stated goals of maximizing customer protection and minimizing costs imposed on customers and the industry as a whole. We appreciate the time the Commission has spent reviewing collateral protection practices in the current bilateral market and its efforts to solicit input from a variety of stakeholders as to their concerns relating to the alternative models to implement Section 4d(f) of the Commodity Exchange Act ("CEA"), including holding two staff Roundtable meetings and issuing an advanced notice of proposed rulemaking (the "ANPR").[2]

BlackRock supports the Dodd-Frank Act's ("DFA") objectives of creating a comprehensive regulatory framework for swaps that will reduce systemic risk, increase price transparency, and promote market integrity while maintaining liquidity. As the voice of and a fiduciary for our clients, BlackRock has a vested interest in the development of a sustainable and fair regulatory regime, that minimizes overall risk to the financial system and provides customer protection by protecting the collateral posted for cleared swaps.[3]

The Commission's innovative and thorough thinking on this customer protection issue is commendable. As discussed in more detail below, BlackRock believes the Complete Legal Segregation Model presents the best available approach to balance the two principal concerns of market participants: adequacy of collateral protection and costs.

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[1] BlackRock is one of the world's leading asset management firms. We manage over $3.6 trillion on behalf of institutional and individual clients worldwide through a variety of equity, fixed income, cash management, alternative investment, real estate and advisory products. Our client base includes corporate, public, multi-employer pension plans, insurance companies, third-party mutual funds, endowments, foundations, charities, corporations, official institutions, banks, and individuals around the world.

[2] *See* Advance Notice of Proposed Rulemaking for Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies, 75 Fed. Reg. 75162 (Dec. 2, 2010).

[3] BlackRock has been strongly advocating for a clearing regime that supports the protection of customer collateral for cleared swaps. *See* BlackRock's Comment Letter, dated November 15, 2010 as a follow-up to the Roundtable held by the CFTC on October 22, 2010 and BlackRock's comment letter dated January 18, 2011 in response to the ANPR.

The DFA's clearing mandate will contribute to the safety and soundness of the U.S. financial markets and BlackRock supports the CFTC's efforts to promote clearing of standardized swaps.[4] The central counterparty clearinghouse system that has developed in the futures market (the "Futures Model") involves what has become known as "fellow customer risk." Put simply, customers of a clearing member may incur losses if another customer caused the clearing member to default. Fellow customer risk has never been a part of the swap markets, because swap counterparties bilaterally negotiate their own terms to protect posted collateral.

Nevertheless, we believe the establishment of an appropriate clearing model for swaps and the widespread clearing of these financial instruments will reduce systemic risk, and we support the CFTC's efforts to adopt a clearing model appropriate to the swap markets. We believe such a model should account for the salient differences between the risk profiles of futures and OTC swaps and should not replicate the status quo Futures Model of customer collateral protection. We agree with those commenters who, in response to the ANPR, explained that swaps, including cleared swaps, are inherently different from exchange-traded futures contracts. These characteristics affect the magnitude of the risks that cleared swaps customers assume.

In particular, we believe the CFTC should adopt a collateral protection model for swap markets that, among other things, eliminates fellow customer risk and facilitates "immediate" portability of customer positions if required. Eliminating fellow customer risk will give swap market participants security that their collateral is protected and used for a known set of risks. Portability refers to the ability to transfer swap positions (and related collateral) of a non-defaulting customer from one FCM to another FCM, without liquidating and re-establishing such swaps. It is important that cleared swaps customers be able to "port" their positions and related collateral without delay from one FCM to another FCM. This will allow customers to continue to participate in the market with minimum business disruption in case there is a concern about their FCM. Closing out positions with one FCM and re-establishing the positions with another FCM is costly, an unnecessary expense and time-consuming. Facilitating immediate portability also produces systemic benefits by providing an orderly framework to allow customers of an insolvent FCM to move positions to another FCM where the porting of positions is based on each customer's risk profile and not linked to the insolvent FCM.

