



Pension Investment
Association of Canada
Association canadienne des
gestionnaires de caisses de retraite



Association Européenne des Institutions Paritaires
European Association of Paritarian Institutions
Association Internationale de droit belge - établie 1979

May 19, 2014

Elizabeth M. Murphy, Secretary
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 (RIN 3235 – AL12; File No. S7-08-12)

The American Benefits Council (the “Council”), the Committee on Investment of Employee Benefit Assets (“CIEBA”), PensionsEurope, the European Association of Paritarian Institutions (“AEIP”), the National Coordinating Committee for Multiemployer Plans (“NCCMP”), and the Pension Investment Association of Canada (“PIAC”) (together, the “Global Pension Coalition”),¹ is providing the Securities and Exchange Commission (“Commission” or “SEC”) with additional comments to supplement the Global Pension Coalition’s comment letter to the SEC dated January 29, 2013.² The earlier letter was in respect of the SEC’s proposed rules (“Proposed Rules”) on capital, margin, and segregation requirements for security-based swap dealers (“SBSDs”) and major security-based swap participants.³ This letter is to provide the SEC with specific comments on the provision in the Proposed Rules that would impose a 100% capital charge on SBSBs where non-SBSD counterparties hold initial margin for security based swaps (SB swaps) with a third party custodian instead of the SBSB.

¹ The Global Pension Coalition represents a very significant portion of the largest private defined benefit and defined contribution pension plans in the U.S., Canada, and Europe as well as the companies that sponsor those pension plans. The pension plans represented by the Global Pension Coalition provide retirement benefits for over a hundred million individuals in more than a dozen countries.

² The prior comment letter is available at: <https://www.sec.gov/comments/s7-08-12/s70812-19.pdf>.

³ “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>.

A capital charge for accepting initial margin through a third party custodian will have a negative impact and is unnecessary.

The imposition of a 100% capital charge on SBSBs for initial margin held by third party custodians for their non-SBSB counterparties would negatively affect the use of third party custodians. The practical consequence of this capital charge will be for SBSBs to eschew SB swaps with counterparties that want to use third party custodians or, alternatively, for SBSBs to pass on the cost of the capital charge to those counterparties, either directly or in the form of higher pricing and other charges on counterparties. Non-SBSB counterparties that prefer to use third party custodians will effectively be subject to twice as much margin as counterparties that do not use third party custodians, with SBSBs less anxious to engage in SB swaps with them.

Third party custodial arrangements provide SBSBs with collateral protection that provides significant security for the dealer at the same time the counterparty has protection from the dealer's credit risk. The kinds of third party custodial arrangements accepted in the derivatives industry are inevitably implemented under "control" agreements in accordance with Articles 8 and 9 of the Uniform Commercial Code ("UCC"). These arrangements function as UCC control agreements because all parties agree that the custodian must always follow orders from the secured party, including orders to liquidate collateral, without further consent of any other person. UCC control is widely regarded as giving the secured party rights that are legally equivalent and functionally comparable to having physical possession of the collateral. These kinds of UCC "control" arrangements are well-established and in common use for many kinds of collateral including, but not limited to, collateral for over-the-counter derivatives.

Third party custodial arrangements protect non-dealer pledger counterparties by diminishing the credit risk created by posting initial margin directly to a dealer. As we commented in our prior letter, segregation of margin with a third party custodian also reduces systemic risk, and aids regulators in overseeing the liquidation of a dealer because collateral can be identified faster and with greater certainty in a dealer bankruptcy. The benefits of these arrangements have been recognized by the European Union in its rules for cleared swaps that require central clearing parties and clearing members to offer segregation of margin to their customers⁴, the Consultative Document issued by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions⁵, and provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") that provide non-dealer counterparties with the option to elect to have their initial margin held by a third-party custodian.⁶

The SEC's adoption of a capital charge would dramatically impede the ability to use third party custodians, counter to the express intent of Dodd-Frank and at odds with other regulators. As a result, pension plans will have fewer third party custodial arrangements, leaving them less protected from dealer credit risk, and diminishing their prospects of quickly identifying and

⁴ Regulation (EU) No 648/2012 of the European Parliament of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, Article 39.

⁵ Consultative Document entitled "Margin requirements for non-centrally-cleared derivatives" (July 2012).

