



STATE STREET.

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November 16, 2010

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

Via Email: SegBankruptcy@cftc.gov

Re: Pre-Proposal Comments Related to Segregation of Collateral for Swaps

Dear Mr. Stawick:

State Street Corporation (“**State Street**”)¹ is writing in support of the Commodity Futures Trading Commission (the “**Commission**”) announcement that it will seek additional public input, through an Advance Notice of Proposed Rulemaking (“ANPR”), on collateral segregation rules for cleared swaps, and suggest similar outreach to market participants, particularly buy-side, real money managers, on rules related to segregation of collateral for non-cleared swaps. We believe these segregation rules, required under Section 724 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) will be critical to the achieving the swaps market related goals of Dodd-Frank, and urge the Commission to fully consider the issues described below.

¹ With over \$20 trillion of assets under custody and administration and \$1.9 trillion of assets under management at September 30, 2010, State Street is a leading specialist in meeting the needs of institutional investors worldwide. Our customers include mutual funds, collective investment funds and other investment pools, corporate and public retirement plans, insurance companies, foundations, endowments and investment managers. Including the United States, we operate in 25 countries and more than 100 geographic markets worldwide. We conduct our business primarily through our principal banking subsidiary, State Street Bank, which traces its beginnings to the founding of the Union Bank in 1792. State Street Bank’s current charter was authorized by a special act of the Massachusetts Legislature in 1891, and its present name was adopted in 1960.

I. Buy-Side Concerns Regarding Segregation and Protection of Collateral and the Need for Public Input Prior to Issuing a Rule Proposal

A. *Buy-Side and Systemic Risk Concerns*

State Street acts as service provider to a broad range of institutional, buy-side market participants, who are likely to become counterparties to transactions in the new swaps environment. Based upon our discussions with these clients, we believe that many buy-side participants have significant concerns regarding anticipated Commission rulemaking with respect to segregation and protection of customer collateral for cleared and non-cleared swaps. Despite considerable efforts by the Commission, including a public roundtable on customer collateral protection on October 22, 2010, it appears many market participants have not yet focused upon the impact of potential Commission rulemaking. While the October 22 roundtable was highly informative, it revealed a significant need for additional data and other input from the public before a rule is proposed.

The development of appropriate rulemaking initiatives for segregation and protection of customer collateral – for both cleared and non-cleared swaps – is critical to the success of Dodd-Frank in reducing systemic risk and avoiding a recurrence of the swaps market related issues that contributed to the recent market crisis. Specifically, from the perspective of our buy-side customers, segregation rules that do not increase protection of collateral posted by a buy-side counterparty to a dealer and minimize operational inefficiencies would be particularly troubling. As a result, we suggest that, the Commission seek additional public input on numerous issues related to both cleared and non-cleared swaps. Addressing these issues to the satisfaction of all participants will be a key element in the ultimate success of the new swap marketplace.

B. *Specific Concerns for Cleared and Non-Cleared Swaps*

For cleared trades, there is a substantial risk that the cleared swaps market will not be viewed by the buy-side as viable, if the clearing system that is developed under Commission rules does not address the concerns of market counterparties arising after the Lehman Brothers bankruptcy. While strong prudential and other rules for clearing members and clearinghouses are essential, the new regulatory system cannot succeed without high levels of protection for collateral posted by counterparties as well. Today, the collateral posted by market counterparties on a bi-lateral basis, while subject to other risks, are not subject to the risk of default of other market participants that enter into transactions with swap dealers, and it is imperative to replicate the same level of protection in a cleared environment. Otherwise, the buy-side will be reluctant to participate in the market, and the U.S.

swaps market may not develop robustly, in particular compared to non-U.S. markets. In addition, a market in which buy-side participants are not comfortable participating would lead to reduced investment options for U.S. pension plans and mutual fund investors.

For non-cleared swaps, insufficiently robust implementation of the third-party segregation option under Dodd-Frank could signal lack of regulatory support for market movement towards the counterparty negotiation of strong collateral segregation treatment, and encourage use of collateral management practices that contributed to the recent financial crisis.

For both cleared and non-cleared swaps, we believe the use of tri-party custody arrangements could, with appropriate rulemaking, provide buy-side counterparties higher levels of protection and greatly increase operational efficiencies compared to the existing swaps environment, where dealers are allowed broad use of comingled customer assets, or compared to a new structure modeled after current practices of Futures Commission Merchants (“FCM”), where customer assets are held separately from the FCM, but comingled with other customers.² Incorporating viable options for third-party custody (including protection of posted collateral in the event of another client default or the bankruptcy of the FCM) into the new regulatory environment should ameliorate growing buy-side concern over implementation of the Dodd-Frank swaps mandate and the resulting market environment for investing in swaps.

II. Scope of Recommended Advance Notice of Proposed Rulemaking

To determine the impact on investors that use the swaps market, the Commission should seek comment on a range of possible segregation and custody arrangements for both cleared and non-cleared swaps. Given the importance of segregation of collateral under the new market structure envisioned by Dodd-Frank, it is imperative for the Commission to seek additional buy-side input in relation to the following issues.

