

August 8, 2011

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

**Re: RIN 3038-AC99/Protection of Cleared Swaps Customer Contracts and Collateral:  
Conforming Amendments to the Commodity Broker Bankruptcy Provisions**

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 notice of proposed rulemaking and request for comments ("NPR") concerning the protection of margin 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.

The Commission has proposed the legally separate but operationally commingled model ("LSOC")<sup>1</sup> for the holding of cleared swap margin provided to a customer's futures commission merchant ("FCM"). The LSOC model potentially removes the risk that pension plans' initial margin could be utilized in a FCM bankruptcy to cover losses caused by other customers ("fellow-customer risk") of the bankrupt FCM. In brief, while we support the LSOC model as a significant improvement over the current futures model, the LSOC model still poses significant risks to pension plans including FCM investment risk, FCM misappropriation risk, recordkeeping risk in an FCM bankruptcy, and lack of transparency into the FCM's omnibus accounts for a pension plan's investment manager/plan sponsor. Accordingly, in addition to adopting the LSOC model, we urge the Commission to allow FCMs to give their customers an option to post margin for cleared swaps into individual physically segregated accounts in the customer's name with third-party custodians for the benefit of the relevant derivatives clearing organization ("DCO"). Without this option, the clearing requirement under the Dodd-Frank Act would force pension plans to take on significant additional risks which they can presently minimize or eliminate entirely by using third-party custodians with appropriate contractual provisions. If an FCM goes into bankruptcy as a result of the failure of one of its customers and

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<sup>1</sup> Defined in the NPR as the "Complete Legal Segregation Model".

the FCM has failed to keep appropriate records, pension plans in the aggregate could stand to lose billions of dollars in margin as a result of having to share in losses of the FCM's other customers or due to the FCM's investment activities or fraudulent actions, despite the application of LSOC. We believe the Commission needs to consider this important cost/benefit factor in adopting its final segregation rules. In addition, we strongly believe that the cost of providing pension plans with this option will not be excessive, particularly because (i) such an option is currently provided by swap dealers, (ii) this option is required as a matter of law for every U.S. registered investment company utilizing swaps today (many of which hold pension plan assets), (iii) clearing organizations and their clearing members will earn significant income as a result of the mandatory clearing of swaps, thus offsetting the costs of segregation, and (iv) pension plan beneficiaries will benefit from the additional protections of physical segregation of their assets with a third-party custodian.

## **I. Background**

In its Advance Notice of Proposed Rulemaking ("ANPR"), the Commission sought comments on three alternative models: the Legal Segregation Model, the Physical Segregation Model and the Futures Model.<sup>2</sup> In response to the ANPR, the Commission received 15 letters from buy-side firms or groups.<sup>3</sup> Eleven of these firms favored having the option to physically segregate customer margin. We note that certain commenters expressed concerns that mandatory physical segregation for all FCM customers would be overly burdensome. We are not requesting that the Commission adopt a mandatory physical segregation model, but rather that pension plans have the option to physically segregate margin.

We appreciate that the Commission's proposal to adopt the "LSOC" model could, subject to adequate recordkeeping of an FCM, address the critical issue of "fellow-customer" risk. Pension plans, which are subject to strict regulation and oversight, are particularly vulnerable to the default risk of less creditworthy fellow customers. However, the use of LSOC results in other risks being imposed on customers of cleared swaps with respect to margin, and we urge the Commission to allow FCMs to offer their customers, including pension plans, the option to have their margin posted to an account in the customer's name (for the benefit of the relevant DCO) with a third-party custodian, which arrangement would permit FCM customers to mitigate or eliminate these risks as many currently choose to do.

## **II. We support the Commission's proposal of the LSOC model, but urge the Commission to give FCMs the ability to also offer their customers the full physical segregation option.**

### **A. The Commission should allow pension plans the option to physically segregate margin in an individual settlement account ("ISA") as described below.**

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<sup>2</sup> Commission ANPR, "Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies", 17 CFR Part 190, RIN 3038-AD99, 75 Fed. Reg. 231 at 75162.

<sup>3</sup> Commission NPR, "Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions", 17 CFR Parts 22 and 190, RIN 3038-AC99, ("Proposed Rule") 76 Fed. Reg. 111 at 33822.

The structure for a physically segregated ISA that is used to hold margin for cleared swaps is as follows and has been reviewed by a major U.S. DCO as an operational matter<sup>4</sup>:

## 1. Legal Framework

A pension plan that maintains an account with an FCM through which swap contracts are carried and cleared (a "Swap Account") will establish a physically segregated ISA pursuant to an agreement (a "Quad-party Agreement") among the relevant DCO, the FCM, the pension plan and a custodian that is also a settlement bank of the DCO (the "Custodian"). The ISA would be an account held in the name of the pension plan (for the benefit of the DCO) at the Custodian and the Quad-party Agreement would expressly provide that the ISA and its proceeds are property of the pension plan, and not of the FCM. Assets standing to the credit of the ISA will be used for the purpose of satisfying all of the pension plan's Swap Account margin obligations to the DCO. The DCO will have an unrestricted right to use margin deposited in the ISA to cover the pension plan's obligations to the DCO.

The DCO will have a first priority lien on the ISA and will be permitted to direct withdrawals from it. The FCM will have a secondary lien on the ISA for the sole purpose of securing repayment of any outstanding FCM loan to the ISA (as described in Flow of Funds below), subordinated to the lien of the DCO and the FCM will have no rights to the assets in the ISA, except in respect of its secondary lien. The Quad-party Agreement will provide that in the event of any claim by the FCM against the ISA or any asset of the ISA, the records of the custodian will be conclusive. Each ISA established with a DCO will also be subject to any additional rules the DCO may establish from time to time.

The rights and responsibilities of the parties, as described above, will be established under the Quad-party Agreement. Nothing in the Quad-party Agreement will change the FCM's liability to the DCO for the pension plan's transactions, so the FCM will remain liable to the DCO for the pension plan's performance.

## 2. Flow of Funds

Unlike the Futures Model, a pension plan using an ISA would not have its assets transferred through the accounts of the FCM. Instead, the pension plan will transfer margin for its Swap Account directly to the ISA. Such assets will then be transferred from the ISA to the DCO to fund margin payments for the pension plan's Swap Account. Any payments by the DCO or returns of margin from the DCO will also be deposited into the ISA. In addition, if an FCM makes loans to the pension plan in order for the pension plan to meet margin calls, the FCM will deposit the loaned funds directly into the ISA. The Customer would repay such loans by transferring funds into the ISA and directing the custodian to transfer such funds to the FCM.

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<sup>4</sup> In the interest of identifying an effective segregation option for certain cleared swap customers that have a legal or other need for physical segregation, the Chicago Mercantile Exchange has reviewed this approach and advised us that they believe it would work well.