We believe the Complete Legal Segregation Model proposed by the Commission adequately addresses these risks and we commend the Commission for carefully examining the risk profile of the swap market. In response to the Commission's request for additional comment on the risk characteristics for futures and swaps and their bearing on the costs and benefits on the Proposal and potential alternatives, the table below highlights some of the key differences between futures and swaps as it relates to collateral management and risk. This table illustrates the need to eliminate fellow customer risk and develop a model that affords appropriate protection to cleared swaps customer collateral and reduces systemic risk.

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[4] *See* BlackRock Comment Letter dated June, 3, 2011 Re: Opening and Extension of Comment Periods for Rulemakings Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Criteria	Swaps	Financial Futures
Liquidity & Depth of Market	> futures	< Swaps
Average Tenor of contract	8 years	<3 months
Notional Outstanding	$600 Trillion*	$15 Trillion
Margin (Cleared) requirements	> futures	< Swaps
Character of instruments	Standard and non-standard	Standard

* Approximately $300 trillion cleared on LCH.

BlackRock agrees with the Proposal's conclusion that Section 4d(f) of the CEA authorizes the Commission to afford individualized protection to cleared swaps customer collateral. There is statutory evidence that Congress did not intend for swaps to be subject to the existing collateral segregation provision. Specifically, throughout the DFA, Congress frequently updated CEA provisions by merely adding the words "or swaps," to indicate that a particular provision should also apply with respect to swaps.[5] But Congress took a different approach for collateral segregation. CEA Section 4d(b) sets out the collateral protection regime in the futures market. Instead of making this provision applicable to swaps, Congress inserted an entirely separate, parallel (but not identical) provision at Section 4d(f)(6). Given Congress' choice simply to add "swaps" to other CEA sections, the decision to create a distinct provision for collateral segregation for swaps reflects Congress' intent to permit the CFTC to consider other collateral protection schemes.

Indeed, the differences between Sections 4d(b) and 4d(f)(6) provide the CFTC with sufficient authority to adopt a collateral protection regime for swaps that is tailored to the swap market.[6] Section 4d(f) of the CEA permits the CFTC to "prescribe by rule, regulation, or order" the "terms and conditions by which any "property of the swaps customers of a futures commission merchant . . . may be commingled and deposited in customer accounts with any other money, securities, or property received by the futures commission merchant."[7] Nothing in the DFA suggests that Congress intended to deprive swaps customers of adequate protection for their collateral. In fact, this would be contrary to the DFA's goals of reducing systemic risk, promoting market integrity and protecting customer funds.

As discussed, there are marked differences between swaps and futures regulation under the CEA; there is not an active regulatory scheme being supplanted for cleared swap transactions and there are statutory differences in the CEA between the swaps and futures regimes.

[5] Congress employed this tactic in CEA Section 2a, 4b, 5b, 6c, 9, and 22, as amended by the DFA, to achieve such goals as expanding the CFTC's jurisdiction, defining unlawful actions, and creating private rights of action. Swaps also were added to a number of existing CEA definitions (often in conjunction with security futures products and commodity options).

[6] The following portion of Section 4d(f)(6) emphasizes some of these differences: "It shall be unlawful for any person, including any derivatives clearing organization and any depository institution, that has received any money, securities, or property for deposit in a separate account **or accounts** as provided in paragraph (2) to hold, dispose of, or use any such money, securities, or property as belonging to the depositing futures commission merchant or any person other than the swaps **customer** of the futures commission merchant."

[7] *See* Dodd-Frank Sec. 724(a) (enacting CEA Sec. 4d(f)). Congress also authorized the Commission to "require [that property] be separately accounted for and treated and dealt with as belonging to the swaps customer of the futures commission merchant." Dodd-Frank Sec. 724(a) (enacting CEA Sec. 4d(f)(3)(B)).

These differences all provide the CFTC with a basis to conclude that it has the authority to act to protect customer collateral. We do not think that deviating from or enhancing the Futures Model for protection of cleared swaps collateral represents a departure from existing CFTC policy.

BlackRock agrees with the conclusion reached by the Commission that the Complete Legal Segregation Model: (i) protects cleared swaps customer collateral in the manner mandated by the DFA, and (ii) provides the best balance between (a) the benefits of mitigating fellow customer risk, investment risk (as defined in the Proposal) and systemic risk, inducing changes in behavior, and enhancing portability from the current omnibus model as well as potentially facilitating portfolio margining, and (b) the operational and risk costs associated with implementation.

