BLACKROCK

November 15, 2010

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

RE: Customer Protection for Cleared Swaps

Dear Mr. Stawick:

BlackRock Inc.[1] is submitting this letter as a follow-up to the Roundtable held by the Commodity Futures Trading Commission on October 22, 2010 (the "Roundtable").[2] We were pleased to be a participant in that Roundtable to provide our views as a fiduciary for our clients on the need to maintain the protections for posted collateral that exist in the OTC derivatives market today as many swaps move from the bilateral world of OTC to the cleared environment.

It is clear that this issue has generated vigorous debate among industry participants. If the Commission believes it needs additional information in order to assist it in identifying an optimal solution, we respectfully suggest that it issue an Advance Notice of Proposed Rulemaking ("ANPR"). In the ANPR, the Commission should request information on specified alternative solutions (as discussed at the Roundtable and otherwise) and the costs to the industry and the costs to investors for these alternatives.

Focus of Financial Reform. We believe the essence of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA") is to increase the overall safety and soundness of the US financial markets. While the greatest structural changes will come to the OTC derivatives

---

1 Blackrock is one of the world's leading asset management firms. We manage $3.45 trillion on behalf of institutional and individual clients worldwide through a variety of equity, fixed income, cash management, alternative investment, real estate and advisory products. Our client base includes corporate, public, multi-employer pension plans, insurance companies, mutual funds and exchange traded funds, endowments, foundations, charities, corporations, official institutions, banks, and individuals around the world. BlackRock does no proprietary trading and does not take any principal positions.

2 A transcript of Roundtable is available at: http://www.cftc.gov/LawRegulation/DoddFrankAct/OTC_6_SegBankruptcy.html

markets, the existing futures markets and their participants will also be required to adapt. We support clearing of all eligible derivatives, recognizing that this provides an opportunity for systemic risk reduction (although centralized clearing does also concentrate risk at clearing organizations). As derivatives which represent a different asset class and have different risk profiles than futures, make their DFA-mandated move towards the futures model, adjustments need to be made to this model to accommodate these differences. In sum, in order to achieve the objectives of the DFA, re-engineering of practices and processes will be required by all derivatives market participants.

The DFA essentially creates a statutorily-mandated oligopoly for DCOs, replacing a market that currently has numerous counterparties negotiating their own terms, including mechanisms for the protection of posted collateral. The Commission should carefully examine the claims of the sell-side that established practices in the futures regime are necessary and serve well both the interests of individual participants (buy-side) and protecting against systemic risk. The Commission should carefully examine whether FCMs and swap dealers are using the DFA requirement for mandatory clearing as an opportunity to leverage the statutory clearing mandate to impose risks and costs on the buy-side (and to increase revenue for themselves) that are less achievable in the bilateral environment. In the FCM model, customers should have appropriate margin requirements set by an FCM based on their credit risk profile, and not rely on "fellow clients" to provide protection for the soundness of the overall FCM model.

Risk Management. As the OTC derivatives market migrates to a central counterparty cleared environment from a bilateral uncleared environment, DCOs are said to have become the new "too big to fail" entities. As the CFTC has recognized, this requires stricter and more rigorous risk management internally within the DCOs. There is also a need for more rigorous and timely risk management by all constituents involved in risk transfer from point of trade execution to trade settlement with final counterparty credit risk assigned to the DCOs for all market participants. These constituents will include Designated Contract Markets, Swap Execution Facilities, FCMs, and their buy-side and sell-side clients, as they adapt to a system of more concentrated central counterparty credit risk.

No one has shown that better individual customer protection will introduce overall systemic risk. Individual customer protection could be achieved in tandem with other appropriate reforms to accommodate new customer protections. As discussed at length at the Roundtable, these reforms among others could include the defaulter pay model by increasing initial margin requirements or changes in default fund contributions whereby better protection cost is shared by all market participants or a combination of both. There is no reason other than protection of revenue and return for existing FCM business models that the only supposed "solution" to increased customer risk is the status quo.

Cost Analysis. As we and others stated during the Roundtable, care must be taken to view costs associated with the introduction of customer segregation accounts for cleared derivatives as separate from costs associated with the required re-engineering due to the changes required more generally by the DFA.[3] It is of course also important to separate out the one-time costs of changes to the current FCM/DCO model from the on-going costs of maintaining customer collateral protection. Care must also be taken to account for current costs that are paid in the uncleared swap market that will transfer to the cleared market, which although new in the FCM model, are not additional for OTC derivatives. If the Commission determines to issue an ANPR, it should request that cost estimates reflect these factors.

We understand that even after DFA driven re-tooling costs are appropriately distinguished from the one-time costs of implementing customer protection for cleared swaps, an estimate of on-going costs may be difficult.[4] We would like to suggest a potential proxy for this cost.