3. Flow of Information

For any trade, the pension plan will notify the FCM of its order. The FCM will execute the trade on the relevant marketplace (either an exchange or a swap execution facility). The FCM will then clear the trade through a DCO, submitting the appropriate information to the DCO. The DCO will inform the FCM of the DCO's initial margin requirements and the FCM will inform the pension plan of the relevant margin requirements. The pension plan would be required to make transfers to the ISA to meet the relevant margin requirements. Any call for variation margin by the DCO will go to the FCM which will then call for margin from the pension plan. At the termination of a trade, the DCO will make payments directly to the Custodian. The Custodian will inform the FCM and the pension plan of the receipt of funds into the ISA. In addition, the Custodian will inform the pension plan on a periodic basis of amounts in the ISA.

4. Customer Relationship with the FCM

A pension plan that deposits margin in an ISA will remain a customer of the FCM. Aside from the transfer of assets to the ISA, the nature of the pension plan's relationship to the FCM would remain unchanged and would not be abrogated in any way. The table below demonstrates that using an ISA would not fundamentally change the relationship between the FCM and a customer.

<b>Operation</b>	<b>Futures Model</b>	<b>ISA</b>
Appointment of FCM	FCM is appointed pursuant to a Customer Agreement	Same
Initiation of Orders	Pension plan initiates order with FCM and FCM then attempts to match the order through a Designated Contract Market ("DCM") or a Swap Execution Facility ("SEF")	Same
Reporting of Matched Orders	DCM/SEF reports any trade resulting from a matched order to the FCM	Same
Clearing of Trades	The trade is cleared by the DCO for the account of the FCM	Same
FCM Liability to DCO for Trades	The FCM is liable to the DCO for the pension plan's obligations under the cleared trades	Same
Margin Requirements	Minimum amount and type of margin is set by the DCO which may be increased by the FCM	Same
Margin Calls	Margin calls may be made by the FCM or the DCO on any cleared trade	Same
Transfer of Assets	Transferred by the pension plan to the FCM and then drawn upon by the DCO; reverse flows	Transferred by the pension plan to the settlement account (for the benefit of

Operation	Futures Model	ISA
	use the same structure	the DCO), or loaned by the FCM to the account, then drawn upon by the DCO; reverse flows use the same structure

**B. The LSOC model addresses some of the risks facing customers, but a significant number of risks are still present in the LSOC model and therefore, full physical segregation should be an option.**

As discussed in the NPR, there are a number of risks in the Futures Model, some but not all of which are mitigated by the adoption of the LSOC model. The table below demonstrates the comparative risk exposure under the alternative models followed by a brief description of each risk. In stark contrast, these risks are addressed under the Physical Segregation ("PS") model.

**Risks Inherent in the Proposed Models**

Risks	Current model	Legally Separated Operationally Commingled Model	Physical Segregation Model
Fellow-Customer Risk	√	n/a*	n/a
Bankruptcy/ Recordkeeping of FCM	√	√	n/a
FCM Investment Risk	√	√	n/a
FCM Misappropriation Risk	√	√	n/a
Transfer Risk (Double Default Risk)	√	√	n/a
Lack of Transparency	√	√	n/a

\* Fellow-customer risk is only avoided under LSOC if the FCM's records are accurate and complete.

1. Fellow-customer risk

One of the principal risks posed under the Futures Model is the customer's exposure to the default of the FCM's other customers. This risk is particularly acute for ERISA pension plans which, as highly creditworthy low-risk customers of an FCM, will effectively subsidize higher-risk investors under a system that requires sharing of fellow-customer risk. Further, fellow-customer risk is imposed upon but cannot be mitigated by pension plans because they are not in a position to assess the creditworthiness of the fellow customers of their FCMs.

Subject to an FCM keeping accurate and complete records, fellow-customer risk is eliminated under both the LSOC model and the full segregation model. Under both models, margin of individual customers is legally and/or physically segregated from that of other customers of the FCM, so the margin of non-defaulting customers could not be used to satisfy the obligations of defaulting customers.

## 2. Bankruptcy/ Recordkeeping of FCM

Under the proposed LSOC and the Futures Model, customer property is segregated from FCM property and therefore the bankruptcy of the FCM should not deprive the customer of its property. However, under the LSOC model, unlike in physical segregation, the protection against "fellow-customer" risk is dependent upon proper recordkeeping and retention by the FCM to determine each FCM customer's margin, margin loans and cleared swap positions. If an FCM's records are incomplete or inaccurate or disputed, a large amount of customer margin could remain trapped in the FCM's bankruptcy estate because it could not be readily attributed to customers. Because FCMs nearing bankruptcy are least likely to have the resources to maintain accurate records, the likelihood of an FCM not having appropriate records increases as an FCM's financial condition deteriorates. This was illustrated in the bankruptcy of Lehman's FCM business. A Barclays executive testified that with respect to Lehman's 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."<sup>5</sup> Considering that the swaps market is significantly larger than the futures market – upon insolvency Lehman had an estimated \$10 trillion notional amount of swaps outstanding<sup>6</sup> – the sheer amount of recordkeeping required to accurately reflect customer positions would be a challenge for any FCM, especially one that is nearing insolvency. In addition, due to the much greater size of the swap market, any inaccuracy or incompleteness of FCM records could result in significant losses to FCM cleared swap customers.

In contrast, margin in a physically segregated account would not be subject to FCM bookkeeping risk because it would be held with a third-party custodian (and thus would not form part of the FCM's bankruptcy estate - see memorandum of law prepared by Clifford Chance US LLP attached as Exhibit I (the "Memorandum")) and the DCO would be able to rely upon the records of such custodian rather than the insolvent FCM.

## 3. FCM Investment risk

Under the Futures and LSOC models, because margin is operationally commingled, customers are subject to losses in margin value due to investment decisions made by the FCM. For example, if the customer delivers cash and the FCM invests the cash in assets that lose value, the customer could suffer a loss in the event the FCM becomes insolvent. Conversely, if a pension plan is able to hold its initial margin in a segregated account in its name for the benefit of the relevant DCO with a third-party custodian, the pension plan would not be subject to the risk of investment decisions made by the FCM. For example, under Commission Regulation 1.25, a FCM could have taken U.S. Treasuries provided by its customers for initial margin, sold them and bought Greek government bonds (when such sovereign bonds were sufficiently highly rated) and, if the FCM went bankrupt, its customers would bear any losses associated with such Greek government bonds. Given that pension plans enter into swaps primarily to hedge interest rate

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<sup>5</sup> "Lehman Derivatives Records a 'Mess', Barclays Executive Says", Bloomberg, August 30, 2010.

<sup>6</sup> Bloomberg article, "'Exaggerated' Swings in Swaps, Notes Likely as Lehman Unwinds", Liz Capo McCormick, Sept. 22, 2008, available at: <http://www.bloomberg.com/apps/news?pid=newsarchive&refer=bond&sid=a.n2PfeAIDng>

risk, it would be incongruous for pension plans, as a resulting of hedging interest rate risk, to be exposed to foreign country or other non-interest rate investment risk as a result of an FCM's use of pension plans' initial margin.

