

September 20, 2010

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

Ms. Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549-1090

Re: File Number S7--16-10 / Definitions of major swap participant and  
major security-based swap participant

Dear Mr. Stawick and Ms. Murphy:

The American Benefits Council (the "Council") and the Committee on the Investment of Employee Benefit Assets ("CIEBA") appreciate this opportunity to provide comments to the Commodity Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission (the "SEC," and collectively, the "Commissions") regarding the definitions of the terms "major swap participant" and "major security-based swap participant" in the Wall Street Transparency and Accountability Act of 2010 (the "Act" or "WSTAA").

The Council is a public policy organization principally representing Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans. CIEBA represents more than 100 of the country's largest pension funds. Its members manage more than \$1 trillion of defined benefit and defined contribution plan assets, on behalf of 15 million plan participants and beneficiaries. CIEBA members are the senior corporate financial officers who individually manage and administer ERISA-governed corporate retirement plan assets.

Swaps and security-based swaps play a critical role for our members' plans. If plans were considered to be major swap participants or major security-based swap participants ("major participants"), plans would have to set aside capital that could otherwise be paid out to retirees and beneficiaries or that could be invested in higher expected return assets such as stocks or bonds. Plan fiduciaries might then opt to avoid using otherwise prudent swaps.

Pension plans use swaps to manage risk and to reduce the volatility of the plan funding obligations imposed on the companies maintaining the plans. If swaps and security-based swaps were to become materially less available or become significantly more costly to pension plans, funding volatility could increase substantially, forcing companies in the aggregate to reserve billions of additional dollars to satisfy possible funding obligations, most of which may never

need to be contributed to the plan because the risks being reserved against may not materialize. Those greater reserves would have an enormous effect on the working capital that would be available to companies to create new jobs and for other business activities that promote economic growth.

The issues we raise regarding the major participant definitions are of great importance to our members, to the plan system generally, and to the economy. We look forward to working with you to ensure that the new rules strengthen financial regulations in a manner that enhances workers' retirement security. It is critical that the new rules not be interpreted in a way that undermines such security.

### **Summary of MSP Issues**

Many plans regulated by the Employee Retirement Income Security Act of 1974 ("ERISA") use swaps to hedge or mitigate the risks endemic to plan liabilities and investments, and such plans conduct these swap transactions through fiduciaries regulated under ERISA. Congress intended to permit plans (including investment vehicles held by plans) to continue to use swaps in this manner and, for this reason, expressly carved out swaps maintained for plans from the "substantial position" statutory threshold that subjects major participants to comprehensive and costly regulation. The Commissions should give full effect to these statutory provisions by:

- For all swaps:
  - Prong one of the major participant definitions (see pages 5-10):
    - Confirming that all swaps relating to asset/liability hedging fall within the plan swap exclusion;
    - Clarifying that swaps entered into primarily to mitigate any plan risks are eligible for the plan swap exclusion;
    - Clarifying that swaps maintained in trust accounts and other vehicles are subject to the statutory exclusion for plans' swaps; and
    - Applying the plan swap exclusion to appropriate foreign-based plans.
  - Prong two (see page 11):
    - Confirm that plans will not become major participants under prong two because they will never create systemic risk; and
  - Prong three (see page 10):
    - Confirm that plans will not become major participants under prong three because they are not "highly leveraged" relative to the amount of capital they hold.
- For uncleared swaps (see pages 9-10):
  - Excluding uncleared plan swaps with four specified protections from the "substantial position" calculation.
- For cleared swaps (see page 10):

- Excluding cleared swaps from the "substantial position" calculation.

### **Summary of Critical Issues Separate from MSP Status**

- For cleared swaps (see pages 11-13):
  - Strengthening clearing systems to allow plans to maintain, separate from other customers, fully collateralized accounts with clearing members, thereby further enhancing the case for excluding cleared swaps from the substantial position analysis.
- For uncleared swaps (see pages 13-16):
  - Clarifying the ability of plans to continue to use third-party custodians to segregate all uncleared swap collateral;
  - Confirming that plans are permitted to enter into swaps that prohibit dealers and major participants from investing or using uncleared swap collateral.

### **The Unique Nature of ERISA Plans**

It is hard to contemplate a counterparty that is less of a risk to the financial stability of the United States or any dealer than ERISA plans. ERISA plans have met their swap obligations to dealers despite the bankruptcy of Fortune 500 plan sponsors, the market crash of 2008, and every other significant financial event since the adoption of ERISA in 1974. There are a number of reasons for the uniqueness of ERISA plans.

