Scott C. Goebel
Senior Vice President
General Counsel
FMR Co.
245 Summer Street V10E, Boston, MA 02210
617.563.0371 FAX 617.385.1331

May 27, 2014

Mr. Kevin M. O'Neill
Deputy Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Submitted electronically through http://www.sec.gov

Re: Comments on Standards for Covered Clearing Agencies (Release No. 34-71699; File No. S7-03-14)

Fidelity Investments ("Fidelity")[1] appreciates the opportunity to provide comments to the Securities and Exchange Commission ("SEC" or "Commission") on its proposed rule on "Standards for Covered Clearing Agencies" (the "Proposed Rule Release").[2] Specifically, we offer our comments to the SEC's proposed amendments to Rule 17Ad-22(e)(14), which establish standards for segregation and portability of customer collateral for security-based swap clearing agencies and complex risk profile clearing agencies (collectively, "SB swap clearing agencies").

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") requires the SEC to adopt rules related to SB swap clearing agencies and Title VIII authorizes the SEC to prescribe new management standards for such clearing agencies. Fidelity supports the Commission's objective of protecting customer collateral posted in connection with cleared security-based swaps ("SB swaps"). We believe that by implementing a regulatory structure that provides appropriate protection for this collateral, the SEC will reduce systemic risk by bolstering SB swaps market participants' confidence that losses related to counterparty risk will be manageable.

We appreciate the SEC's efforts to consider comparable regulations that other U.S. and international regulators have adopted or proposed. It is critical that regulators coordinate in implementing final derivatives reform in order to avoid duplicative and conflicting regulations. Fidelity has been active in meetings with regulators and in various public forums on the topic of protecting posted collateral. We have submitted comment letters to the Commodity Futures

---

[1] Fidelity is one of the world's largest providers of financial services. The firm is a leading provider of investment management, retirement planning, portfolio guidance, brokerage, benefits outsourcing and many other financial products and services to more than 20 million individuals and institutions, as well as through 5,000 financial intermediary firms.

[2] Standards for Covered Clearing Agencies, 79 Fed. Reg. 16866 (March 26, 2014), *available at* http://www.gpo.gov/fdsys/pkg/FR-2014-03-26/pdf/2014-05806.pdf.

Trading Commission ("CFTC") on rule proposals relating to the protection of collateral with respect to swaps under the CFTC's jurisdiction, (together, "Prior Fidelity Letters").[3]

The proposed amendments would require covered clearing agencies "to establish, implement, maintain and enforce written policies and procedures reasonably designed to enable the segregation and portability of positions of a member's customers and the collateral provided to the covered clearing agency with respect to those positions, and effectively protect such positions and related collateral from the default or insolvency of that member."[4] In the Proposed Rule Release, the SEC describes two collateral segregation models that SB swap clearing agencies could implement (an omnibus account structure and an individual account structure), without expressly mandating the implementation of either model.[5] We disagree with the SEC's proposed approach because it is insufficient to ensure the appropriate level of protection for customers, including Fidelity funds and accounts, and may result in adoption of differing models across the industry. Accordingly, we urge the SEC to impose specific structural requirements on segregation of customer collateral for SB swap clearing agencies.

Achieving the highest feasible level of protection for collateral is important to the funds and accounts that Fidelity manages. In our Prior Fidelity Letters, we advocated for an individual account structure that would provide full physical segregation because it provides the highest level of protection for customer assets posted as collateral for cleared swaps.[6] When the CFTC eliminated this model from the options under consideration, we supported adoption for the legal segregation with operational commingling ("LSOC") model, which the CFTC ultimately

---

[3] Letter from Scott C. Goebel, Senior Vice President and General Counsel, on behalf of Fidelity Investments, to David A. Stawick, Secretary, Commodity Futures Trading Commission, (Jan. 18, 2011), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27188&SearchText, responding to CFTC's Advanced Notice of Public Rulemaking for Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies, 75 Fed. Reg. 75162 (Dec. 2, 2010); Letter from Scott C. Goebel, Senior Vice President and General Counsel, on behalf of Fidelity Investments, to David A. Stawick, Secretary, Commodity Futures Trading Commission, (Aug. 8, 2011), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=48014&SearchText, responding to CFTC's Proposed Rules for Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 76 Fed. Reg. 33818 (June 9, 2011); and Letter from Scott C. Goebel, Senior Vice President and General Counsel, on behalf of Fidelity Investments, to David A. Stawick, Secretary, Commodity Futures Trading Commission, (Dec. 8, 2011), *available at* http://www.sec.gov/comments/s7-22-11/s72211-7.pdf, further comments responding to CFTC's Proposed Rules.

[4] Proposed Rule Release at 16904.

[5] *Id.* at 16905.