4. FCM Misappropriation risk

Allowing customers to physically segregate margin at a third-party custodian also reduces the risk of misappropriation of assets or other fraud by the FCM, because (i) the margin in an ISA could only be utilized to meet the margin obligations of the relevant customer and no other activity (such as investment by the FCM) would be permitted, (ii) there would be transparency into the activity in such ISA as a result of reports by a third-party custodian provided to each of the DCO, FCM and FCM customer, and (iii) it is much harder to hide fraud in an account containing one customer's assets than it is in an account containing hundreds, if not thousands, of customers' assets.

5. Transfer risk (Double Default Risk)

The Futures and LSOC models require customers to first transfer margin to the FCM for subsequent transfer to the DCO. However, if the FCM becomes insolvent prior to transferring the margin to the DCO (but after collecting the margin from the customer), the customer could be required to post margin again to support its obligation under the swap. The customer could be required to double its margin payments until its initial margin was returned from the bankruptcy estate of the FCM. By contrast, physically segregated margin would not pass through the account of the FCM and, thus, this risk would be avoided.

6. Lack of transparency and daily independent oversight

There is no independent daily oversight of records of the margin posted to an FCM under either the Futures or the LSOC model. Although FCMs provide margin reports to customers on a periodic basis, they do not typically do so on a real-time basis and there is no transparency for FCM customers into the FCM's omnibus customer account in which customer assets are held and to the investment risks and fellow customer risks of such accounts. Although reports are provided by the FCM to the DCO under the LSOC model regarding positions, it will be very difficult if not impossible for DCOs to be able to daily reconcile the accuracy of such reports as compared to the records of each FCM customer absent independent reporting by an entity other than the FCM (such as a custodian). LSOC does not provide for such independent reporting being provided to a DCO. Nor does LSOC provide for any surprise or special audits of such LSOC accounts which could serve to identify material deficiencies in the recordkeeping of such LSOC accounts in advance of an FCM bankruptcy.

In contrast, under the physical segregation model, there would be real-time transparency into the activities and holdings of an ISA provided to each of the DCOs, FCMs and their customers. This independent reporting also strengthens the entire clearing system in that it allows DCOs to have direct access to information about the swap positions and posted margin of customers choosing the physical segregation option. Also, because the ISA is in the name of the customer (for the benefit of the DCO), the customer would have the right to have such accounts audited.

**C. Optional Physical Segregation will be recognized under the Bankruptcy Code.**

In the NPR, the Commission suggested that optional physical segregation may not be recognized in bankruptcy because of the Bankruptcy Code requirement that all FCM "customer property" must be distributed to customers on a ratable basis. As further detailed in the Memorandum, because margin held in a physically segregated account in the name of the customer (for the benefit of the DCO) with a third-party custodian would not constitute "customer property" of an FCM, it would not be subject to ratable distribution under the CEA. Therefore, there is no impediment under the Bankruptcy Code to physical segregation of customer margin. In addition, the Commission has the authority under the CEA to clarify that margin held in a segregated account would not be part of "customer property", and we urge it to do so.

**D. We urge the Commission to adopt rules permitting FCMs to offer pension plans the option to use ISAs.**

In order to facilitate the ISA structure, we urge the Commission to promulgate rules stating that (i) FCMs are permitted to offer the ISA structure, (ii) that assets held in an ISA are not "customer property" and (iii) that DCOs may not unreasonably restrict FCMs from offering ISAs to pension plans. Clarifying that FCMs are permitted to offer physical segregation to pension plans will provide regulatory certainty for FCMs. Also, without regulatory constraints, DCOs may refuse to provide ISAs to pension plans or subject them to unreasonable rules or delays that would vitiate the physical segregation option. We therefore urge that the Commission adopt the following rule:

**§22.17: Physically Segregated Accounts for Pension Plans**

(a) **Futures Commission Merchant.** A futures commission merchant may offer an individual segregated account to any pension plan customer to hold the Cleared Swaps Customer Collateral of that customer. Each such account shall be in the name of the relevant customer for the benefit of the relevant derivatives clearing organization.

(b) **Customer Property.** Any Cleared Swaps Customer Collateral in an individual segregated account, shall be an account eligible for transfer pursuant to Commission regulation 190.06(e) and Bankruptcy Code Section 764(b) but shall not otherwise be customer property for the purposes of Part 190 of the Commissions Regulations or the Bankruptcy Code.

(c) **Derivatives Clearing Organization.** Each derivatives clearing organization shall by rule or otherwise make reasonable accommodations for the establishment of an individual segregated account for any futures commission merchant's pension plan customer, subject to any applicable rules established by such derivatives clearing organization; provided that no derivatives clearing organization may (i) promulgate or establish any rule that imposes unreasonable restrictions or costs on the creation or operation of such individual segregated accounts, or (ii) unreasonably delay the establishment or implementation of any such segregated account, whether by promulgation of a rule or otherwise.



For conforming purposes, we urge the Commission to insert

(i) in Section 22.1, in the definition of Cleared Swap Customer Collateral, after each instance of the phrase "derivatives clearing organization" the following: "(or by an individually segregated account for the benefit of the derivatives clearing organization)",

(ii) in Section 190.08(d)(2), after the words " after the words "the equity to be transferred to margin such contract" the following: "(including any equity in such customer's individual segregated account for the benefit of a derivatives clearing organization)", and

(iii) in Section 1.03, the following definitions:

"individual settlement account" means a bank account maintained by a pension plan at the settlement bank of a derivatives clearing organization for the purposes of satisfying the pension plan's margin and settlement obligations with respect to commodity contracts maintained by the pension plan in an account with a futures commission merchant.

"pension plan" means an employee benefit plan as defined in Section 3 of Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) ("ERISA plan") and any entity which contains funds from an ERISA plan.

**E. Many customers, including pension plans and every U.S. registered investment company that utilizes swaps, currently use third-party custodians for swaps and their ability to use third-party custodians should be retained.**

In drafting the Dodd-Frank Act, Congress was clear that its intention was to provide for greater transparency and protection of customers in the swap market. In the swaps market today, customers, including pension plans and every U.S. registered investment company that utilizes swaps (and many such investment companies also contain pension plan assets), currently benefit from the additional protection afforded to them by segregated margin accounts. There is no reason why physical segregation of margin, particularly in the form of an ISA, could not be applied to cleared swaps as well as over-the-counter traded swaps. We do not believe that Congress intended to weaken the protection available to customers, including pension plans and mutual funds, and therefore urge the Commission to allow customers to continue to enjoy the same standard of swap margin security that they are able to obtain from third-party custodians today.

