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Via Electronic Submission: rule-comments@sec.gov

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers (S7-08-12) (the "Proposing Release")

Dear Ms. Murphy:

We appreciate this opportunity to comment on the rules proposed by the Securities and Exchange Commission (the "Commission") under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") relating to capital, margin, and segregation requirements for security-based swap dealers ("SBSDs") and major security-based swap participants ("MSBSPs") and capital requirements for broker-dealers (the "Proposed Rules").[1] We provide our comments from the perspective of large institutional investors and "financial entities" on the buy-side of the market. Along with both buy- and sell-side institutions, we support the Commission's efforts to reduce risk and promote stability in the U.S. financial system, while also maintaining a robust market for cleared and non-cleared swaps to suit the varying needs of a wide range of market participants.

Our comments primarily focus on the application of the Proposed Rules to security-based swaps between SBSDs and MSBSPs, on the one hand, and large institutional investors, on the other hand. As described in more detail below, we respectfully request that the Commission: (i) require bilateral (rather than unilateral) exchange of initial and variation margin; (ii) harmonize its rules with those of other regulators by applying the exception to mandatory posting of initial and variation margin to all non-financial entities, rather than only non-financial entities who are entering into transactions to hedge or mitigate risks relating to commercial activities; (iii) expressly permit netting of initial margin for non-cleared security-based swaps and netting of initial margin across cleared and non-

[1]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).

cleared security-based swaps; (iv) require that tri-party custodial accounts used to segregate margin be in the name of the counterparty for the benefit of the SBSD or MSBSP (rather than in the name of the SBSD or MSBSP) and be governed by a provision that allows a counterparty to a SBSD or MSBSP to take control of collateral in the tri-party account upon the SBSD's or MSBSP's bankruptcy or insolvency; and (v) reconsider the proposed requirement that entities that elect individual segregation enter into a subordination agreement with the SBSD counterparty.

As a general matter, we support the Commission's effort to balance the Act's goals of reducing risk by promoting central clearing (and, where clearing is not available, implementing measures to reduce risks associated with non-cleared security-based swaps) with the need to maintain active buy-side participation in our markets. However, we remain concerned that, from the perspective of those large, sophisticated buy-side participants that have implemented their own extensive risk management, some of the requirements suggested by the Commission will unduly increase both the cost and risk of transacting with SBSDs and MSBSPs. This may have significant adverse effects both on the investment activities of these buy-side investors, and on the stability and depth of the financial markets in general.

As our major institutional investors invest on an international scale, we urge the Commission to harmonize its regulations with those in other jurisdictions, most notably the policy recommendations set forth by the Basel Commission on Banking Supervision and the International Organization of Securities Commissions Working Group on Margin Requirements ("WGMR").[2]

I. Mandatory Bilateral Exchange of Initial and Variation Margin

In Proposed Rule 18a-3, the Commission addresses initial and variation margin for non-cleared security-based swaps between SBSDs and their counterparties. Proposed Rule 18a-3 would require SBSDs to collect margin from counterparties (with very limited exceptions, as discussed in more detail below), but not to pay initial or variation margin to such counterparties. Bilateral exchange of initial and variation margin is a key principle in the Basel Report, and bilateral exchange of variation margin is a nearly uniform market practice today.

We join the WGMR and other market participants in encouraging the Commission to require bilateral posting of initial and variation margin in security-based swaps between SBSDs and their non-SBSD financial entity counterparties. First, bilateral exchange of margin will have the effect of reducing systemic risk in the financial markets and limiting the amount of unsecured exposure between security-based swap counterparties. Bilateral exchange of variation margin addresses actual current mark-to-market exposures (*i.e.*, losses) between counterparties and its daily exchange helps to avoid accumulation of large, uncollateralized losses that a party may not be able to cover during a time of significant market stress. It is standard market practice for parties to swap

[2] Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, Consultative Document, Margin Requirements for Non-Centrally-Cleared Derivatives (July 2012) (the "Basel Report").

transactions to exchange bilateral variation margin. Requiring the bilateral exchange of variation margin would reinforce this sound market practice, causing little disruption to the market. In addition, because non-cleared security-based swaps in many cases will tend to be more customized and therefore less liquid than their cleared counterparts, failing to remove current exposures in connection with such swaps through bilateral exchange of margin could exacerbate losses in the event of a default by the SBSD (because such swaps might be more difficult and/or expensive to liquidate), particularly during a time of significant market stress.