[6] Based on our years of entering into swaps transactions for the funds and accounts that we manage, Fidelity continues to believe that full physical segregation is the structure that would provide the most protection to customers. However, because consistency across the market is critical, we recommend that the SEC harmonize its segregation and portability rules with the CFTC's rules.

adopted.[7] We recommend that the SEC repropose a rule to adopt the LSOC model as the default customer collateral segregation structure that covered clearing agencies must provide.

In describing the omnibus account structure, the SEC suggests that these structures "be designed in a manner that operationally commingles collateral related to customer positions while protecting customers legally on an individual basis."[8] However, the SEC does not make this legal segregation a requirement. We believe that the legal segregation under the LSOC model provides the minimum level of protection that should be afforded to holding and segregation of customer collateral posted in connection with cleared SB swaps. Second only to full physical segregation, we also believe LSOC is the best choice for the market generally. We request that the SEC take into account the following considerations:

- The SEC should not allow SB swap clearing agencies to provide less protection for customer collateral for SB swaps than is currently provided in the over-the-counter market, or that is provided for cleared non-SB swaps. Accordingly, any final rule should adopt the LSOC structure as a default standard for protection of customer collateral.
- The final rule should ensure a customer's ability to transfer collateral together with cleared SB swap transactions to a new futures commission merchant ("FCM") immediately, particularly following an event of default by the customer's current FCM.
- The SEC should coordinate with other U.S. and foreign regulators to harmonize any final rules in order to develop a uniform framework for collateral segregation and to prevent the burdensome costs and complexities that would result from multiple regulatory regimes.

Fidelity also cites with favor certain comments in the letter that the Investment Company Institute ("ICI") filed with the SEC, which details further the industry's concerns with the SEC's proposed account structure for segregation and portability of customer collateral.[9] We agree with the ICI's recommendation that the SEC adopt the LSOC model as the default standard for protection of customer collateral. In addition, we support the ICI's comments on the Proposed

---

[7] CFTC final rule: Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 77 Fed. Reg. 6336 (Feb. 7, 2012), *available at* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-1033a.pdf ("CFTC Cleared Swap Segregation Rule"). The LSOC model offers the operational and cost efficiencies of omnibus segregation with some of the legal protections of individual segregation.

[8] Proposed Rule Release at 16905.

[9] Letter from Dorothy M. Donohue, Acting General Counsel, Investment Company Institute, to Kevin M. O'Neill, Deputy Secretary, Securities and Exchange Commission, (May 21, 2014), *available at* http://www.sec.gov/comments/s7-03-14/s70314-9.pdf.

Rule Release with respect to its recommendations for a uniform margining regime, a prohibition on covered clearing agencies from using haircutting of customer variation and initial margin as recovery tools, and a requirement for covered clearing agencies to have public representation on their boards.

The SEC's Final Rule Should Adopt the LSOC Structure as a Default Standard to Prevent Degrading Existing Collateral Protections

Section 805(b) of the Dodd-Frank Act requires that the SEC, in prescribing regulations for covered clearing agencies, "(1) promote robust risk management; (2) promote safety and soundness; (3) reduce systemic risks; and (4) support the stability of the broader financial system."[10] In furtherance of these objectives, we believe that the collateral protection model for cleared SB swaps should not afford less protection to market participants than either the protections they currently enjoy in the over-the-counter SB swaps market or the protections the CFTC has adopted for cleared and uncleared swaps.

The over-the-counter market for uncleared SB swaps has established practices that effectively mitigate the most significant risks of SB swap transactions. In the current market, an SB swap counterparty can negotiate the extent to which it is willing to assume risks, including counterparty credit risk. Funds and accounts that Fidelity manages, like many buy-side participants (and all investment company participants), currently have tri-party custodial arrangements in place with dealer counterparties that require segregation of collateral posted to such dealers in connection with SB swaps transactions. Market participants, many of which assess the risk of entering into SB swaps based, in part, upon the practice of using tri-party custodial arrangements for protection of their collateral, should not be required to take on additional risks in their use of swaps as a result of central clearing. We also believe that collateral posted to an FCM to secure cleared SB swaps should have similar protections to uncleared SB swaps collateral; anything less than an LSOC model would provide less protection for cleared SB swaps than what has been proposed for uncleared SB swaps.[11]

As the SEC is aware, the CFTC considered multiple segregation options, including the omnibus account structure and LSOC, before ultimately adopting the LSOC model for cleared swaps collateral. In the adopting release to the final rules, the CFTC described the comments received in response to its proposed rules. The CFTC noted that "commenters generally viewed the [LSOC] Model as the minimum level of protection necessary for Cleared Swaps Customer

---

[10] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), §803(b).