⁶ Dodd-Frank §§ 724 and 764.

recovering collateral in dealer insolvency scenarios.⁷ Moreover, as investors in mutual funds and other entities that use third party custodial arrangements, pension plans also will indirectly bear the negative impact imposed on mutual funds by a capital charge. The protections and safeguards that third party custodial arrangements provide should be encouraged, not discouraged, as will be the result of this capital charge.

We appreciate the SEC's interest in ensuring that a dealer can liquidate and act on counterparty collateral quickly in a counterparty crisis situation. However, this policy goal cannot be pursued at the expense of the equally-important interest in protecting non-dealer counterparties in dealer crisis situations. These interests would be appropriately balanced by, as suggested by other commenters, conditioning the use of third party custodial arrangements on having certain contractual provisions that enable the custodial arrangement to function as a control agreement in accord with Articles 8 and 9 of the UCC, that give the secured party exclusive control upon a pledger insolvency and that require secured party consent for substitutions and withdrawal of excess.⁸ Permitting SBSBs to accept initial margin held under these conditions without incurring a capital charge will protect a SBSB's access to initial margin, while giving purpose to the Dodd-Frank provision allowing third party custodial arrangements.

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We thank the Commission for the opportunity to provide this additional comment and we strongly urge the Commission not to adopt a capital charge on SBSBs for initial margin for SB swaps held with a third party custodian.

⁷ In some cases, dealers also have wrongly used or misappropriated funds. See U.S. Commodity Futures Trading Commission v. Peregrine Financial Group, Inc. and Russell Wasendorf, Sr., (No. 12CV05383, N.D. Ill.), July 10, 2012, *available at*: <http://cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enpfpgcomplaint071012.pdf> (Peregrine bankruptcy with a shortfall of more than \$200 million in Peregrine's customer segregated funds account); In re M.F. Global, Inc., Report of the Trustee's Investigation and Recommendations, Case No. 11-2790 (MG) SIPA, U.S. Bankruptcy Court for the Southern District of New York, June 4, 2012, ("Trustee's Report") *available at*: <http://cftc.gov/ucm/groups/public/@newsroom/documents/file/mfglobalinvestreport060412.pdf>; (MF Global bankruptcy trustee reported a deficiency in MF Global's customer segregated accounts); Final Notice, J.P. Morgan Securities Ltd., UK Financial Services Authority, Ref. No. 155240, May 25, 2010, *available at*: <http://www.fsa.gov.uk/pubs/final/jpmsl.pdf> (JP Morgan UK fined for continuously failing to segregate futures client funds for nearly seven years); In the matter of Lehman Brothers International (Europe) (In Administration) and In the matter of the Insolvency Act 1986, Judgment, UK Supreme Court, Hilary Term, [2012] UKSC 6, February 29, 2012, *available at*: http://www.supremecourt.gov.uk/decided-cases/docs/UKSC_2010_0194_Judgment.pdf (Lehman bankruptcy revealed customer segregation discrepancies); *Commodity Futures Trading Commission vs. Sentinel Management Group, Inc., Eric A. Bloom, and Charles K. Mosley*, (No. 08CV2310, N.D. Ill.), April 28, 2008 ("CFTC Action"), *available at*: <http://cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfcomplaintsentinel044808.pdf> (CFTC charged Sentinel with failure to segregate customer funds); *Rogers Raw Materials Fund, L.P. and Rogers International Raw Materials Fund, L.P. v. Refco Capital Markets, Ltd.*, Case No. 05-60006 (RDD), U.S. Bankruptcy Court, Southern District of New York, October 24, 2005 (Refco fraudulently transferred customer funds out of segregation).

⁸ See e.g., February 24, 2014 comment from the Managed Funds Association, *available at* <https://www.sec.gov/comments/s7-08-12/s70812-57.pdf>. Should the SEC impose conditions on third party custodial arrangements we request that the SEC make clear that parties are free to determine other parameters of their third party custodial arrangements and are not bound to use industry form agreements.

Sincerely,

American Benefits Council
Committee on Investment of Employee Benefit Assets
PensionsEurope
The European Association of Paritarian Institutions
The National Coordinating Committee for Multiemployer Plans
The Pension Investment Association of Canada