- ERISA plans are required to be prudently diversified. In entering into swaps for plans, ERISA requires that plan fiduciaries act solely in the interest of the plan's participants and beneficiaries and with the care, skill, prudence, and diligence that a prudent person familiar with such matters would use.<sup>1</sup>
- "Investment managers" for ERISA plans are required to be regulated entities (registered investment advisers, banks, or insurance companies) that are (1) subject to the highest standard of care under U.S. law, (2) liable for significant financial penalties for failure to comply with relevant provisions of ERISA, and (3) liable in many instances for the acts of other fiduciaries.<sup>2</sup>
- ERISA plan assets are required to be held in trust for future payment, subject to the oversight of a trustee which is typically a U.S. regulated bank.<sup>3</sup>
- Because of the regulatory structure that applies to ERISA plans, subject to one narrow exception, it would be rare—if it occurs at all—for plans to be highly leveraged.<sup>4</sup> It is for

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<sup>1</sup> ERISA section 404(a)(1)(B).

<sup>2</sup> ERISA sections 3(38) (investment manager requirements), 404(a) (fiduciary standards), 405 (co-fiduciary liability), 409 (fiduciary liability), 502 (ERISA enforcement).

<sup>3</sup> ERISA section 403(a).

<sup>4</sup> Although not flatly prohibited, plans generally do not borrow (outside of special very narrow circumstances regarding loans used to acquire employer securities in certain types of defined contribution plans called

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this reason that whenever adverse market conditions result in a demand that a plan post collateral (typically high-quality collateral) on its swap or security-based swap, the assets in the plan's portfolio are available to meet that demand.

- ERISA plans are financially transparent; they typically have third-party custodians report their net asset value to dealers on a monthly basis and are required by law to report their holdings annually to the Department of Labor.<sup>5</sup>
- ERISA plans are not operating entities subject to business-line risks and competitive challenges.
- There is no provision under any law for ERISA plans to file for bankruptcy or reorganization to avoid their financial obligations to counterparties. Even the filing of bankruptcy by an ERISA plan sponsor or the involuntary termination of the plan does not relieve a plan of its financial obligations to counterparties. In fact, in an involuntary termination, the counterparty has a priority claim with respect to the plan's obligation to it.

Because of the foregoing factors, many dealers treat ERISA plans as if they were AAA-rated entities for credit analysis purposes. The low-risk nature of ERISA plans has been reflected in prior CFTC regulations.<sup>6</sup> To date, the CFTC has relied on ERISA's "pervasive" regulation of plans and plan fiduciaries as the reason it does not need to regulate these plans.<sup>7</sup> Regulating ERISA plans as major participants could, at best, result in duplicative regulation, and more likely, result in conflicting regulation that could cause confusion and harm to plans.<sup>8</sup>

### **Definitions of Major Swap Participant and Major Security-based Swap Participant**

As Treasury Secretary Geithner has testified, the intent of the WSTAA is to "subject all dealers in OTC derivatives markets and any other firms whose activities in those markets pose a *systemic threat* to a strong regulatory and supervisory regime as *systemically important* firms."<sup>9</sup> Consistent with Secretary Geithner's testimony, the Act will impose robust regulation on any entity, whether or not that entity is a dealer, whose swaps and security-based swaps could pose a systemic threat to the stability of our country's financial system.

Secretary Geithner also testified that a key element of addressing systemic risk is to "establish and enforce substantially more conservative capital requirements for institutions that

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"ESOPs"). Using borrowed funds for investment purposes may trigger unrelated business taxable income. See Internal Revenue Code section 514; IRS Rev. Rul. 74-197. Borrowing must also satisfy ERISA's requirements, including the requirement that the decision to borrow be made prudently. The end result is that plans generally do not borrow.

<sup>5</sup> See Form 5500.

<sup>6</sup> See, for example, CFTC Rule 4.5.

<sup>7</sup> See 50 Fed. Reg. 15868, 15869 and 15873 (1985); 58 Fed. Reg. 6371, 6373 (1993).

<sup>8</sup> Our comments are limited to ERISA-regulated plans, unless specifically noted otherwise. We are not speaking for governmental plans.

<sup>9</sup> Secretary of Treasury Timothy Geithner, Written Testimony for the House Financial Services Committee Hearing, March 26, 2009, available at <<http://www.treas.gov/press/releases/tg71.htm>> (last accessed September 3, 2010) (emphasis added).

pose potential risk to the stability of the financial system."<sup>10</sup> In establishing the capital and margin requirements that shall apply to dealers and major participants, WSTAA itself states that the intent is "[t]o offset the greater risk to the swap dealer or major swap participant and the financial system."<sup>11</sup> The Act also imposes business conduct and sales practice rules upon dealers and major participants.<sup>12</sup>

There is significant cost associated with these regulations as considerable resources must be invested in order to comply with such comprehensive requirements. Congress acknowledged this cost and the unintended consequences of overextending this regulation by limiting its application to those entities whose swaps and security-based swaps could threaten the stability of our country's financial system—dealers and major participants.

This cost is particularly burdensome in the case of plans that could otherwise use reserved capital to pay benefits and/or invest more appropriately. Applying the capital requirements to plans would thus have a very adverse effect on workers, retirees, and their benefits.