**III. From a cost-benefit perspective, the LSOC model coupled with the option for physical segregation is preferable to the LSOC model alone.**

We recognize that the CEA requires the Commission to assess the costs and benefits in advance of each rulemaking.<sup>7</sup> We believe that the benefits of giving customers the option of physical segregation considerably outweigh those presented by the LSOC model alone, particularly in terms of risk mitigation. The additional cost of implementing an optional physical segregation

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<sup>7</sup> CEA, Section 15(a); 7 U.S.C. 19(a).

model are justified by the benefits provided to the clearing system and to pension plans and their beneficiaries.

## **A. Benefits**

### **1. Fellow-customer risk**

As discussed above, optional physical segregation would provide even greater protection against fellow-customer risk than the LSOC model alone.

### **2. Portability and systemic risks**

In its release, the Commission states that an additional benefit of the LSOC model is that it fosters portability by preserving the margin of non-defaulting customers.<sup>8</sup> Assets in a physically segregated account containing assets of one customer would be easier to separate from FCM property in the event of an FCM insolvency than assets of thousands of customers held in a single omnibus FCM account under the LSOC model because (i) the simplicity of recordkeeping for an account containing just one customer, and (ii) there would be independent recordkeeping by a going concern (the Custodian) as compared to the potentially suspect records of an insolvent FCM. Such records are essential to both avoiding fellow-customer risk and ensuring the portability of customer positions. As a result, allowing physical segregation would provide greater portability and systemic benefits by allowing customers who choose physical segregation to also protect themselves from failures in FCM recordkeeping and any resulting transfer risk. In addition, physical segregation would increase the efficiency of cleared swap portability because physically segregated margin would be held outside of the FCM's bankruptcy estate and would be readily identifiable due to the availability of real-time customer records and a new ISA would not have to be established but rather the bankrupt FCM could be replaced on such account by a solvent FCM.

Another risk that affects margin preservation and thereby portability and systemic health is the risk of losses due to FCM investment decisions in FCM omnibus customer accounts. The Commission's rules currently permit FCMs to invest customer margin in various types of assets. If FCMs make investments in higher-risk assets that suffer a loss, customers may lose a significant amount of their margin upon the insolvency of the FCM. Because such losses would not be known until an FCM's insolvency, they would distort the amount of margin that is available to market participants (and make the analysis more difficult for regulators and DCOs). In addition, such losses would negatively impact customers' financial condition, which could further destabilize the derivatives market in a time of crisis (such as the failure of an FCM). Furthermore, if, after investment losses, customers cannot receive enough margin from the FCM's estate to cover their positions, it could impact the portability of swaps. As noted earlier, pension plans are highly regulated entities with duties toward their beneficiaries and primarily enter into swaps to hedge interest rate risk. Thus, unlike FCMs which are motivated to seek a return for themselves from the use of margin posted by a pension plan by investing in higher yielding assets, it is more important for pension plans to be able to maintain their hedge positions than to obtain a high return on margin posted. Permitting pension plans to have physical

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<sup>8</sup> Proposed Rule, 76 Fed. Reg. 111 at 33849.

segregation of their margin would minimize the possibility of investment losses on margin and increase the overall stability of the system.

Customer margin is also subject to the risk of misappropriation by an FCM. If an FCM is facing financial difficulties, the FCM may be more likely to resort to misappropriating customer funds for its own purposes. When the FCM then becomes insolvent, the customers would receive significantly less margin from its estate than they had anticipated, which could subject the market to significant uncertainty at a time when an FCM has already failed. By allowing margin to be physically segregated with independent custodians, which are traditionally highly rated entities specializing in such services, this risk could be significantly reduced in the system and increase its stability.

Currently DCOs are unable to determine the individual positions of customers and the amount of margin those customers have posted other than through an FCM's records, which may or may not be available to the DCO. The LSOC model would attempt to address this by increasing the reporting by FCMs to DCOs. However, an FCM's records may be inaccurate or incomplete, especially prior to an FCM's insolvency. Allowing physical segregation would enable DCOs and regulators to be able to quickly determine individual customers' positions. This would allow DCOs to track the aggregate exposures of individual customers (including, potentially, across multiple FCMs), and to be more prepared in the event of a default by such customers. In addition, as noted above, the availability of reliable and easily obtainable records would increase the efficiency of porting customer positions and would also provide the regulators with a more accurate view of the market at a time of systemic stress.

### 3. Induced changes in behavior

The Commission has determined that the LSOC model would provide the benefit of influencing DCO behavior in a positive manner.<sup>9</sup> That is, legal segregation of margin would reduce DCOs' ability to rely on pooled assets and would induce DCOs to implement better screening and monitoring procedures for FCMs and major customers of the FCMs, which would in turn reduce the probability of defaults. The Commission correctly dismissed the concern that there would be a negative impact on customer behavior in monitoring FCM behavior.<sup>10</sup>

Permitting customers to use physical segregation would provide an additional benefit by giving customers the incentive to reduce risk through use of a low cost risk management tool. Pension plans are required by regulation to prudently manage risk and can currently use tri-party custodial arrangements as a tested and proven method to reduce risk. Given the option to use physical segregation as an alternative to the LSOC model, other swaps customers may also be induced to further protect their margin thus increasing the safety and soundness of the clearing system in the event of a FCM default.

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<sup>9</sup> Proposed Rule, 76 Fed. Reg. 111 at 33849.

<sup>10</sup> Proposed Rule, 76 Fed. Reg. 111 at 33849.

#### 4. Quantification of benefits

The primary benefit of giving pension plans the option of physical segregation is to protect their margin from losses due to FCM bankruptcy. As discussed further in the section on operational costs below, we estimate that the custody costs to protect customer margin against loss due to FCM default would be in the range of \$30,000 per custody account (generally 1 to 5 basis points of margin assets held).

The following calculation illustrates the costs and benefits of physical segregation. Consider a pension plan that has \$100 million in assets posted as margin. The plan's investment manager seeks to insulate its posted margin should the FCM become insolvent. As stated below, the custody cost of establishing a physically segregated account is approximately \$30,000 per year. The \$30,000 represents 3 basis points on the \$100 million of margin. This payment can be compared to the purchase of insurance against an FCM bankruptcy. For insurance on \$100 million in pension fund assets at a cost of 1 to 5 basis points per year, the option of physical segregation provides significant protection for a very low cost. By way of rough analogy, credit protection on "A" to "AA" rated banks is currently in the area of 100 basis points.<sup>11</sup>

#### **B. Costs**

In its proposal, the Commission analyzed the cost of the alternative models in relation to the costs incurred in the futures market. We strongly disagree with this approach because it implies that the Futures Model is the status quo for swaps and that physical segregation is the variance from such status quo. Neither the Futures Model nor the LSOC model is currently an option for swaps - physical segregation of swap margin is the status quo for thousands of U.S. registered mutual funds and many pension plans. Because the swaps and futures markets are notably dissimilar, the appropriate comparison should be the incremental cost of transition from existing tri-party custodial arrangements in the swaps market to physically segregated accounts for cleared swaps.<sup>12</sup> We believe that such incremental costs could be kept to a nominal or reasonable level.