[11] Section 763(d) of the Dodd-Frank Act added Section 3E to the Exchange Act. Coupled with Section 3E(f), the related SEC proposed rules would require a dealer to segregate customer collateral posted to secure obligations for such uncleared SB swaps, at the customer's election. *See* Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 Fed. Reg. 70214 (Nov. 23, 2012), *available at* http://www.gpo.gov/fdsys/pkg/FR-2012-11-23/pdf/2012-26164.pdf.

Collateral."[12] Moreover, the CFTC stated that of the 25 comment letters it received addressing the issue of which segregation model to adopt, 20 letters supported LSOC, full physical segregation, or some combination thereof.[13] Accordingly, the CFTC selected the LSOC model because it "provides the best balance between benefits and costs in order to protect market participants and the public."[14]

Fidelity does not believe that the statutory language or intent of the Dodd-Frank Act support the adoption of an omnibus account structure without LSOC. Section 3E(b)(2) of the Securities Exchange Act of 1934 ("Exchange Act"), as amended by the Dodd-Frank Act, prohibits a clearing agency from commingling customer collateral with funds of the dealer or from using one SB swap customer's funds to "margin, secure, or guarantee any trades or contracts" of another SB swap customer.[15] In addition, the prohibition under Section 3E(e) prevents a clearing agency from using the collateral of one customer to cover the losses of another customer or of the FCM or clearing agency.[16] Implementing an omnibus account structure without LSOC would not ensure compliance with these statutory provisions.

As the SEC noted in the Proposed Rule Release, the omnibus account structure exposes customers to "'fellow-customer risk' (*i.e.* the risk that another customer of the same member will default)," which "is of particular concern because customers may have limited ability to monitor or manage the risk of their fellow customers."[17] Because the omnibus account structure does not allow for the SB swap clearing agency to identify an individual customer's assets, there is potential risk that the clearing agency would have recourse to a non-defaulting customer's assets

---

[12] CFTC Cleared Swap Segregation Rule at 6342.

[13] *Id.* at 6344.

[14] *Id.* at 6349. We continue to believe that full physical segregation would provide the most protection for customer assets posted as collateral for cleared SB and non-SB swaps. We note that in its final release adopting the LSOC model for cleared swaps, the CFTC stated that it was "actively considering seeking notice and comment on a proposal to allow individual protection of client assets." *Id.* In addition, European regulators issued final regulations pursuant to EMIR mandating that central counterparties must allow customers to choose between omnibus segregation and individual segregation for their cleared derivatives assets and positions. *See* Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, at 201/36, Article 39(2) and (3), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF.

[15] Exchange Act, Section 3E(b)(2). 15 U.S.C. § 78c-5(b)(2).

[16] Section 3E(e) of the Exchange Act prohibits any clearing agency "that has received money, securities, or property for deposit in a separate account or accounts . . . to hold, dispose of, or use any such money, securities, or property as belonging to … any person other than the swaps customer of the broker, dealer, or security-based swap dealer." 15 U.S.C. § 78c-5(e).

[17] Proposed Rule Release at 16905.

upon a fellow customer's default. Fidelity believes that such an outcome is contrary to the Dodd-Frank Act's goal of enhancing customer protections in the derivatives markets and exposes market participants to risks that they do not face today in the over-the-counter SB swaps market or the cleared and uncleared non-SB swaps markets.

Fellow-customer risk is particularly problematic because it requires a market participant to evaluate not only the creditworthiness of its FCM, but also the creditworthiness of each FCM customer in order to assess its true counterparty risk. Market participants do not have access to their FCM's customer list. Even if customers were granted access to their FCM's customer list, regular monitoring and evaluation of other customers of an FCM would be burdensome, if not outright impossible, and an inappropriate allocation of risks. We expect that the risk of inaccuracies and lack of transparency would be heightened with any entity (whether FCM or customer) that is failing. We believe that these risks should be allocated to the party best able to evaluate them, and that each market participant should bear the burden and consequences of its own investment decisions.

The LSOC structure provides more robust protections than does a basic omnibus account. LSOC protects the collateral of cleared SB swap customers in the event another customer of an FCM defaults. LSOC would require a covered clearing agency to maintain books and records that identify each customer's collateral, but would allow the SB swap clearing agency operationally to hold that collateral in a commingled account separate from any assets of the FCM or clearing agency. Fidelity believes that the LSOC model provides the minimum acceptable level of customer protection and, therefore, we urge the SEC to require clearing agencies to adopt the LSOC structure as the default standard.