We ask that the Commissions interpret the terms related to the major participant definitions in accordance with Congressional intent to prevent systemic risk in a manner that recognizes the limited risk posed by plans.

### **Exclusions For Hedging Or Mitigating Risk**

The first prong of the three-part major participant definitions<sup>13</sup> provides two exclusions for hedging or mitigating risk. The first exclusion from substantial position covers "*positions*

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<sup>10</sup> Secretary of Treasury Timothy Geithner, Written Testimony for the House Financial Services Committee Hearing, March 26, 2009, available at <<http://www.treas.gov/press/releases/tg71.htm>> (last accessed September 3, 2010).

<sup>11</sup> New CEA Section 4s(e)(3)(A), as established by WSTAA Section 731; equivalent security-based swap version at new SEA 15F(e)(3)(A), as established by WSTAA Section 764(a). For capital and margin requirements generally, see new CEA Section 4s(e), as established by WSTAA Section 731, and new SEA 15F(e), as established by WSTAA Section 764(a).

<sup>12</sup> New CEA Sections 4s(f), 4s(g), 4s(h), 4s(i), 4s(j), and 4s(k), as established by WSTAA Section 731; New SEA Sections 15F(f), 15F(g), 15F(h), 15F(i), 15F(j), and 15F(k), as established by WSTAA Section 764(a).

<sup>13</sup> MSP is defined in full (under new CEA Section 1a(33), as established by WSTAA 721(a)(16)) as follows:  
"MAJOR SWAP PARTICIPANT.—  
(A) IN GENERAL.—The term 'major swap participant means any person who is not a swap dealer, and—  
(i) maintains a substantial position in swaps for any of the major swap categories as determined by the Commission, excluding—  
(I) positions held for hedging or mitigating commercial risk; and  
(II) positions maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;  
(ii) whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or  
(iii)(I) is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate Federal banking agency; and

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held for hedging or mitigating commercial risk."<sup>14</sup> Chairman Peterson, Chairman of the House Agriculture Committee, intended a broad interpretation of commercial risk as evidenced by his comment in the legislative record that "few, if any, end users will be major swap participants, as we have excluded "positions held for hedging or mitigating commercial risk" from being considered a "substantial position" under that definition."<sup>15</sup> We ask that the Commissions adopt a rule defining the term "commercial risk" in a manner consistent with this Congressional intent.<sup>16</sup>

To ensure that plans would not become major participants, the second exclusion from substantial position covers "positions maintained by any employee benefit plan (or any contract held by such plan) as defined in paragraphs (3) and (32) of section 3 of [ERISA] for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan."<sup>17</sup> By providing this plan-specific exclusion, Congress clearly stated its intent "to avoid doing any harm to plan beneficiaries."<sup>18</sup> As noted by Senator Lincoln, Chairwoman of the Senate Agriculture Committee and a key author of the Act,

"it may be appropriate for the CFTC and the SEC to consider the nature and current regulation of the entity when designating an entity a major swap participant or major security-based swap participant. . . . [E]mployee benefit

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(II) maintains a substantial position in outstanding swaps in any major swap category as determined by the Commission."

"(B) DEFINITION OF SUBSTANTIAL POSITION.—For purposes of subparagraph (A), the Commission shall define by rule or regulation the term 'substantial position' at the threshold that the Commission determines to be prudent for the effective monitoring, management, and oversight of entities that are systemically important or can significantly impact the financial system of the United States. In setting the definition under this subparagraph, the Commission shall consider the person's relative position in uncleared as opposed to cleared swaps and may take into consideration the value and quality of collateral held against counterparty exposures.

"(C) SCOPE OF DESIGNATION.—For purposes of subparagraph (A), a person may be designated as a major swap participant for 1 or more categories of swaps without being classified as a major swap participant for all classes of swaps.

"(D) EXCLUSIONS.—The definition under this paragraph shall not include an entity whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company."

The MSSP definition under new SEA Section 3(a)(67), as established by WSTAA Section 761(a)(6) is identical to the MSP definition, except that the MSSP definition relates to **security-based swaps** maintained by a person who is not a **security-based swap dealer** and does not include the exclusion found in (D) of the MSP definition.

<sup>14</sup> New CEA 1a(33)(i)(I), as established by WSTAA Section 721(a)(16); New SEA Section 3(a)(67)(A)(ii)(I), as established by WSTAA Section 761(a)(6).

<sup>15</sup> Representative Peterson, Congressional Record—House, June 30, 2010, H5248 (emphasis added).

<sup>16</sup> WSTAA Sections 721(b) and 761(b)(1).

<sup>17</sup> New CEA 1a(33)(i)(II), as established by WSTAA Section 721(a)(16); New SEA Section 3(a)(67)(A)(ii)(I), as established by WSTAA Section 761(a)(6).