The present costs of tri-party arrangements are low. We noted in our prior comment letter to the ANPR that currently in the swaps market, for margin posted by pension plans with a third-party custodian, dealers generally charge minimal or no fees and custodial fees are generally no more than \$30,000 per year per account.<sup>13</sup> The dealer's cost is covered in the bid-ask spread of the transactions and since these spreads have not increased notably as a result of tri-party custody arrangements, the indication is that the costs are not excessive. For example, in its comment letter on the ANPR, BlackRock estimated that the cost of tri-party custodial arrangements for

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<sup>11</sup> See: Marketwatch story, "Fitch Solutions: JP Morgan's CDS Widen 19%; Citigroup Comes Out 13% Ahead of Earnings", July 13, 2011, available at: <http://www.marketwatch.com/story/fitch-solutions-jp-morgans-cds-widen-19-citigroup-comes-out-13-ahead-of-earnings-2011-07-13>.

<sup>12</sup> See also Fidelity comment letter to the Commission's ANPR, letter dated January 18, 2011 ("Fidelity letter"), pp. 4-6.

<sup>13</sup> See CIEBA comment letter to the Commission's ANPR, letter dated January 18, 2011 ("CIEBA letter"), p. 5.

customers is approximately 1.1 basis point of the market value of account assets per year, per account.<sup>14</sup>

### 1. Operational costs

The option to use physical segregation would simply provide customers a choice of whether to use a third-party custodian. Customers would not be required to segregate their margin. Rather, individual customers can base their decision on their own cost-benefit analysis. Presumably, customers that elect to use physical segregation will have determined that the benefit of added protection outweighs any additional cost.

The relative cost-benefit profile of the ISA Model is highly favorable to customers. Although certain market participants have asserted that the costs of adopting full physical segregation of margin could be excessive, we do not agree. The costs of maintaining physically segregated margin are comparable to the costs of paying a third-party custodian to maintain a separate account in the over-the-counter market. In the over-the-counter market swap dealers often segregate the assets of their customers (often pursuant to tri-party custodial arrangements) and determine the value of each customer's trades as well as the value of the margin of each of their customers on a daily basis. Swap dealers determine daily whether particular customers must deliver additional margin or if margin must be returned to customers. A full physical segregation option could therefore be implemented effectively by requiring that FCMs (who are generally the same entities as swap dealers today) provide the DCOs the daily reports currently being provided to their customers, which would allow DCOs to segregate customer assets by relying on such reports. DCOs would therefore not need to create independent methods of valuing the assets of each customer choosing the physical segregation option and would not incur significant new administrative burdens. The current cost of third-party custody services for segregated margin for uncleared swaps is approximately \$30,000 per custody account (generally 1 to 5 basis points of margin assets held). We estimate that the custody costs of an account to hold physically segregated margin for cleared swaps would be the same.

Further, the costs related to recordkeeping for FCMs and DCOs under full physical segregation should not be greater than the cost under the LSOC model. FCMs would be required to keep track of the same information with respect to customer positions under both models. Section 22.11(e) of the proposed rule requires DCOs to confirm the accuracy and completeness of information received from the FCMs as to customer identity and positions, and the cost to DCOs of confirming such information should be no greater to the DCO if the positions are segregated by the FCM under LSOC or by a third-party custodian under the physical segregation model.<sup>15</sup>

Some commenters have noted that full physical segregation may result in customers exercising more discretion over their assets and thereby slowing down certain payments. Under the ISA model proposed in this letter, there would be no slowing down of payments because the DCO would have unfettered rights to draw directly on the customer assets in the ISA. In addition, the risk that customers would not deposit assets into the ISA is no different than such risk today, as in each case the FCMs would make a loan to the customer to cover the DCO's margin call.

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<sup>14</sup> See Blackrock comment letter to the Commission's ANPR, letter dated January 18, 2011 ("Blackrock letter"), p. 3.

<sup>15</sup> Proposed Rule, 76 Fed. Reg. 111 at 33855.

## 2. Risk costs

The Commission evaluated the risk costs of the LSOC model as the direct and indirect costs of reassignment of liability upon customer default. We respectfully suggest that since both LSOC and the Futures model permit FCMs to exercise control over customer margin, the Commission should also consider the very significant costs of potential customer losses due to investment risk or bankruptcy/recordkeeping risk.

To demonstrate the potential loss to pension plans under LSOC or the Futures Model due to the insolvency of an FCM, we present the following example. A pension plan has \$20 billion in liabilities, with an average duration of twelve years which is matched against \$20 billion in assets, of which 60% are invested in high quality fixed income instruments. If the pension plan manager wants to manage the asset-liability match so that the coverage ratio of the assets to liabilities is approximately 2:3 on a DV01<sup>16</sup> basis, the manager can use an interest rate swap overlay to synthetically extend the duration of its assets to achieve this. The total initial margin required on the pension plan's resulting interest rate swap position would be approximately \$225 to 276 million, depending on the duration target. If the pension plan split this position evenly across three FCMs, the initial margin posted with each FCM would be between \$75 and 92 million. If one of the FCMs suffers losses due to investment risk or fails to keep adequate records with respect to customer assets and then becomes insolvent, the pension plan could lose its posted margin, which would be a loss of 38-46 basis points of the pension plan's total assets. Extrapolating this to CIEBA's membership base, which manages more than \$1.4 trillion in ERISA plan assets, the potential losses to pension plans due to FCM insolvency would be on the order of \$5.25 to 6.44 billion. By contrast, margin for cleared swaps that is held in physically segregated accounts would not be subject to this risk and its related costs.

The recent experience with the failures of Lehman, AIG, Refco, and Bear Stearns suggests that the bankruptcy of an FCM can hardly be considered a "remote" risk and underscores the need for the Commission to assess and consider potential losses to customers stemming from such risk as a cost factor in its evaluation of the alternative models. For this reason, among others, pension funds and other customers should be given the opportunity to protect themselves against this and other risks that are not adequately addressed by the LSOC model.

## 3. Induced changes in behavior

Pension plans are required to prudently manage risk to comply with regulatory standards and commonly use tri-party custodial arrangements as a cost-effective method. If the Commission does not allow the option of physical segregation, pension plans will be subject to significantly greater risks than they are currently exposed to today and will be prevented from mitigating such risks. If these risks result in actual losses to pension plans, the LSOC and Futures models will impose significant economic losses on pension plans and other customers that currently use third-party custodial arrangements. While pension plans are held to strict risk management standards by regulation, other customers may choose to take on more risk rather than incur

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<sup>16</sup> DV01 refers to the dollar value of one basis point, and is a measure of price volatility expressed as the change in price of the instrument given a one basis point move in interest rates.

increased costs. Such increase in risk exposure would be an implicit cost to the system and undermine its overall stability.