Apart from fellow-customer risk, there are other risks inherent in implementing a model that degrades the protections provided to collateral by current practices in the over-the-counter SB swaps market and cleared and uncleared non-SB swaps market. For example, in the relatively new market for cleared swaps and SB swaps develop, significant initial operational hurdles have arisen due to the need to implement new technology platforms, trading arrangements, and communication processes. These hurdles have in many cases resulted in disruptions in the trading and clearing process among FCMs, swap execution facilities, derivatives clearing organizations ("DCO") and the ultimate customers. Given the short time that the cleared swaps market has been operational, neither market participants nor the SEC have had an opportunity to analyze fully and prepare for the risks that might arise when an FCM's credit deteriorates. Market participants need time to develop and implement policies and documentation that provide for the assignment of SB swap positions and the movement of related collateral to more creditworthy FCMs when necessary or desirable. Accordingly, it is critical that the SEC mandate the LSOC model as the default standard for protection of cleared SB swaps collateral that SB swaps clearing agencies must provide to customers.

The SEC's Final Rule Should Ensure Portability

An omnibus model without legal segregation does not ensure portability and therefore could concentrate the risk and cost of an FCM default among fewer customers. As an FCM's credit deteriorates, customers inevitably will attempt to transfer their cleared SB swap positions and the associated collateral to a more creditworthy FCM. If DCOs are able to access collateral of non-defaulting customers to satisfy a defaulting customer's obligations, customers that have more assets and can post additional collateral to the FCM to whom they are porting their positions are more likely to be able to port their positions in a timely fashion. These more solvent customers would not be relying on the porting of their posted collateral together with their transactions. However, other customers may not have the resources to post the full amount of collateral necessary to port positions to a new FCM while they wait for their current FCM to return their collateral, or portion thereof. The ability of larger or more solvent customers to transfer first would mean a greater share of the cost of default would be borne by those customers who remain unable to transfer their cleared SB swap positions, effectively concentrating the cost of a default with those customers and leaving fewer assets for the DCO than anticipated by the market. With LSOC, however, because assets posted as customer collateral are attributable to specific clients, each client will be on equal footing with respect to porting of its collateral together with its transactions.

We believe that immediate portability is essential to protect non-defaulting customers and the financial system more generally, as well as to establish a consistent and open system for trading. International regulators have emphasized the importance of portability,[18] and we are hopeful that regulators in other jurisdictions eventually will adopt similar models to the LSOC model. The LSOC model is most likely to help ensure that SB swap transactions are readily transferable and to help facilitate the creation of a functioning cleared SB swaps market.

The SEC Should Seek to Harmonize its Final Rule with Comparable Global Regulations

Fidelity urges the SEC to consider the importance of harmonizing the segregation and portability standards for cleared SB swaps with those that other U.S. and international regulators implement. Consistent international regimes are critical to mitigating the risk of regulatory arbitrage. Should arbitrage opportunities arise due to different regulations in the international SB swaps market, smaller market participants, particularly participants who are not international SB swap dealers, will be disadvantaged in the market. Furthermore, there is nothing about the U.S. SB swaps market that merits different regulatory treatment from other swaps markets in the U.S. or abroad.

---

[18] *See* Principles for Financial Market Infrastructures, Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions (April 16, 2012), at 82, *available at* http://www.bis.org/publ/cpss101a.pdf (noting that a clearing counterparty "should structure its portability arrangements in a way that makes it highly likely that the positions and collateral of a defaulting participant's customers will be transferred to one or more other participants").

Title VII of the Dodd-Frank Act added new provisions to the Exchange Act, including Section 17A(i), which authorizes the SEC to promulgate rules that establish standards for SB swap clearing agencies.[19] The SEC acknowledged in the Proposed Rule Release that "Section 17A(i) also provides that the Commission, in establishing clearing agency standards and in its oversight of clearing agencies, may conform such standards and such oversight to reflect evolving international standards."[20] We emphasize the importance of consistent rules with respect to the protection of cleared collateral to ensure certainty and efficiency in trading swaps and SB swaps on the same desks. This is particularly true as between the SEC and CFTC's rules. Different regulatory requirements would impose significant additional compliance costs and operational complexity. Ultimately, fund shareholders would bear these additional costs.

* * * * *

We appreciate the opportunity to comment on the Proposed Rule Release. Fidelity would be pleased to provide any further information or respond to any questions that the SEC staff may have.

Sincerely,

cc: The Honorable Mary Jo White, Chair
The Honorable Luis A. Aguilar, Commissioner
The Honorable Daniel M. Gallagher, Commissioner
The Honorable Michael S. Piwowar, Commissioner
The Honorable Kara M. Stein, Commissioner

The Honorable Mark P. Wetjen, Acting Chairman, Commodity Futures Trading Commission
The Honorable Scott D. O'Malia, Commissioner, Commodity Futures Trading Commission

[19] Dodd-Frank Act Section 763(b). 15 U.S.C. 78-q-1(i).

[20] Proposed Rule Release at 16869.