<sup>18</sup> Senator Lincoln, Congressional Record—Senate, July 15, 2010, S5906.

plans are already subject to extensive regulation relating to their usage of swaps."<sup>19</sup>

When establishing the criteria for swaps that are excluded from the substantial position analysis, we request that the Commissions clarify three points, consistent with these statements of Congressional intent.

First, ERISA requires that all plan assets be held in trust. In light of this requirement, we request that the Commissions confirm that the Act's plan exclusion will apply to positions held in trust as "plan assets," including by entities such as master trusts and group trusts. To find otherwise would make this plan exclusion meaningless.

Second, the Act's plan exclusion applies to all swaps and security-based swaps maintained by an ERISA plan "for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan." Congress included two separate uses of swaps that would satisfy the exclusion: hedging and mitigating. The term "hedging" in the context of a pension plan would clearly include, for example, hedging the interest rate exposure associated with the asset-liability profile of a pension fund. The mismatch between the interest rate sensitivity of the plan's promised payments to its beneficiaries (i.e., the plan's liabilities) and its investments is one of the single biggest risks facing pension plans. Moreover, there may be other investment-related risks that the plan wishes to hedge, such as currency risk.

By including "or mitigating" in the statutory language, Congress expanded this exclusion beyond the traditional hedges noted above to include other forms of managing risk. Congress recognized that swaps used for risk management also should be covered by the plan exclusion. We ask that the Commissions take into account the many risks directly associated with the operation of the plan that a plan fiduciary traditionally hedges or mitigates through the use of swaps or security-based swaps. These traditional hedges and risk-mitigation activities include:

- hedging the interest rate exposure associated with the asset-liability profile of a plan;
- hedging foreign exchange translation risk of non-U.S. denominated securities;
- matching asset cash flow with expected liabilities;
- hedging the risk of adverse price changes in stocks, bonds or other assets held by the plan;
- mitigating the risk of non-diversification by gaining exposure to traditional or alternative asset classes or financial markets;
- rebalancing investments to a policy target, thus diminishing the risk of varying from the stated investment policy and/or not being prudently diversified as required by ERISA;
- controlling the risk of volatility in plan assets and reducing the funded status volatility of a pension plan.

Each of these risks can directly impact the financial health and viability of a plan. A plan fiduciary's reduction and management of these risks will be viewed as prudent (and in many cases, required) by ERISA. As so many plans today use these kinds of risk hedging and

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<sup>19</sup> Senator Lincoln's Colloquy, July 15, 2010, S5907.

management strategies, it is fair to say that the Congressional intent underlying the plan exclusion could be frustrated unless the Commissions recognize in their rulemakings that the plan exclusion applies to swaps used for these purposes.<sup>20</sup>

In short, if any plan swap is done to hedge or mitigate risk as discussed above, such swap should clearly be excluded in determining whether the plan maintains a “substantial position” under the first prong of the major participant definition.

If any plan swaps are taken into account in determining whether the plan has a substantial position under the first prong, such swaps should be taken into account based on the aggregate amount the plan would owe its counterparties (net of collateral posted and other contractual obligations) if the swaps were terminated early. This figure would be determined over an averaging period, such as a quarter, to avoid permitting quirky volatility from affecting the analysis. All that being said, it is hard for us to imagine that plans could ever have a substantial position under the statutory rule, consistent with Congressional intent.

Third, the Act's plan exclusion covers employee benefit plans as defined in paragraphs (3) and (32) of section 3 of ERISA. This definition of “employee benefit plan” does not include foreign plans (but does include U.S. plans maintained by foreign sponsors). Many of our members have foreign affiliates, and foreign plans are maintained for the benefit of those affiliates' employees. If a foreign plan is subject to regulation in its home country and a swap is entered into in the United States on behalf of the foreign plan for the primary purpose of hedging or mitigating any risk associated with the operation of the plan, we ask that the Commissions clarify that such swaps will not be counted towards the plan's substantial position, to the extent that the WSTAA applies. We understand that the level of regulation may vary by jurisdiction, but we believe that the Commissions should, at the very least, recognize the equivalent regulatory oversight of Canada, the United Kingdom, and EU jurisdictions.

### **Substantial Position**

The first and third prongs of the three-part major participant definitions revolve around the term "***substantial position***." Under both prongs, a non-dealer who "maintains a substantial position in swaps for any of the major swap categories as determined by the Commission" may be a major participant. As stated in the WSTAA, Congress has directed the Commissions to define the term substantial position "*at the threshold that the Commission determines to be prudent for the effective monitoring, management, and oversight of entities that are **systemically important** or can significantly impact the financial systems of the United States.*"<sup>21</sup>

"*Systemically important*" is not defined in the Act, but the plain words of the statute and the legislative history noted above both point directly to systemic risk. That is, a person is

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<sup>20</sup> Congressional Record—House, June 30, 2010, H5248.