Some commenters have raised concerns that physical segregation for customer margin would lead only "high-risk" customers to remain in commingled pools, thus increasing the risks to FCMs. We do not believe this would be the case. If FCMs determine that certain customers are "high-risk", they can impose additional margin requirements on such customers or even require them to physically segregate their margin so as not to "contaminate" the commingled pool. In addition, the task of identifying and managing "high risk" customers is part of an FCM's business, and they are best positioned to perform this function efficiently. Finally, we note that nothing in the Dodd-Frank Act indicates that it is in the "public interest" to lower the standard of protection available to highly creditworthy low-risk swap customers such as pension plans so that high-risk swap customers (e.g., hedge funds) can effectively "free-ride" – i.e., enjoy greater protections due to the higher creditworthiness of their fellow customers. Therefore, if FCMs raise margin requirements or charge higher fees for "high risk" customers, it would not be an increased cost to the market but rather a proper reallocation of costs.

#### 4. Portability

The Commission determined that the LSOC model would not decrease portability. This determination relies on the assumption that the bankrupt FCM would have accurate and complete records at the time of bankruptcy that would permit portability. While LSOC may not decrease portability in comparison to the futures market, relative to the current swaps market in which tri-party custodian arrangements are common, adoption of the LSOC model without the option for physical segregation would adversely impact portability from the current state of the swaps market. In the earlier discussion of benefits of risk mitigation, we detailed how the option for physical segregation would mitigate risks that reduce portability. Implementation of the LSOC model without the option for physical segregation would impose an additional cost in the form of reduced portability in the event that FCM records are either incomplete or inaccurate or otherwise result in legal challenges that delay or prevent portability of positions.

#### **C. DCOs will benefit from significantly increased revenues and should readily assume the reasonable costs of implementation of physical segregation.**

To permit the option of physical segregation, DCOs and the clearing member FCMs would need to scale up their reconciliation procedures and operational personnel in order to support such accounts. As discussed below, we believe that such increase in operations to support a physical segregation of margin option for FCM customers is not only mandated by the Dodd-Frank Act but also supported as a business matter by the existing practices of swap dealers. As noted earlier, the status quo for swaps today is for swap dealers to permit pension plans and mutual funds to have physical segregation of their swap margin with an independent third-party custodian. So if the Commission were to allow physical segregation as an option, FCMs and DCOs would only be required to adopt a business model already proven by swap dealers to be viable, profitable and cost-effective.

We believe that the significant scaling up by the DCOs and clearing FCMs of their operations is already a cost effectively "mandated" by Dodd-Frank by imposing a mandatory requirement for

the clearing of standardized swaps. The movement of hundreds of trillions of dollars of swap positions by FCMs onto DCOs necessarily requires DCOs and FCMs to make significant operational expenditures and enhancements to their existing operations. However, these costs are far outweighed by the very significant economic benefit provided by Congress to DCOs and FCMs under the Dodd-Frank Act. The mandatory clearing requirement for standardized swaps under the Dodd-Frank Act will result in a dramatic increase in the volume of business for DCOs and their clearing members. Assuming that 85% of the over \$600 trillion swaps market is currently traded over-the-counter, and subsequently 50% of the swaps market migrates to clearing, DCOs and their clearing members stand to triple their business volume. With such a windfall in volume and corresponding increased revenues, DCOs and their clearing members should be called on to pay for some of the increased costs of implementing the LSOC model and the option for physical segregation.

\* \* \*

We thank the Commission for the opportunity to comment on its NPR on customer margin for cleared swaps.

**THE COMMITTEE ON INVESTMENT OF EMPLOYEE BENEFIT ASSETS**



## EXHIBIT I

**C L I F F O R D**  
**C H A N C E**

CLIFFORD CHANCE US LLP

### Memorandum of Law

TO	The Committee on the Investment of Employee Benefit Assets	DATE	August 8, 2011
FROM	Clifford Chance	DIRECT DIAL	

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This memorandum of law (the "**Memorandum**") examines the treatment of a customer's cleared swap collateral and margin held in a physically segregated account upon the insolvency of the futures commission merchant carrying the account of the customer.

#### I. *Background*

The great majority of swap transactions in the United States have been conducted in the bilateral over-the-counter ("**OTC**") market. The Dodd-Frank Act<sup>1</sup> ("**Dodd Frank**") granted significant regulatory jurisdiction over swaps to the Commodity Exchange Act, as amended (the "**CEA**"), as administered by the Commodity Futures Trade Commission (the "**CFTC**") and required certain swaps to be cleared through a CEA registered multilateral derivatives clearing organization (each a "**DCO**"),<sup>2</sup> and for any persons accepting funds or property to secure any cleared swap to be registered as a futures commission merchant ("**FCM**") under the CEA.<sup>3</sup> In the OTC market, assets used to secure obligations under swaps are held on behalf of customers in various ways, including in physically segregated accounts held with third party custodians. Certain commenters<sup>4</sup> urged the CFTC to allow customers the option to retain physically segregated accounts at FCMs for swaps that are required to be cleared under Dodd Frank. On June 9, 2011 the CFTC issued proposed rules regarding, among other things, the treatment of customer assets deposited with an FCM to secure cleared swaps (the "**Proposed Rules**").<sup>5</sup> In the Proposed Rules the CFTC stated that it had preliminarily declined to offer the option to physically segregate

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<sup>1</sup> The Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111-203, H.R. 4173).

<sup>2</sup> See Section 2(h) of the CEA.

<sup>3</sup> See Section 4(d) of the CEA.

<sup>4</sup> See BlackRock letter to CFTC dated January 18, 2011 and Fidelity letter to CFTC dated January 18, 2011.

<sup>5</sup> See 17 CFR Parts 22 and 190 RIN Number 3038-AC99. Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions.

those assets at the FCM "because it may not be compatible with the Bankruptcy Code and regulation part 190".<sup>6</sup> This Memorandum considers the compatibility of a proposed physically segregated account for cleared swaps with the US Bankruptcy Code (the "**Code**") and the rules promulgated under the CEA (the "**CFTC Rules**").

## *II. Conclusion*

Subject to the analysis below, our conclusion is that the physically segregated account structure presented in this memorandum would be recognized in the insolvency of an FCM and the assets held in such physically segregated account would not be part of the FCM's bankruptcy estate.

## *III. Proposed Structure*

The structure proposed for a physically segregated account holding assets used to secure obligations under swaps cleared on a DCO would be as follows.

