



STATE STREET.

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Via: <http://comments.cftc.gov>

The Honorable Gary Gensler
Chairman
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Protection of Cleared Swap Customer Collateral (RIN 3038-AC99)

Dear Chairman Gensler:

In the wake of the serious issues raised by the bankruptcy of MF Global Holdings Ltd. (“MF Global”) for the protection of customer funds,¹ State Street Corporation (“State Street”)² wishes to reiterate the importance of allowing buy-side market participants to use tri-party custody arrangements to better protect their initial margin requirements with futures commission merchants. It is critical that the Commodity Futures Trading Commission (“Commission”) amend the Commodity Exchange Act rules to address this financial risk to buy side swaps participants in light of the migration of the \$300 trillion swap market to a cleared environment, but it is equally appropriate that the Commission permit the use of such tri-party custody arrangements in relation to futures.

State Street provides services, including clearing for futures and swaps, to a broad range of institutional buy-side market participants. State Street provided comments to the Commission on January 18, 2011³

¹ See Aaron Lucchetti and Dan Strumpf, Missing MF Global Funds Could Top \$1.2 Billion, *Wall Street Journal*, November 22, 2011, available at <http://online.wsj.com/article/SB10001424052970204443404577052143849159420.html> (describing MF Global’s bankruptcy and noting that losses from customer accounts “could total over \$1.2 billion”).

² With over \$21.5 trillion of assets under custody and administration and \$1.9 trillion of assets under management at September 30, 2011, State Street is a leading specialist in meeting the needs of institutional investors worldwide. Our customers include mutual funds, collective investment funds and other investment pools, corporate and public retirement plans, insurance companies, foundations, endowments and investment managers. Including the United States, we operate in 26 countries and more than 100 geographic markets worldwide.

³ Letter from Stefan M. Gavell, Executive Vice President, State Street, to David Stawick, Secretary, Commodity Futures Trading Commission, re: Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies (January 18, 2011). The comments were provided in response to the Commission’s Advance Notice of Proposed Rulemaking regarding the protection of margin collateral posted by customers with respect to cleared swap transactions. See Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies, 75 FR 75162 (December 2, 2010).

regarding the significant concerns raised by buy-side participants that cleared swaps margin held in an omnibus client account would be exposed to the risk (“fellow-customer risk”) of a default of another customer of their futures commission merchant (“FCM”). The recent challenges in recovering funds from customer accounts following the bankruptcy of MF Global, and apparent deficiencies in recordkeeping, have added to buy-side participant concerns, and highlighted the potential loss of funds that clearly were required to be segregated under the rules of the Commodity Exchange Act and the various exchanges.⁴ To address these important concerns, State Street believes that the Commission should adopt rules that provide buy-side participants clearing through FCMs with the option of using a tri-party custody arrangement for holding initial margin required to be delivered on those transactions.

Under an optional tri-party custody regime, a customer would post margin to a custodian in an amount at least equal to the margin required to be posted by the FCM to the clearinghouse. While we recognize that there are issues raised by customer optionality under existing bankruptcy laws, as discussed in the Commission’s June Notice of Proposed Rulemaking⁵ (the “NPR”), the NPR also notes that the Commission is considering various options to resolve these issues, and thus we believe the potential incompatibility between the Bankruptcy Code and optional tri-party custody model can ultimately be addressed. Under appropriately structured third-party custody arrangements, customers would be protected from both defaults of other FCM customers (“fellow customer risk”) and default of the FCM. Under such an approach, customers would be able to avoid commingling funds with either “fellow customers” or the FCM, and unlike any of the other options considered by the Commission --- Physical Segregation, Complete Legal Segregation, Legal Segregation with Recourse, or the Futures Model --- third party custody does not rely on the FCM or clearinghouse’s recordkeeping to monitor the location of customer funds, which the experience of MF Global has proven may not be adequate in times of financial distress.

Clearinghouses would remain fully funded, as FCMs would provide their own funds as customer initial margin to the clearinghouse. These funds would be required to be invested consistent with the standards for investments of customer funds that the Commission applies to exchange-traded futures.⁶ The result would be increased customer protection through fully segregated collateral accounts for individual customers, potentially augmented by increased capital requirements on FCMs.⁷ FCMs could charge a financing fee to any customer that elects to use tri-party segregation, thus focusing the cost on those customers who wish to use the service. The widespread use of tri-party custody arrangements for initial margin globally today demonstrates that market participants are willing to bear this additional cost to benefit from the additional protections of legal and physical segregation.

State Street recognizes the Commission’s previously articulated concerns regarding the role of custodial accounts in the futures market⁸ but believes that rules could be designed to help ensure that tri-party custody arrangements do not, as the Commission has feared in the past, inhibit movement of customer

⁴ See, for example, December 2, 2011 Managed Funds Association letter at <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=50006&SearchText=> and December 8, 2011 Fidelity Investments letter found at:

<http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=50012&SearchText=>

⁵ See Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 76 Fed. Reg. 33,818 (proposed June 9, 2011).