<sup>21</sup> New CEA Section 1a(33)(C), as established by WSTAA Section 721(a)(16) (emphasis added); New SEA Section 3(a)(67)(B), as established by WSTAA Section 761(a)(6) (emphasis added).



systemically important if that person's failure in a major swap category would "pose[s] potential risk to the stability of the financial system."<sup>22</sup>

When establishing the substantial position threshold, the Act requires the Commissions to consider other factors that affect systemic risk. One such factor is whether the swap is cleared. WSTAA mandates that, "[i]n setting the definition [substantial position], the Commission shall consider the person's relative position in uncleared as opposed to cleared swaps."<sup>23</sup> When determining a person's uncleared swap positions, we request that regulators not view all uncleared swaps to represent the same level of risk, but rather analyze the systemic risk of an entity's swap positions by considering: (i) the regulatory oversight of such entity (*e.g.*, plans are regulated under ERISA); (ii) whether such person is leveraged after taking into account that person's available capital; (iii) whether adequate collateral is contractually required to be posted in a timely manner after material market movements; and (iv) the quality of collateral posted.

### Substantial position - Uncleared Swaps

The amount of systemic risk varies tremendously within the universe of uncleared swaps. Uncleared swaps for which neither party posts any collateral pose the most systemic risk of all swaps. Here, if one of the two parties to such a swap defaults on its obligations for that swap, the other party's recourse is limited to that of an unsecured creditor in bankruptcy. To reduce risk when entering into an uncleared swap, many market participants (including employee benefit plans and registered investment companies as noted by Senator Lincoln) "typically post collateral."<sup>24</sup>

The terms of collateral arrangements vary widely and impact greatly the amount of risk that collateralization minimizes, which explains the rationale for the provision in the Act that authorizes the Commissions to consider "*the value and quality of collateral held against counterparty exposures.*"

When plans enter into an uncleared swap, the amount of collateral usually required will be an agreed-upon portion (often 100%, disregarding *de minimis* market movements) of the current market value of the amount that a party would owe if the swap became due (which value will change based on daily market movements). The greater the value of collateral posted by a party, the less risk the other party has that the posting party would be unable to pay what it owes on the swap when it becomes due. The less time a party has to post collateral after an adverse market movement, the less risk the other party incurs. When an uncleared swap is 100% or "fully" collateralized (other than with respect to *de minimis* market movements), risk can be effectively negated.

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<sup>22</sup> Secretary of Treasury Timothy Geithner, Written Testimony for the House Financial Services Committee Hearing, March 26, 2009, available at <<http://www.treas.gov/press/releases/tg71.htm>> (last accessed September 3, 2010)..

<sup>23</sup> New CEA 1a(33)(B), as established by WSTAA Section 721(a)(16); Equivalent text applicable to MSSPs is provided as new SEA 3(a)(67)(B), as established by WSTAA Section 761(a)(6).

<sup>24</sup> Senator Lincoln, Congressional Record-Senate, July 15, 2010, S5907.

Whenever parties agree to post collateral, the parties also agree upon the types and quality of collateral that may be posted. Parties may further minimize risk of an uncleared swap by limiting acceptable collateral to securities whose value is considered stable. For example, many plans only accept cash (in stable currencies) and U.S. Government obligations.<sup>25</sup>

In this context, for purposes of determining whether a party has a "substantial position" in swaps, we ask that the Commissions acknowledge and promote risk reduction practices, such as the kinds discussed above, by excluding, for purposes of determining whether a party has a "substantial position" in swaps, an uncleared swap that has all the following four characteristics:

- the party is subject to regulatory oversight (*e.g.*, plans regulated under ERISA);
- the party is unleveraged after taking into account its available capital;
- the uncleared swap is adequately collateralized in a timely manner after material market movements; and
- all collateral is cash (in stable currencies) or high-quality investments (such as U.S. Government obligations).

Because an uncleared swap that meets all of these criteria poses little counterparty risk and therefore effectively no systemic risk to our country's financial system, such an uncleared swap should not be counted towards a person's substantial position threshold for purposes of the major participant determination.

#### Substantial position - Cleared Swaps

As Chairman Gensler has stated, "[c]learinghouses have effectively reduced risk since they were first developed in the futures markets in the late Nineteenth Century."<sup>26</sup> Indeed, clearing a swap can dissipate counterparty exposure by mutualizing counterparty risk among the clearinghouse's clearing members. Regulated clearinghouses have a laudable record for financial integrity subject to the oversight of the Commissions. Congress therefore was on solid ground in the Act when it encouraged the Commissions, in effect, not to count cleared swaps towards the substantial position threshold for major participant purposes. We strongly support that result for cleared swaps.

#### **Leverage**

The third prong of the major participant definitions only applies to persons that are highly leveraged. Plans will rarely, if ever, be "highly leveraged" under any definition developed by the Commissions. In fact, outside of the specialized context of "ESOPs" (a type of defined contribution plan that is specifically permitted to use borrowed funds to buy employer securities), the signatories to this letter are unaware of any plan that could possibly be considered highly leveraged.