After evaluating the benefits and limitations of each of the alternative models discussed in the Proposal, we believe that the Complete Legal Segregation Model is the appropriate segregation regime for cleared swaps and related customer collateral and an important step in achieving the goals of the DFA. Our analysis is set out below.

I. The Models

The three models as outlined in the Proposal are:

(a) The Physical Segregation Model

Under this model, prior to an FCM default, each FCM and derivatives clearing organization ("DCO") would segregate, in its books and records, the cleared swaps of each individual customer and relevant collateral. However, unlike the Legal Segregation Model, each FCM and DCO would maintain separate individual accounts per customer for the relevant collateral.

(b) Legal Segregation Model

Under the Legal Segregation Model, each FCM and DCO would enter, or "segregate", in its books and records, the cleared swaps of each individual customer and relevant collateral ensuring that such entries are separate from FCM or DCO obligations and (ii) the obligations of non-cleared swaps customers. Operationally, however, each FCM and DCO would be permitted to hold or commingle the relevant collateral in one account with appropriate record keeping. Further, under this model the Commission proposed two alternatives after a simultaneous default of the FCM and of one or more cleared swaps customers.

(i) The *Complete Legal Segregation Model* would permit the DCO to access the collateral of the defaulting cleared swaps customers, but not the collateral of the non-defaulting cleared swaps customers; or

(ii) The *Legal Segregation with Recourse Model*, which would permit the DCO to access the collateral of the non-defaulting cleared swaps customers, after the

DCO applies its own capital to cure the default, as well as the guaranty fund contributions of its non-defaulting clearing members.

(c) The Futures Model

The Futures Model presumes that the model in use for the US futures markets is to be used for cleared swaps. This would mean each FCM and DCO would be permitted to commingle all cleared swaps collateral for all customers of an FCM in one account and when an FCM defaults, due to a default by a customer, following the depletion of the FCM funds, the DCO would be permitted to access the collateral of the non-defaulting cleared swaps customers before applying its own capital or the guaranty fund contributions of other non-defaulting clearing members. In other words, the funds of non-defaulting customers of an FCM are at the top of the waterfall to cure any losses to the DCO after the funds of the defaulting customer and the defaulting FCM are depleted.

Finally, the Proposal considers permitting a DCO to choose between (i) the Legal Segregation Model (whether Complete or with Recourse), (ii) the Physical Segregation Model, and (iii) the Futures Model, rather than mandating any particular alternative. We would support optionality if the Commission decides this approach is prudent. However, BlackRock believes that permitting a particular DCO to offer multiple approaches to customer collateral protection may present operational challenges to implement and may result in delays with regard to portability of portfolios.

II. Discussion of the Various Models

Although each of the models considered by the Commission has its own advantages and disadvantages, we believe that the Complete Legal Segregation Model provides the best balance between the benefits and costs in protecting cleared swap market participants. LCH.Clearnet, the only clearinghouse currently with experience in this area, has adopted for swap clearing in Europe (and has indicated a willingness to do so in the US) a collateral protection model that "ensures that non-defaulting clients can be protected from the risks of other defaulting clients" and is "structured so as to enable the clearinghouse to identify and cover the risks associated with an individual customer's portfolio as if the clearinghouse were required to take on its management in isolation, as could happen in the event of a FCM member default."[8] In its response to the ANPR, LCH.Clearnet noted that a legal segregation model for customer protection similar to the Complete Legal Segregation Model would require "no changes to its default management structure (relative to the [Futures Model])" to implement and could be supported without "incur[ring] any incremental costs."[9] In light of this information, BlackRock fully supports the Complete Legal Segregation Model and would also consider recommending this model as the preferred option to its clients as it does not have higher ongoing costs than the other models due to the unavailability of customer funds. In addition from an operational standpoint, Complete

[8] *See* LCH.Clearnet Comment Letter, dated January 18, 2011 Re: RIN 3038-AD99 "Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies" at 4.

[9] *See* LCH.Clearnet Comment Letter, dated January 18, 2011 Re: RIN 3038-AD99 "Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies" at 7.