⁶ See 17 C.F.R. 1.25.

⁷ See Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 76 Fed. Reg. 33,818 (proposed June 9, 2011).

⁸ See Commodity Futures Trading Commission, Amendment of Financial and Segregation Interpretation No. 10, 70 FR 24768 (May 22, 2005) (withdrawing an interpretation that permitted the conditional use of custodial accounts for futures).

collateral or pose risks to FCMs or clearinghouses. The Commission could adopt an approach for optional tri-party customer arrangements for cleared swaps and require, for example, that:⁹

- the FCM be permitted to access margin only under pre-agreed circumstances, such as the default of the customer and upon submitting a written statement under the penalty of perjury that the FCM is entitled to the margin;¹⁰
- custodian banks immediately comply with properly verified FCM margin requests;
- neither the custodian nor the customers would be permitted to withdraw or access margin without the prior consent of the FCM;
- the custody account be in the name of the FCM for the benefit of the customer;
- the custodian be financially liable to the FCM for breaches of the tri-party custody agreement; and
- the custodian provide a daily report to the FCM of all assets held in the account.

These protections would help ensure that, when necessary, customer margin would be available and the FCM could access it without delay.

Allowing optional third-party custody of cleared swaps margin would promote consistency across U.S. and global markets for swaps—both cleared and uncleared. Custodial arrangements to protect customer initial margin exist in the U.S. swaps market today and have become increasingly common since the financial crisis. In Europe, tri-party custody is used in a variety of contexts. For example, tri-party custody is used in the European futures market, and U.K. Financial Services Authority rules allow funds held with a custodian to enjoy the benefits of customer asset protections.¹¹ Moreover, Section 724(c) of Dodd-Frank mandates that swap dealers and major swap participants provide customers the option to have initial margin for uncleared swaps segregated with an independent third-party custodian, evidencing Congress’ understanding of the importance of such arrangements.

In short, the Commission should allow buy-side participants the option to have cleared swaps margin held by an independent, third-party custodian to shield buy-side participants from commingling of posted margin with either “fellow customers” or FCM funds. This approach would preserve the financial stability of FCMs or clearinghouses and promote consistency across instruments and across U.S. and foreign markets. If the Commission’s rules do not address the concerns of buy-side participants, there is a substantial risk that the buy-side will be reluctant to participate, or may minimize its participation, in the cleared swaps market, which would adversely impact the development of these markets and provide reduced investment and risk management options to these investors, including U.S. pension plans and mutual funds.

Finally, while State Street acknowledges differences exist between the Dodd-Frank Act statutory framework for swaps and the existing statutory framework for futures, we believe the benefits of tri-party custody apply equally to margin posted with FCMs in connection with futures transactions. In light of the MF Global experience, the Commission should allow futures customers to use tri-party custody of customer margin for futures as protection against the inappropriate use of customer funds by FCMs. We

⁹ The Commission addressed its prior concerns regarding the risks to FCMs and clearinghouses in its proposal for segregation of margin for uncleared swaps. *See* Proposed Rule, Protection of Collateral of Counterparties to Uncleared Swaps, 75 FR 75432 (Dec. 3, 2010).

¹⁰ *See, e.g., id.*, at 75434 (proposing that custody accounts for uncleared swaps margin require a written statement signed under the penalty of perjury to release funds to a party to the tri-party arrangement).

¹¹ ISDA, Managed Funds Association, and SIFMA, Independent Amounts White Paper 9 (October 2009) (citing relevant Financial Services Authority rules), available at: http://www.isda.org/c_and_a/pdf/Independent-Amount-WhitePaper-Final.pdf.

also urge the Commission to consider other means of enhancing the safeguards available to futures customers in order to achieve the level of protection contemplated by the Commission's proposed legal segregation approach for cleared swaps or under our recommended approach.

* * *

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

Sincerely,

A handwritten signature in black ink, appearing to read "Stefan M. Gavell". The signature is fluid and cursive, with the first name being the most prominent.

Stefan M. Gavell

cc: The Honorable Jill E. Sommers, Commissioner, Commodity Futures Trading Commission
The Honorable Bart Chilton, Commissioner, Commodity Futures Trading Commission
The Honorable Scott D. O'Malia, Commissioner, Commodity Futures Trading Commission
The Honorable Mark Wetjen, Commissioner, Commodity Futures Trading Commission
David Stawick, Secretary, Commodity Futures Trading Commission
Jeffrey N. Carp, State Street Corporation, EVP and Chief Legal Officer
David C. Phelan, State Street Corporation, EVP and General Counsel