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<sup>25</sup> Similarly, many mutual funds insist that collateral be posted only in the form of cash (in stable currencies) and U.S. Treasury obligations.

<sup>26</sup> Remarks of Chairman Gary Gensler, Over-the-Counter Derivatives Reform, Institute of International Bankers Washington Conference, March 1, 2010.

### **Substantial Counterparty Exposure**

The second prong of the major participant definitions captures non-dealers "*whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets.*" Any fear that a plan could default on its derivative obligations and have a meaningful effect on the financial stability of the U.S. banking system, financial markets, or any counterparty is misplaced and is not supported by the history of plans regulated under ERISA or the experience of any dealer counterparty. The unique attributes of plans (outlined at the beginning of this letter) should be sufficient, by themselves, for the Commissions to conclude that the swap positions of plans, whether cleared or uncleared, do not "*create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets.*" We respectfully request that the Commissions' regulations regarding "substantial counterparty exposure" for purposes of the second prong of the major swap participant definitions exclude positions of plans regulated under ERISA.

In any event, in determining whether plans can give rise to substantial counterparty exposure that could threaten the financial markets, all cleared swaps should be disregarded, as should all uncleared swaps with respect to which, as discussed above:

- the party is subject to regulatory oversight (*e.g.*, plans regulated under ERISA);
- the party is unleveraged after taking into account its available capital;
- the uncleared swap is adequately collateralized in a timely manner after material market movements; and
- all collateral is cash (in stable currencies) or high-quality investments (such as U.S. Government obligations).

### **Other Issues Critical to the Protection of Plans.**

We have discussed above why plans' swap positions pose very little risk. In fact, many plans would like to go further and ensure that they have even less risk. That is certainly consistent with the intent of the legislation. In that context, we offer the following recommendations.

**Allow Plans to Elect the Same Protections with Respect to Cleared Swaps That They Now Have with Respect to Uncleared Swaps.** While cleared swaps will generally pose less of a systemic risk threat than many uncleared swaps, current clearing systems do expose plans to some risks that many uncleared swaps currently do not experience. These are risks the Commissions and the clearinghouses could remove by adopting changes in current clearing practices. If these reforms were to be implemented, it would greatly strengthen the case for excluding cleared swaps from the "substantial position" threshold determination. A description of these risks and proposed solutions follows.

First, with respect to unclear swaps, plans generally do not post initial margin. Thus, the initial margin requirements associated with clearing create new risks to plans, risks that are exacerbated by the way margin is held in the clearing context, as discussed below.

With a cleared swap, margin posted by a customer to its clearing member is posted by the clearing member to the clearinghouse, where it is held in a single aggregate customer account at the clearinghouse for all of the clearing member's customers' swaps. This potentially places the customer's margin at risk if one of the other customers who has margin held in that same account defaults and neither the clearing member nor the clearinghouse system can make up the shortfall.<sup>27</sup> For example, if ten customers have swap positions cleared by the same clearing member at a particular clearinghouse and one of those ten customers defaults on its swaps, the margin that the clearing member posted to the clearinghouse on behalf of the remaining nine customers could be used to satisfy the shortfall of the clearing member's defaulting customer after certain other resources are used.

This is especially troubling to plans as the level of this risk will not be transparent to the plan fiduciary. A plan fiduciary will never know who the clearing member's other customers are nor the amount of margin involved. As the plan fiduciary will not be able to assess the creditworthiness of its clearing member's other customers, it will therefore have less information upon which to determine the plan's own credit risk.<sup>28</sup>

Moreover, because of the WSTAA clearing mandates, dealers will have more customers and more assets in their pooled customer margin accounts, which, by virtue of statistical probability, increases the likelihood that there will be a defaulting customer in the pooled margin account. In this regard it is important to remember that the volume of trading on futures exchanges has recently only been a fraction of the total size of the derivatives market. It has been estimated that only 16% of the outstanding derivatives market is now traded on exchanges.<sup>29</sup> It is contemplated that a significant portion of the remaining 84% of the global derivatives market will move to clearing platforms in response to the WSTAA clearing requirement. Even if only 50% of the over \$600 trillion swap market moves to clearing platforms, this will represent a nearly 300% increase in the amount of trading on clearing platforms and a corresponding increase in the risk of a default by a customer in a margin account. Importantly, this volume will:

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<sup>27</sup> In contrast, where a triparty custodian is used for uncleared swaps, segregated collateral is posted by each party to an account created specifically for, and only used by, the party posting the collateral.

<sup>28</sup> Before entering into a swap (or security-based swap) on behalf of a pension plan, Department of Labor directives require a plan fiduciary to evaluate the plan's credit risk, market risk, operational risk and legal risk by:

- Considering how the swap fits within the plan's portfolio and investment policy and its potential exposure to loss;
- Securing sufficient information to analyze the plan's credit risk, and the effects of market risk on the plan's portfolio and its overall risk using an appropriate methodology;
- Determining whether the plan has adequate information and risk management systems in place given the nature, size and complexity of the plan's derivatives activity; and
- Ensuring the plan has proper written documentation.