A customer ("**Customer**") that maintains an account with an FCM through which swap contracts are carried and cleared (a "**Swap Account**") will be permitted to establish a physically segregated individual settlement account (an "**ISA**") pursuant to an agreement (a "**Quad-party Agreement**") among the DCO, the FCM, the Customer and a settlement bank of the DCO (the "**Settlement Bank**"). The ISA would be an account held in the name of the Customer (for the benefit of the DCO) at the Settlement Bank and the Quad-party Agreement would provide that the ISA and its proceeds are property of the Customer, and not of the FCM. Assets standing to the credit of the ISA will be used for the purpose of satisfying all of the Customer's Swap Account collateral and margin obligations to the DCO. Unlike the current clearing model for the CFTC regulated futures market<sup>7</sup>, the Customer using an ISA would not have its assets transferred through accounts of the FCM. Rather, the assets standing to the credit of the ISA will be used to fund payments in respect of the Customer's Swap Account and would go directly to the DCO. Any payments or returns of collateral or variation margin from the DCO to the Customer will also be deposited directly into the ISA.

Variation margin may be funded by the Customers or pre-funded (in cash form only) by a loan from the FCM for the benefit of the Customer deposited into the ISA. If an FCM pre-funds any variation margin call, it would do so by way of a deposit into the ISA and the Customer would repay such advance through a funds transfer into the ISA. The FCM will have a secondary lien

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<sup>6</sup> See footnote 5, id.

<sup>7</sup> This model is referred to in the Proposed Rules as the "Futures Model".

on the ISA for the sole purpose of securing repayment of any outstanding FCM loan to the ISA, subordinate to the first priority lien of the DCO.<sup>8</sup> The Quad-party Agreement will provide that in the event of any claim by the FCM against the ISA or any asset of the ISA, the records of the custodian will be conclusive.

The DCO will have an unrestricted right to use the collateral and variation margin deposited in the Customer's ISA to cover that Customer's Swap Account obligations to the DCO. The DCO will directly instruct the Settlement Bank with respect to ISA collateral and margin payments and the FCM will have no rights to the assets in the Customer's ISA, except in respect of the secondary lien. The FCM will remain responsible for the performance of the Customer's Swap Account with the FCM cleared transactions obligations to the DCO.

Each ISA established with a DCO will be subject to any additional rules the DCO may establish from time to time.

#### ***IV. Assumptions***

For the purposes of this Memorandum we have made the following assumptions:

- a) The ISA will be structured per the terms set forth in "Proposed Structure" above.
- b) The ISA will be documented and operated in conformance with CFTC rules and any relevant rules established by the DCO.
- c) The FCM holding the Customer's Swap Account will comply with all DCO requirements and CFTC Rules.
- d) The DCO will set minimum swap collateral requirements which may be increased by the FCM.
- e) The CFTC will promulgate rules that confirm DCOs may accept collateral and variation margin by means of an ISA and to assure that assets in the ISA are properly taken into account in any calculation of the FCMs compliance with requirements to segregate assets securing customer swaps.

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<sup>8</sup> Under an alternative ISA structure, the FCM would pre-fund variation margin directly to the DCO and would be repaid by a direct payment from the Customer. Under this alternative structure the FCM would not have a secondary lien on the ISA.

- f) Any transfers of assets contemplated or discussed in this Memorandum are entered into prior to the formal commencement of insolvency proceedings against any party to the Quad-party Agreement.

## ***V. Questions Presented***

This Memorandum addresses the following questions:

- a) How would the assets standing to the credit of the ISA be treated in the insolvency of an FCM?
- b) Would the proposed physically segregated ISA violate the provisions of the CEA?
- c) Is any public policy purpose expressed in the Code or the CEA furthered by physical segregation?

## ***VI. How would the assets standing to the credit of the ISA be treated in the insolvency of an FCM?***

FCM liquidation, including the distribution of Customer property held by an FCM, is governed by Subchapter IV of Title 11 of the Code, which also provides that certain terms included therein are defined in the CEA. Section 766(h) of the Code requires a bankruptcy trustee to "distribute customer property ratably to customers [of an FCM] on the basis and to the extent of such customers allowed net equity claims". The CFTC suggested in the Proposed Rules that this *pro rata* distribution requirement would render optional physical segregation ineffective under the Code because in an insolvency of the FCM of physically segregated Customer property would be distributed ratably with the property of Customers that did not choose physical segregation.

However, the ratable distribution requirement of Section 766(h) only applies to "customer property", which is defined in the Code<sup>9</sup> as:

cash, a security, or other property, or proceeds of such cash, security, or property, received, acquired or held by or for the account of the debtor, from or for the account of a customer....but (B) not including property to the extent that a customer does not have a claim against the debtor based on such property.

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<sup>9</sup> Section 761(1) of the Code.

Assets held in an ISA will be in a physically segregated account with a third party custodian, so would not be considered "held by or for the account of" the FCM. In addition, because the assets held in the ISA will be in the name of the Customer and will be held with a third party custodian, the Customer would not have a claim on the FCM based on such assets in an FCM's insolvency because they would not be part of the FCM's bankruptcy estate.<sup>10</sup>

Therefore assets standing to the credit of an ISA would not meet the Section 766(h) definition of "customer property", as they are not acquired or held by or for the account of the FCM, and the customer would not have a claim against the FCM in respect of such property. As the ratable distribution requirement of Section 766(h) only applies to "customer property", it would not apply to any property standing to the credit of the ISA. Thus the physical segregation of a customer's assets standing to the credit of the ISA should be recognized in the event of an FCM insolvency.

This conclusion is not altered in the event that the FCM makes a loan to the Customer to pre-fund variation margin and becomes insolvent prior to the full repayment of such loan by the Customer. While there remains a possibility that the release of any ISA assets will be delayed due to a bankruptcy stay, there is reason to believe that the FCM's trustee will be authorized to promptly release those assets or that any delay will be minimal due to the conclusive nature of the records of the Settlement Bank.<sup>11</sup> However, even if a stay is applied, the FCM's interest in

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<sup>10</sup> Due to its second lien over the account, upon its insolvency the FCM may have a lien against the assets in the ISA with respect to any loans made by the FCM to pre-fund variation margin that have not been repaid by the Customer. However, the FCM's bankruptcy estate would only have a secured interest in the ISA assets, which would still remain outside of the bankruptcy estate.

<sup>11</sup> In the event an FCM files for bankruptcy, an automatic bankruptcy stay will normally apply with respect to any property interest of the FCM. Since the FCM has a secondary lien on the ISA it is possible that the stay would prohibit transfers from the ISA to a solvent FCM. Section 766(c) of the Code, however, provides limited exemption from the stay: it states that "the trustee shall...transfer on such customer's behalf, such security, property or commodity contract to a commodity broker that is not a debtor under this title". While this exemption is not on its face limited to transfers of "customer property" as defined by Section 766(h), which does not include the ISA, it is a subsection entitled "treatment of customer property" and there is a risk that it will be read by a court to relate solely to "customer property". Thus, this express right's application to an ISA may be challenged. We note that Section 766(c) does not refer to "customer property", but rather to property, so the CFTC may already have the ability make such transfers.