Legal Segregation provides the most operationally efficient framework to manage risk on a daily basis or port portfolios especially in periods of stress.

(a) The Physical Segregation Model

The Physical Segregation Model is intended to ensure that a DCO does not use the collateral of one cleared swaps customer to support the obligations of another customer by maintaining an individual account for each customer at both the FCM and the DCO. This separation assures that the collateral of a non-defaulting customer is not used to satisfy the obligations of either a defaulted customer, a non-defaulting customer or any other obligations of the FCM or DCO. It may also provide assurance that customer positions and related collateral can be easily identified in a "crisis" situation. However, after a simultaneous default of the FCM and of one or more of its cleared swaps customers, the Physical Segregation Model leads to the same result as the Complete Legal Segregation Model. Specifically, the DCO would be permitted to access the collateral of the defaulting cleared swaps customer, but not the collateral of the non-defaulting customers.

The Physical Segregation Model has two key drawbacks. First, the Physical Segregation Model may substantially increase operational complexity for some market participants. Second, the initial start-up costs under such a model could be significant. These costs will ultimately be paid by end users and the complexity of implementation may potentially delay the ability to participate in the cleared swaps market. For these reasons, we believe the Complete Legal Segregation Model is a more elegant solution than the Physical Segregation Model. Following a default, it leads to the same result as the Physical Segregation Model but with less disruption and lower start-up and maintenance costs as the current operational flows existing for futures collateral and margin management can be leveraged.

We agree with the Commission that the Physical Segregation Model would decrease uncertainty of investment risk because the FCM and DCO would invest the collateral of one cleared swaps customer separately from the collateral of another such customer. Therefore, the FCM or DCO could attribute losses on such investments to one particular customer. The Legal Segregation Model (whether Complete or with Recourse) and the Futures Model permit the FCM and DCO to hold the collateral of all cleared swaps customers in one account, and therefore neither the FCM nor the DCO are able to attribute investments (and losses thereon) to any one particular customer but rather such investments (and losses thereon) are attributed to the customers as a whole. We do not believe that the increased costs associated with the Physical Segregation Model are warranted by the need to separate the investment risk (which is relatively low)[10] compared to pro-rata distribution by customer. Finally, we agree with the Commission that the Physical Segregation Model and the Complete Legal Segregation Model both enhance portability and therefore would have similar impacts on reducing systemic risk.

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[10] Regulation 1.25 serves as an effective mechanism to reduce investment risk, although we have expressed concerns about limitations on diversification that may result from the Commission's proposed amendments to Regulation 1.25. *See* BlackRock's Comment Letter, dated December 3, 2010 Re: Investment of Customer Funds and Funds Held in Account for Foreign Futures and Foreign Options Transactions, 75 Fed. Reg. 67,642 (Nov 3, 2010); RIN 3038-AC15.

In sum, given that the Physical Segregation Model would provide only a marginal advantage related to separation of investment risk over the Complete Legal Segregation Model but would impose significantly higher operational costs, we believe that Complete Legal Segregation provides the best balance for customers, who would ultimately bear the costs of implementing any model.

(b) Legal Segregation Models

In choosing between the Complete Legal Segregation Model and the Legal Segregation with Recourse Model, the Commission notes that commenters have argued that implementing the former would result in increased risk costs in the form of default guaranty fund contribution or initial margin requirement, whereas implementing the latter would result in no risk costs. We believe that the risk cost of both should be similar because in either case the customer collateral availability is present only as long as the customer positions are maintained at a particular FCM or DCO. Said differently, in a worst case scenario, the customer collateral funds may not be available to pay for the defaulting FCM's shortfall to the DCO in all of these models as non-defaulting customers may port their positions ahead of an FCM default to another FCM.

The operational costs for the Complete Legal Segregation Model and the Legal Segregation with Recourse Model are approximately the same. With respect to benefits, however, the Complete Legal Segregation Model would mitigate fellow-customer risk even in extreme FCM defaults, unlike the Legal Segregation with Recourse Model. The Complete Legal Segregation Model also would support immediate portability to a significantly greater extent than the Legal Segregation with Recourse Model. The Legal Segregation with Recourse Model and the Futures Model would not facilitate portability to the same extent as the Complete Legal Segregation Model because a DCO may be unable to release the collateral of non-defaulting customers until it has completed the process of liquidating the portfolio of the defaulting FCM and its customers.