Likewise, we urge the Commission to require bilateral posting of initial margin. We believe that one-way posting of margin will, in addition to the problems discussed previously, distort the swaps market and have the effect of discouraging central clearing of swaps. Under the Act and the Proposed Rules, SBSDs will be required to post initial and variation margin for cleared swaps, but will able to avoid legally-imposed margin requirements altogether in connection with non-cleared security-based swaps. We are concerned that allowing dealers to avoid having to post initial or variation margin to their counterparties could incentivize dealers to try to structure transactions to avoid central clearing, where the SBSD will be required to post initial and variation margin.

In the Proposing Release, the Commission discusses the relative amounts of risk that commercial end users and non-commercial end users pose to SBSDs in support of its imposition of initial and variation margin requirements on the latter but not the former. Our concerns with this approach are discussed in more detail in Section II below. We do not agree that all non-commercial end users necessarily pose greater risk to SBSDs than all commercial end users, or that a non-commercial end user necessarily poses greater risk to a SBSD than the SBSD poses to the non-commercial end user. To be sure, in many of the cases in which we are involved, the counterparty to the SBSD is more creditworthy than the SBSD itself, whether measured by credit ratings or other relevant objective criteria. For this and the other reasons noted above, we respectfully request that the Commission require bilateral (as opposed to unilateral) posting of initial and variation margin in security-based swaps between SBSDs and their financial entity counterparties, as discussed in more detail below.

II. Exception for Commercial End Users

We urge the Commission to reconsider its proposal to exempt only a very narrow category of security-based swap counterparties from the requirements to post initial and variation margin to SBSDs. As currently drafted, proposed Rule 18a-3 generally would exempt only commercial non-financial entities that are using non-cleared security-based swaps to hedge or mitigate risk relating to the entity’s commercial activities from the requirement to post margin to SBSDs. This proposal is significantly narrower than rules proposed by the Commodity Futures Trading Commission (“CFTC”) and the U.S. prudential regulators, as well as the proposals of the Basel Committee on Banking Supervision and the International Organization of Securities Commissions joint Working Group on Margining Requirements, which enable SBSDs and all of their non-financial entity counterparties to negotiate appropriate margin thresholds based on individual circumstances.

The Proposed Rules do not adequately identify different levels of risk among security-based swap end users. As the Commission is aware, there exists a wide variety of size, sophistication, experience, creditworthiness and financial resources among derivatives end users. By providing only a very narrow exception to the requirement to post margin, the Proposed Rules assume that nearly all buy-side counterparties pose the same amount of risk – and therefore should be required to post the same amount of initial and variation margin – and ignore this variety, leaving those sophisticated and creditworthy counterparties that have robust risk management practices with disproportionate amounts of capital tied up with their SBSD counterparties (while receiving no initial or variation margin in return). It is difficult to understand how this scenario serves to reduce risk or promote stability in the financial system.

Furthermore, the Proposed Rules do not provide for thresholds below which margin is not required to be posted. In contrast, the Basel Report states that "it may be desirable to apply different threshold amounts to different types of derivative market participants."[3] In its proposed rules governing margin for non-cleared swaps, the CFTC asked a number of questions regarding thresholds, including whether its proposals "adequately identify financial entities that have different levels of risk."[4] We respectfully submit that parties to non-cleared swaps (including where the end user is a financial entity) should be permitted to use thresholds that are determined by contract and customized by the parties to the swap. We believe that the parties to the swap – especially where the parties have had a longstanding trading relationship – are in the best position to evaluate each other's creditworthiness and to determine appropriate margin requirements. Finally, we agree with and support the CFTC's and the U.S. prudential regulators' proposals to allow the parties to security-based swaps between a swap dealer and a non-financial entity to determine initial and variation margin requirements and applicable thresholds, and urge the Commission to align its Proposed Rules with those of other U.S. regulators in this regard.

III. Netting of Initial Margin

The Proposed Rules permit parties to net variation margin in a security-based swap between a SBSD and an end user. This is consistent with current market practice among many market participants (*e.g.*, pursuant to master netting agreements), allowing them to efficiently deploy capital while ensuring that overall exposure to a counterparty is appropriately collateralized.