In any event, this "stay risk" would be limited and minimized in connection with an ISA. The CFTC is only permitted to transfer "customer property" under Section 766(c) after it has determined how much property the customer is entitled to under Section 766(h). A bankruptcy trustee would do the same calculation with respect to the ISA to determine the amounts owed to the FCM. However, in the case of an ISA, this determination would be significantly simpler as the ISA property would not be commingled and the bankruptcy trustee would be able

the ISA would only be that of a secured creditor, so the ISA assets would not be "customer property" and thus not part of the bankruptcy estate.

***VII. Would the proposed physically segregated ISA violate the provisions of the CEA?***

Section 20 of the CEA allows the CFTC, notwithstanding the provisions of the Code, to promulgate certain rules with respect to an FCM that is a debtor under Chapter 11 of the Code. In particular, Section 20 of the CEA provides the CFTC with the ability to make clear that "certain cash, securities, other property, or commodity contracts are to be included in or excluded from customer property or member property". The CFTC has not promulgated any rules with respect to collateral held by a Settlement Bank in an individual customer segregated account (such as an ISA), so there is no CFTC rule that would treat collateral in an ISA as FCM "customer property" and require it to be subject to Section 766(h) of the Code.

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to rely on the records of an independent third party custodian rather than the records of an insolvent FCM. In addition, variation margin would only be pre-funded in cash, so there would be no valuation disputes regarding amounts owed by the Customer which would permit a rapid determination by the bankruptcy trustee.

(We note that under the alternative ISA structure described in footnote 8 there would be no "stay risk" because the FCM would not have a lien over the ISA and would therefore be an unsecured creditor.)

In addition, Section 766(c) provides that the bankruptcy trustee's ability to transfer customer property is "subject to such rules or regulation as the [CFTC] may prescribe..." The CFTC therefore has the authority to create rules that permit a trustee to transfer property standing to the account of the ISA as well. Thus, the CFTC can enhance certainty to the issue by promulgating a rule linking the bankruptcy trustee's transfer of ISA property to its ability to transfer the swap contracts under Section 766(c) (subject to retaining in the ISA any amounts owed by the customer to the FCM with respect to the pre-funding of variation margin).

The CFTC's authority in this respect should be respected by the courts. In *In re Griffin Trading Company* (245 B.R. 291) a Bankruptcy Court in the Northern District of Illinois ruled that the CFTC's ability to create rules regarding property that was not "customer property" was limited. However, *Griffin* is distinguishable from present circumstances. In *Griffin*, the court invalidated a CFTC rule that allocated assets unrelated to securing performance on DCO obligations to "customer property" which, in effect, placed the debtor's commodity customers ahead of its general unsecured creditors assets.

These facts clearly distinguish *Griffin* from the present circumstance. Allowing the bankruptcy trustee to transfer ISA property to a solvent FCM would be consistent with the protection of property securing performance to the DCO and would enhance the operational stability of the swap market which furthers the statutory intent of Dodd Frank. In addition, like a transfer of "customer property" under 766(c), the trustee would only be able to transfer property standing to the credit of the ISA so long as it did not result in the customer receiving more than it is entitled to. Moreover, unlike in *Griffin*, the swap customers would not be gaining any undue priority over an FCM's other creditors, as the assets standing to the credit of the ISA are clearly the assets of the Customer.

Section 4d(a) of the CEA requires FCMs to segregate any property held to secure the swap obligations of a customer. However, the CEA does not require that property securing a customer's swap obligations be held with the FCM. In addition, neither the CEA nor the CFTC Rules (a) require that obligations of an FCM to a DCO with respect to customer obligations under swaps must be satisfied from customer assets held with the FCM,<sup>12</sup> nor (b) restrict the ability of an FCM to fulfill its obligations to a DCO with respect to customer obligations under swaps by means of a direct customer-to-DCO transfer.<sup>13</sup> The FCM is therefore not prohibited from standing behind the customer's obligations with respect to a Swap Account despite not holding the assets used to secure such customer's obligations. Without any requirement to hold the assets otherwise standing to the credit of the ISA or a prohibition on the ability of customers to transfer assets to the DCO directly, there is no CEA impediment to the establishment by a customer of a physically segregated account such as the ISA.

Section 5(b)(c)(2) of the CEA requires each DCO to comply with certain core principles, including maintaining adequate risk management (including measurement of credit exposure and margin requirements) and maintaining sufficient settlement procedures. These core principles do not require a DCO to deal with customers only if their property is held by an FCM and do not prohibit direct transfers of variation margin or collateral between a DCO and a customer. In fact, holding assets securing customer swaps in an ISA would likely further the core principles, as they would allow for a more direct settlement process and would improve a DCO's risk management by providing more clarity regarding the swap positions of customers.

### ***VIII. Is any public policy purpose expressed in the Code or the CEA furthered by physical segregation?***

The CFTC initial proposed rules to implement Subchapter IV of Title 11 of the Code stated that "the twin objectives of this legislation are greater protection of commodity customer property than existed under prior law and protection for the first time of the markets from the reversal of

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<sup>12</sup> In fact, the definition of "customer funds" under the CFTC Rules contemplates that the customer's assets may be received either by an FCM or a DCO. *See* CFTC Rule 1.3(gg). In addition, an FCM is expressly permitted to extend its own funds to customers for the purpose of margining or securing the customer's positions which indicates that the FCM's obligations in connection with a customer's positions may be satisfied with assets other than those transferred by a customer to the FCM. *See* CFTC Rule 1.30.

<sup>13</sup> We note that although the collateral segregation requirements in CFTC Rule 1.20 contemplates a structure in which the FCM deposits customer funds with the DCO, the purpose of Rule 1.20 is to protect customer funds deposited with the DCO. However, the customer's ability to hold property securing its obligations under swaps in an ISA would not impact the obligation of the DCO under Rule 1.20 to segregate property and Rule 1.20 certainly does not require any property to be deposited directly with the FCM.

certain transfers of money or other property."<sup>14</sup> The ISA would further the two policy goals stated above as it would provide greater protection to customers that elect ISAs and would remove collateral held in such accounts from a potentially lengthy and cumbersome liquidation process, thus allowing for a rapid transfer of positions from an insolvent FCM to another FCM.

The Proposed Rules state that Dodd-Frank "was enacted to reduce risk, increase transparency and promote market integrity within the financial system."<sup>15</sup> Currently in the OTC market swaps customers that wish to have their properly physically segregated with an independent custodian have the option to do so. Nothing in Dodd-Frank suggests that Congress intended that swaps customers should be deprived of the high level of collateral protection they currently enjoy. In fact, this would be contrary to Dodd-Frank's goals of reducing of risk and promoting market integrity.

Providing swap customers greater protection by allowing the optionality of full physical segregation in the form of an ISA would further the policy objectives of Dodd-Frank.

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This memorandum of law is rendered solely to The Committee on the Investment of Employee Benefit Assets and not to its individual members and may not be relied upon by any other person without our prior written consent.

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<sup>14</sup> See Proposed Rules Implementing the Bankruptcy Reform Act of 1978. 46 F.R. 57535

<sup>15</sup> See footnote 5, id.