The current LCH Clearnet model is a dealer-to-dealer model where each account is legally and physically separated for its dealer accounts. As LCH Clearnet currently has a majority of all cleared interest rate swaps, this can act as a proxy of cost that the industry has been willing to pay for account segregation over the past 10 years. The cost associated with the protection received due to the legally and physically separate collateral accounts for the dealers is embedded in the bid/ask price paid by their clients. The current market structure for OTC derivatives already absorbs this cost of collateral protection and when the market structure migrates to the cleared world the cost of segregation in order to receive collateral protection will migrate along with it.

Sell-side Conflicts. We continue to have a dialogue with major swap dealers on our views about maintaining customer collateral protection for cleared swaps—a model each understands because it is in place today in the bilateral environment and has been the primary model used by the dealer to dealer clearing construct for the last 10 years. The defense of the futures model for customers while the firms' dealer desk has better protections for the firms own collateral (in the dealer-to-dealer construct of swaps clearing) appears to be motivated by concerns that FCMs may experience negative changes in their expected revenue and returns.

Potential Solutions for Customer Protection for Cleared Swaps. BlackRock, as a fiduciary for its clients, has a goal—to maintain customer collateral protection for cleared swaps as is available

---

3 These costs are not just borne by dealers, DCMs, DCOs, SEFs and FCMs and other sell-side market participants. Institutional investors and other buy-side participants will also expend considerable sums to comply with the new clearing, exchange-trading and reporting requirements of the DFA.

4 Note also that the current OTC bilateral model includes the cost of customer protection segregated accounts through the ability to opt to have a tri-party custodial arrangement. Any cost estimate which fails to take this existing cost into account will necessarily overstate maintenance costs.

in today's bilateral world. We are open to alternative solutions to those currently in use in the bilateral swap market, provided this goal is achieved.

During the Roundtable, several options to achieve this goal were mentioned—with some discussed at length—and subsequently several others have emerged. We discuss each in turn below.[5]

1. *Physical Individual Segregation Accounts at the FCM and/or DCO.* This approach, which would mimic the treatment of customer collateral in the bilateral swaps world, would provide in the event of an insolvency of a carrying FCM a known and clear path to the transfer of positions (accompanied by the necessary margin) of non-defaulting customers. Another approach to individual physical segregation is an expansion of the LCH Clearnet model beyond dealer to dealer with individual customer account segregation occurring at the DCO. Both of these approaches could also provide an alternative that customers could elect to "opt out" of commingled customer segregation and into the individual segregation.

   Individual segregation at the customer account level may increase operational complexity, although we believe much of this can be handled through automated processes, much as routine computational and other back office and custodial operations are managed today.

2. *Legal Segregation/Operationally Commingled ("LSOC").* As explained at length at the Roundtable, this solution seeks to combine the advantages of individual segregation without disrupting existing FCM operational processes (beyond what will be required for re-engineering due to the DFA in general). On a day-to-day basis, the FCM would manage the customer segregation account on an omnibus basis as is done today in the futures model. In the event of the insolvency of a clearing member due to the default of its customer, the DCO would have sufficient information (and sufficient collateral value) to identify the non-defaulting customers and allow for the orderly transfer of open positions and margin to another clearing member without disruption. As in the individual segregated account proposals, the non-defaulting customers would be protected from "fellow customer risk".

   At the Roundtable there was a discussion that elimination of customers from the mutualization of loss among customers of an FCM would result in the need to increase the margin that might otherwise be required for cleared swaps. There was also a discussion that an alternative would be to increase the amount of the DCO guaranty fund, with an acknowledgment that protection of customers and clearing members could be achieved through either lever, and that some DCOs may choose to use a combination of both. A combination would likely decrease the amount of the increase in initial margin to the

[5] For purposes of the discussion of these alternatives, we assume that the Commission will use the authority provided to it under the Bankruptcy Code to amend Part 190 consistent with the solution or solutions adopted.

individual customer and likely increase clearing fees so as to increase the size of the guaranty fund. An increase in clearing fees would be borne by all market participants.[6]

There have also been statements that elimination of omnibus customer segregation creates a "moral hazard" in that customers will not choose their carrying FCM with the same care and due diligence. This presumes that today futures customers have access to sufficient information to make truly informed decisions which does not exist. Instead, customers rely to a large extent on the combination of DCO oversight and capital standards set by the Commission. Only the DCO has access to certain elements of the risk profile of its clearing members—whether those risks stem from the proprietary strategies in the house account or the strategies of the FCM's customers. We note also that there are market efficiencies in having DCOs perform this due diligence function, rather than the thousands of customers each attempting to perform a detailed due diligence—the costs of which are ultimately reflected in the market as a whole.