It is less clear whether netting of initial margin would be permitted under the Proposed Rules. We respectfully urge the Commission to clarify in the final rules that parties may net initial margin. Clarifying in the final rules that parties may net initial margin would be consistent with the Proposed Rules governing variation margin and current industry best practice.

[3] Basel Report at 10.
[4] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23732 at 23740 (Apr. 28, 2011).

In addition, we respectfully urge the Commission to clarify in the final rules that SBSDs and their counterparties may net initial margin between cleared and non-cleared security-based swaps. The Proposed Rules are silent on this issue. Many market participants currently have the ability to net initial margin between cleared and over-the-counter transactions through the use of master netting agreements. As mentioned previously, these netting arrangements allow parties to provide an amount of margin that appropriately reflects overall exposure to a counterparty.

IV. Custodial Arrangements

Proposed Rule 18a-4(d) requires SBSDs and MSBSPs to notify each counterparty of the SBSD or MSBSP at the beginning of a non-cleared security-based swap transaction that the counterparty has the right to require the segregation of initial margin with an independent third-party custodian ("individual segregation").

As currently drafted, the rules do not provide specific requirements with respect to how margin subject to individual segregation will be held. For example, the rules do not require that such an account would be held in the name of the counterparty (for the benefit of the SBSD or MSBSP), rather than in the name of the SBSD or MSBSP. In addition, the rules do not specify the circumstances under which a counterparty that elects individual segregation would be entitled to take control of the margin, and instead leave this to negotiation between the parties. These terms can have a significant impact on whether the segregation of a counterparty's initial margin would be upheld in an insolvency of the SBSD or MSBSP or whether the counterparty's initial margin would be treated as part of the insolvent SBSD or MSBSP's "customer property."[5] We respectfully request that the Commission require in Rule 18a-4 that, at a minimum, margin subject to individual segregation will be held in an account in the name of the counterparty electing individual segregation, and that such counterparty is entitled to control of the margin subject to the agreement without delay to the extent the SBSD or MSBSP becomes bankrupt or insolvent. Without these basic protections, the Congressional intent of section 3E(f)(1)(A) of the Securities Exchange Act, as amended, will not be fulfilled. This is also a key principle in the Basel Report, which states that "collected margin must be subject to arrangements that fully protect the posting party in the event that the collecting party enters bankruptcy to the extent possible under applicable law."[6]

In addition, Proposed Rule 18a-4(d) would require a SBSD to obtain from a counterparty that elects individual segregation an agreement in which the counterparty agrees to subordinate all of its claims against the SBSD to the claims of security-based swap customers of the SBSD, to the extent that

[5] *See, e.g.*, Sec. Investor Prot. Corp. v. Lehman Bros. Inc., 433 B.R. 127 (Bankr. S.D.N.Y. 2010) (concluding that the amounts in a tri-party account maintained with a customer's custodian in the name of Lehman Bros., as pledgee, were "customer property" and therefore subject to the Securities Investor Protection Act insolvency proceeding in connection with Lehman's insolvency).

[6] Basel Report at 25.

funds or other property under individual segregation are not treated as "customer property" in a liquidation of the SBSD. This requirement does not seem necessary, since the net equity claim of the counterparty to the SBSD's "customer property" would be reduced to the extent that the initial margin provided such counterparty was subject to individual segregation and therefore not part of the SBSD's "customer property." Since in a liquidation of an SBSD, "customer property" of the SBSD is allocated to customers based on their respective net equity claims, if the initial margin of a counterparty is subject to individual segregation and therefore not "customer property," such counterparty would not receive credit for such margin in determining the distribution of "customer property." Therefore, we believe that the subordination agreement is not necessary. We respectfully request that the Commission not include this requirement in the final rules, because we do not think that counterparties to SBSDs should be subjected to unfavorable terms that SBSDs may insist on including in their subordination agreements in order for their counterparties to elect individual segregation. A legally unnecessary subordination agreement is prone to creating ambiguity, unforeseen consequences and complications in already complex counterparty relationships, and runs contrary to the goal of investor protection for dealer counterparties.

We appreciate the Commission's attention to these comments.

Sincerely yours,

/s/ Christopher A. Klem
Christopher A. Klem

/s/ Leigh R. Fraser
Leigh R. Fraser

/s/ Molly Moore
Molly Moore