U.S. Department of Labor letter to Comptroller of the Currency, March 2, 1996.

<sup>29</sup> "The Global Derivatives Market: An Introduction," Deutsche, Boise/Eurex White Paper, April 2008.

- (i) increase to unprecedented levels the ratio of the amount traded on the exchanges to the capital of clearing members, and thus the likelihood that a default could occur that would exceed the available capital of all the clearinghouse's members;
- (ii) increase the number of clearing members that could default and impact the clearinghouse and any default guarantee fund;
- (iii) increase the number of new types of contracts traded on exchanges, which contracts contain risks to which the clearinghouse had not been previously exposed, thus reducing the historical confidence in the clearinghouse margin and default fund arrangements; and
- (iv) increase the number of customers that could default in a combined customer margin account and potentially impact other customers' margin.

It is not unrealistic to contemplate a scenario where a single clearing member or small number of clearing members represent a significant portion of a contract's market, e.g., credit default contracts. If the volume of trading expands exponentially and only a few members' capital is relied upon to pay a significant portion of the clearinghouse margin and the clearinghouse default guarantee fund, the risks discussed above are materially heightened.

Given (1) the fact that plans do not generally post initial margin in the OTC context, (2) the ability of plans to negotiate protections today for margin in segregated and fully collateralized third-party custodian accounts in the OTC context, and (3) as discussed above, the increased risks to plans' margin in clearing platforms, we ask that the Commissions provide a plan with the ability to elect that a separate account be maintained by the clearing member at the clearinghouse on its behalf and that the margin in such accounts not be available under any circumstances to satisfy the default of any other clearing member customer or of a clearing member. In addition, we request that the margin account requirements applicable with respect to plans making such an election be sufficient to "replicate" the collateral protections that plans can negotiate for in the OTC context where such OTC accounts contain high-quality collateral that is segregated with a third-party custodian for the benefit of the secured party (including interest thereon), held in the United States, and protected from rehypothecation, borrowing or lending by the dealer. The implementation of these protections for plans would ameliorate the risks described above and further solidify the rationale for not counting a plan's cleared swaps when determining whether a plan maintains a substantial position.

**Preservation of Plans' Ability to Negotiate for Greater Security in the Case of Uncleared Swaps.** While some swap counterparties agree to post collateral directly to each other, others insist that all collateral be segregated and held by a third-party custodian that is not affiliated with either party. This use of a third-party custodian can further protect the collateral posted if one of the two parties files for, or otherwise finds itself in, bankruptcy. Congress recognized the importance of collateral segregation and the use of a third-party custodian by including a provision in the WSTAA that preserves the ability of plans and other end users to insist on segregation and use of a third-party custodian for uncleared swaps. In pertinent part, the Act provides:

*"At the request of a counterparty to a swap that provides funds or other property to a swap dealer or major participant to margin, guarantee, or secure the obligations of the counterparty, the swap dealer or major swap participant shall—*

*(i) segregate the funds or other property for the benefit of the counterparty; and  
(ii) in accordance with such rules and regulations as the Commission may promulgate, maintain the funds or other property in a segregated account separate from the assets and other interests of the swap dealer or major swap participant.*

. . .

*The segregated account described [above] shall be—*

*(A) carried by an independent third-party custodian; and*

*(B) designated as a segregated account for and on behalf of the counterparty."<sup>30</sup>*

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<sup>30</sup> WSTAA Section 724(c) provides in full:

(c) SEGREGATION REQUIREMENTS FOR UNCLEARED SWAPS.— Section 4s of the Commodity Exchange Act (as added by section 731) is amended by adding at the end the following:

“(l) SEGREGATION REQUIREMENTS.—

“(1) SEGREGATION OF ASSETS HELD AS COLLATERAL IN UNCLEARED SWAP TRANSACTIONS.—

“(A) NOTIFICATION.—A swap dealer or major swap participant shall be required to notify the counterparty of the swap dealer or major swap participant at the beginning of a swap transaction that the counterparty has the right to require segregation of the funds or other property supplied to margin, guarantee, or secure the obligations of the counterparty.

“(B) SEGREGATION AND MAINTENANCE OF FUNDS.—At the request of a counterparty to a swap that provides funds or other property to a swap dealer or major swap participant to margin, guarantee, or secure the obligations of the counterparty, the swap dealer or major swap participant shall—

“(i) segregate the funds or other property for the benefit of the counterparty; and

“(ii) in accordance with such rules and regulations as the Commission may promulgate, maintain the funds or other property in a segregated account separate from the assets and other interests of the swap dealer or major swap participant.