² We understand that the Commission has previously limited the use of tri-party custody arrangements. See Commodity Futures Trading Commission, Amendment of Financial and Segregation Interpretation No. 10, 70 FR 24768 (May 22, 2005) (the “**Interpretation 10 Withdrawal**”) (withdrawing an interpretation that permitted the conditional use of custodial accounts for futures). However, we note that there have been significant changes in the market since the Commission issued the Interpretation 10 Withdrawal, including the financial crisis and the enactment of Dodd-Frank. Thus, for the reasons discussed in this letter, we believe the Commission should reconsider its prior action.

(i) **Consistency between cleared and non-cleared swaps.**

In the aftermath of the Lehman Brothers bankruptcy, buy-side market participants have become increasingly focused on the counterparty risk presented by their relationships with swap dealers. Many sophisticated participants currently negotiate tri-party custody arrangements for non-cleared swaps as a means to mitigate the risk of default by their swap counterparties.³ The Commission should seek the views of buy-side participants on the use of tri-party custody arrangements for both initial and variation margin to mitigate risks in the swap market and the effect on their participation in the cleared swaps market if they are not permitted to use tri-party custody arrangements, as is common in the over-the-counter (“OTC”) market. The Commission should ask whether there are efficiencies in leveraging, with respect to swaps, the operationally efficient tri-party custody arrangements that are used today in various markets, such as the OTC swaps market. For example, would monitoring of collateral be enhanced by using tri-party custody arrangements? Could existing systems for communications and monitoring of tri-party arrangements be applied to the swaps market? If so, would permitting buy-side participants to leverage these efficiencies encourage robust buy-side participation in the redesigned swaps market?

(ii) **Consistent treatment of cleared and non-cleared swaps may promote risk management techniques currently employed in the swap market**

Over the past five years, buy-side firms have come to rely on more dynamic portfolio margining regimes to calculate their collateral requirements. Under these dynamic margining regimes, collateral changes daily based on changes in one’s portfolio, independent market prices, and overall market conditions. Portfolio margining regimes ascribe collateral at a portfolio level; consequently, this advance in risk management would be curtailed if market participants are required to calculate collateral separately and under distinct requirements on cleared and non-cleared swaps with the same dealer. The Commission should seek commentary on whether portfolio margining regimes reduce overall risk in the system by creating the right incentives for market participants to assemble balanced, nettable portfolios at their counterparties and, if desirable for risk

³ See, e.g., ISDA, Managed Funds Association, and SIFMA, Independent Amounts White Paper 7-10 (Oct. 2009) (discussing the use of tri-party arrangements in the over-the-counter market).

management purposes, how such arrangements can be promoted as part of the Commission's rulemaking.

(iii) **Creating a Meaningful Third Party Custody Option for Un-Cleared swaps.**

The buy-side views as essential the requirement in Dodd-Frank for buy-side counterparties to be able to elect third party custody of initial margin for non-cleared swaps. The Commission should exercise rulemaking authority under this provision of Dodd-Frank to make this right meaningful and robust. Among other questions, the Commission should seek buy-side commentary on the cost or efficiency benefits of permitting a buy-side counterparty, as opposed to the dealer, to designate the third-party custodian, and how best to ensure that the third-party custody option is meaningful, such as through mandatory non-discriminatory pricing, or rules that require execution and collateral management to be separately priced.

III. Conclusion

We believe the Commission will benefit from market participants' input on whether tri-party custody arrangements are essential for a robust swaps market. Specifically, the Commission should seek public input on the issues discussed above to determine buy-side perspectives on the relative advantages of the emerging regulatory environment for the swaps market in the U.S. and around the world. We believe that seeking additional guidance on these and other issues will foster market acceptance, including by buy-side participants, of margin practices and protection in the redesigned swaps market. Market acceptance of the regulatory structure for the new swaps market is essential to further the purposes VII of Dodd-Frank.⁴

We believe the Commission's plans to issue an ANPR in connection with cleared swaps is a step in the right direction, and urge the Commission to seek similar additional public input in relation to segregation of collateral for non-cleared swaps.

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⁴ See 156 Cong. Rec. S 5902, 5921 (daily ed. July 15, 2010) (Statement of Senator Blanche Lincoln: "The mandatory clearing and trading of certain swaps and security-based swaps, along with real-time price reporting, is at the heart of swaps market reform.")

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State Street appreciates the opportunity to provide our views regarding the Commission's consideration of segregation of collateral. We would be happy to discuss the foregoing at your convenience.

Sincerely yours,

A handwritten signature in dark ink, appearing to read "David W. Puth". The signature is fluid and cursive, with the first name "David" being the most prominent.

David W. Puth
Executive Vice President,
State Street Corporation

cc: Gary Gensler, Chairman
Michael Dunn, Commissioner
Jill E. Sommers, Commissioner
Bart Chilton, Commissioner
Scott D. O'Malia, Commissioner
Ananda Radhakrishnan, Director, Division of Clearing and Intermediary Oversight
Robert B. Wasserman, Associate Director, Division of Clearing and Intermediary Oversight