We also are pleased that the Commission has reaffirmed the importance of accurate recordkeeping to the Complete Legal Segregation Model. In particular, this model requires an FCM to keep books and records that identify each customer's cleared swaps and the relevant collateral and provide this information to the DCO.[11] There is a potential for loss resulting from bookkeeping errors by, or missing records of, the FCM. The risk of inadequate or inaccurate recordkeeping is inherent in any custodial relationship but is particularly critical in the context of bankruptcy. Thus, we recommend that the Commission mandate that DCOs adopt and enforce rules which require their member FCMs to comply with the reporting and recordkeeping requirements including the level of detailed information that would be necessary to implement the Complete Legal Segregation Model in a bankruptcy situation. Subject to the Commission's oversight, DCOs also should be required to monitor their

[11] Proposal at 33820. The maintenance of separate books and records for cleared swap positions and related collateral is defined as the "Legal Segregation Model," of which the Complete Legal Segregation Model is a subset.

member FCMs for compliance with such rules, including periodic audits. DCOs would benefit from administering this type of risk management requirement because they would gain routine access to customer-level information that was previously reported to the DCO only upon request.

(c) The Futures Model

For reasons illustrated in the table above, BlackRock believes the Futures Model should not be an option for cleared swaps. We note that some statements have been made that elimination of omnibus customer segregation creates a "moral hazard" in that customers will not choose their carrying FCM with the same care and due diligence. This presumes that today, futures customers have access to sufficient information to make truly informed decisions. However, in many, if not all instances, futures customers lack such access. Currently, there is no requirement or incentive to notify customers in an omnibus structure if a "fellow customer" is in a "stress" or potential default situation. Instead, customers rely to a large extent on the combination of DCO oversight and capital standards set by the Commission. Only the DCO has access to certain elements of the risk profile of its clearing members—whether those risks stem from the proprietary strategies in the house account or the strategies of the FCM's customers. We note also that there are market efficiencies in having DCOs perform this due diligence function, rather than the thousands of customers each attempting to perform a detailed due diligence review—the costs of which are ultimately reflected in the market as a whole. We believe more transparency and credit information disclosures made by FCMs will help clients of an FCM monitor the financial strength of their FCMs. We also believe there needs to be an obligation placed on an FCM and a DCO to inform other clients of an FCM if they are exposed to unusual risks due to client choice and client portfolio of the FCM.

One can argue that in the current Futures Model the buffer provided by customer collateral as the first line of loss makes for a less rigorous selection of clients by the FCMs, subsidizing of margin requirements by higher credit worthy clients for lesser credit worthy clients and less rigorous oversight by the DCOs. It may also contribute to the setting of lower minimum capital requirements. Customers will continue to monitor the credit quality of their carrying FCM as they do for all entities to which they have credit risk exposure. But they would not need to be concerned about the unknown secondary risk posed by trading conducted by other customers of the FCM or the risk management of the FCM towards other FCM clients—a concern which, as noted above, cannot be managed today in the Futures Model. By providing clients with better protection for collateral, especially for swaps given the amount of collateral and the duration of which the collateral is being locked-up, we can avoid a potential situation where clients begin to port or close out their portfolio at the slightest sign of uncertainty surrounding a big client or an FCM default.

We appreciate the Commission's consideration of the strengths and weaknesses of each model for customer collateral protection and we endorse the Commission's view that the Complete Legal Segregation Model would protect customer collateral from fellow customer and other risk without imposing undue costs on market participants, including

FCMs and DCOs. In addition, the Complete Legal Segregation Model will increase the safety and soundness of the U.S. financial system by facilitating portability of positions. Accordingly, we encourage the Commission to adopt the Complete Legal Segregation Model for swaps clearing.

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BlackRock thanks the Commission again for its efforts and for the opportunity to provide the foregoing comments and recommendations regarding the protection of cleared swaps customer collateral. If we can answer any questions or provide further information concerning this important topic, please do not hesitate to contact us.

Sincerely,

Joanne Medero
Richard Prager
Supurna VedBrat