One can argue that in the current FCM model the buffer provided by customer collateral as the first line of loss makes for a less rigorous selection of clients by the FCMs and less rigorous oversight by the DCOs. It may also contribute to the setting of lower minimum capital requirements. Customers will continue to monitor the credit quality of their carrying FCM as they do for all entities to which they have credit risk exposure. But they would not need to be concerned about the unknown risk posed by trading conducted by other customers of the FCM—a concern which, as noted above, cannot be managed today in the futures model.[7]

3. *Default Waterfall Sequence*. While not specifically mentioned in the Roundtable discussion, an additional option that could improve customer protection is changing the order of loss liability in the default waterfall at a DCO so that the customer collateral pool is last to bear any losses. Enhanced customer protection would result from the low probability that a default event would be so severe that the other funds in front of the customer pool would be insufficient. The advantage of this approach would be minimal changes to the current FCM model and the DCO default waterfall concept.

4. *Insurance*. Another suggestion is that buy-side counterparties for cleared swaps either acquire an insurance policy against the potential of its clearing FCMs insolvency or that the industry establish an insurance company vehicle that would provide this protection. Default

---

6 The current LCH Clearnet model balances defaulter pay versus clearing fee impact by having a high initial margin and a smaller guaranty fund requirement.

7 The issue of "fellow customer risk" has been a topic of discussion and concern at the Commission ever since the bankruptcy of Volume Investors in 1985. While we are not seeking a change in the model for futures, we do not see any logic in perpetuating the issue for swaps as they make their DFA mandated move into the cleared environment.

insurance for this type of risk is not a currently well-accepted, well-understood or liquid product offering. The use of such mono-line insurance raises other issues, as demonstrated by the claims paying failures of several mono-line financial guaranty insurance companies during the financial crisis. A solution that is not reliable at the time when it is most needed is not an adequate solution.

5. *Clearing Membership by Buy-side Firms.* It has been suggested that buy-side participants, particularly large asset managers, become clearing members of DCOs. Under this proposal, by becoming a clearing member and maintaining an omnibus customer account, the asset manager could effectively manage so-called "fellow customer risk" because it would be able to control this risk through its choice and knowledge of its clients.

   While this novel approach may merit further exploration, we have identified several issues with this proposal.

   First, while it is obvious that clearing on behalf of its clients by an asset manager ("self-clearing") would disintermediate some FCMs, what is less obvious is that those asset managers that could qualify as clearing members would also do so, causing investment management clients to migrate to asset management firms that could clear for their clients. While this may inure to the benefit of firms like BlackRock, we strongly believe that investors—many of whom are themselves fiduciaries—should not be forced to make their decision of investment manager choice based on the ability of the investment manager to protect their collateral due to the manager being able to self-clear[8].

   Second, to the extent the clearing member criteria and capital requirements set by DCOs are established on a basis other than an appropriate risk analysis, , this creates barriers to entry for potential members whose business model does not include a large volume of transactions or highly leveraged positions.

   Last, assuming an asset manager was able to clear the financial, legal and other hurdles to clearing membership, in the current model, in the event of an FCM default and a failed auction of the positions, a DCO has for most asset classes the ability to force allocate positions or loss value on a pro-rata basis among the clearing members. This would be akin to the asset manager being forced to take a proprietary position or absorb losses, something that is in potential conflict with its responsibilities as a fiduciary and potentially inconsistent with its business model.

<u>Recommendation.</u> BlackRock supports a solution that will maintain the customer collateral protections as available today in the bilateral OTC market. We believe there are several

---

[8] Some large public and private pension funds also manage their plan assets directly. Clearing membership is simply not an option for these institutional investors.

proposals that could provide this solution, including legal segregation/operationally commingled and changes in the DCO default waterfall. We also believe that an expanded version of the individual segregation provided by the LCH Clearnet model would be effective. The Commission should consider amending Part 190 to allow DCOs enhanced flexibility in how they will serve both financial integrity and customer protection. The Commission should eliminate the futures model of an omnibus customer segregation account as the sole solution for cleared swaps.

We fully understand the concerns that for some solutions, the costs may outweigh the benefits. An ANPR would provide the opportunity to ask market participants providng the clearing service to estimate the costs of alternative solutions, with sufficient specificity such that the Commission and others can compare the costs and benefits of specific proposals. The cost estimates should distinguish one-time re-tooling costs from on-going costs, as well as the source of each cost (e.g., changes in initial margin, contributions to guaranty funds, etc.) broken down by margin requirements, fee structures and guaranty fund changes so the market has the ability to analyze and assess the right solution.

* * *

BlackRock supports financial reform that protects investors and promotes responsible growth of the global financial markets. A safe and sound financial system is important to all of us. We appreciate the extraordinary outreach made by the Commission and Staff to market participants and the public for their input. We recognize, as does everyone involved in this effort, the importance of achieving DFA implementation through the selection of the best policy outcomes to serve the public interest and the needs of market participants. If we can answer any questions or provide further information concerning this important topic, please do not hesitate to contact us.

Sincerely,

Joanne Medero

Richard Prager

Supurna VedBrat