“(2) APPLICABILITY.—The requirements described in paragraph (1) shall—

“(A) apply only to a swap between a counterparty and a swap dealer or major swap participant that is not submitted for clearing to a derivatives clearing organization; and

“(B)(i) not apply to variation margin payments; or

“(ii) not preclude any commercial arrangement regarding—

“(I) the investment of segregated funds or other property that may only be invested in such investments as the Commission may permit by rule or regulation; and

“(II) the related allocation of gains and losses resulting from any investment of the segregated funds or other property.

“(3) USE OF INDEPENDENT THIRD-PARTY CUSTODIANS.—The segregated account described in paragraph (1) shall be—

“(A) carried by an independent third-party custodian; and

“(B) designated as a segregated account for and on behalf of the counterparty.

“(4) REPORTING REQUIREMENT.—If the counterparty does not choose to require segregation of the funds or

*(cont'd)*

Although this provision does "not apply to variation margin payments,"<sup>31</sup> for years, some plans have insisted that all of their collateral be segregated and held by an independent, third-party custodian.<sup>32</sup> It would be a perverse result indeed if the limited scope of this provision cost these plans the additional protection of segregated variation margin for uncleared swaps. That would mean that the WSTAA would have the result of reducing the security and stability of the swap system. Rather, consistent with the Act's goal of reducing systemic risk to the financial markets of the United States, we request that the Commissions clarify that the limited application of this provision was not intended to suggest that plans' variation margin or mark-to-market collateral for uncleared swaps could no longer be segregated as a matter of contract. The surest way for the Commissions to help preserve existing variation margin segregation practices is to adopt regulations that permit these plans to retain their ability to insist that variation margin be segregated and held by a third party custodian.

One additional layer of protection insisted upon by some plans is prohibiting borrowing, lending, or rehypothecating collateral.<sup>33</sup> Rehypothecation of collateral posted by a plan for uncleared swaps may diminish the plan's rights to recover this collateral in the event of a dealer bankruptcy. For example, if a dealer is permitted to rehypothecate and, accordingly, transfers such collateral to a secured creditor of the dealer, and the dealer then enters bankruptcy, custodial claimants may well only have a proprietary claim to the extent of any excess remaining after the dealer's obligation to its secured creditor is fully satisfied. Many investors who thought they had "collateralized" swap positions with Lehman suffered serious losses when they realized that their arrangements permitted Lehman to rehypothecate posted collateral.

There is ample authority in the WSTAA for the Commissions to adopt rules allowing parties to prohibit such rehypothecation, borrowing or lending of collateral for uncleared swaps. The Act expressly states that the provisions regarding segregation of uncleared swap collateral or uncleared security-based swap collateral shall "not preclude *any* commercial arrangement regarding . . . the investment of segregated funds or other property that may only be invested in such investments as the Commission may permit by rule or regulation[.]"<sup>34</sup> This plainly allows swap parties to prohibit the use of uncleared collateral by contract. Accordingly, we ask that the Commissions preserve and confirm the ability of plans to prohibit dealers and major participants

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other property supplied to margin, guarantee, or secure the obligations of the counterparty, the swap dealer or major swap participant shall report to the counterparty of the swap dealer or major swap participant on a quarterly basis that the back office procedures of the swap dealer or major swap participant relating to margin and collateral requirements are in compliance with the agreement of the counterparties."

Equivalent text applicable to security-based swap dealers and MSSPs is provided as new SEA Section 3E(f), as established by WSTAA Section 763(d).

<sup>31</sup> New CEA 4s(1)(2)(B)(i), as established by WSTAA Section 724(c); New SEA Section 3E(f)(2)(B)(i), as established by WSTAA Section 763(d).

<sup>32</sup> Similarly, some mutual funds use independent third-party custodians for their swaps' collateral.

<sup>33</sup> Similarly, some mutual funds prohibit the borrowing, lending, or rehypothecating of collateral.

<sup>34</sup> New CEA Section 4s(2)(B)(ii), as established by WSTAA Section 724(c); New SEA Section 3E(f)(2)(B)(ii), as established by WSTAA Section 763(d).

with whom they enter into uncleared swaps from rehypothecating, borrowing, or lending funds posted as collateral.

. . .

It is critical that our members' plans continue to be able to use swaps to provide retirement security and health benefits to millions of Americans across the country. Plans are unique, heavily regulated entities that are required by law to act prudently in the sole interest of plan participants and that do not need extra layers of unnecessary requirements that would adversely affect participants. Accordingly, Congress made it clear that it did not intend to apply such requirements to plans that use swaps to manage risk rather than to create risk. In addition, it is critical that the new law not be interpreted in such a way as to eliminate important tools that plans now use to obtain greater security with respect to their swaps.

We thank the Commissions for the opportunity to comment in advance of their joint rulemaking on definition of the key terms and the regulation of major participants. If you have any questions, please do not hesitate to call Lynn Dudley (202-289-6700, the Council) or Judy Schub (301-961-8682, CIEBA).

American Benefits Council

Committee on the Investment of Employee Benefit Assets