



Derivatives Market Structure  
Changes

August 2010

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# BlackRock Overview

## Independent firm in ownership and governance

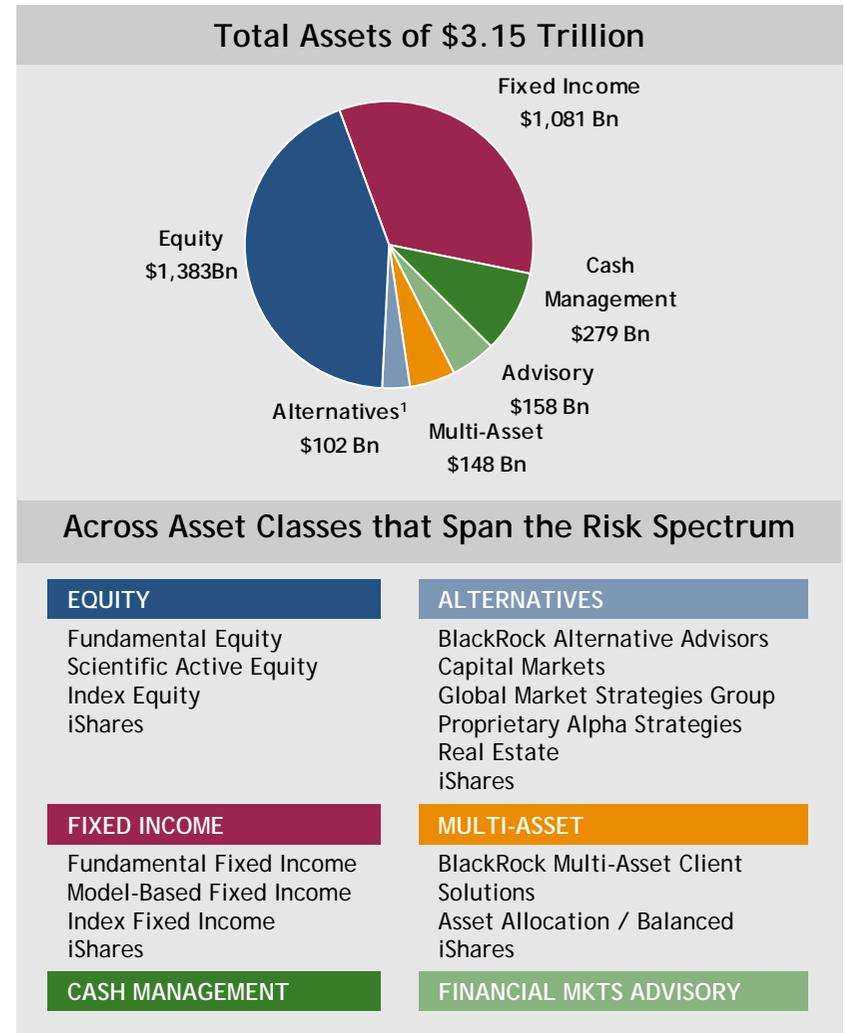
- Established in 1988, BlackRock is a public company (NYSE:BLK)
  - No majority owners
  - Majority of Board of Directors is independent
- Laurence Fink, Chairman & CEO since firm's inception

## Fiduciary for our clients

- Leader in creating solutions for clients
- "One BlackRock" approach results in consistency & quality throughout firm

## Pioneer in risk management and technology

- Provide risk management and enterprise investment services for \$9 trillion in assets
- BlackRock Solutions® offers independent risk management products



<sup>1</sup>Includes commodity and currency mandates  
AUM in USD as of 30 June 2010

# We Have a Significant Presence in All Major Markets

Extensive resources provide deep understanding of local markets and economies

- Headquartered in NYC with investment centers across asset classes worldwide
- Operating in 24 countries and more than 60 cities
- Extensive fund offerings registered in domiciles worldwide
- Governance model balances functional and regional leadership



\* Joint venture

# We Are a Fiduciary For Our Clients

The current implementation of change in over-the-counter (OTC) derivatives regulation has presented an opportunity to enhance the existing market structure

BlackRock's perspective on these changes represents both our views as a fiduciary that has to implement new rules on behalf of our clients, and we believe, the views of our clients

## BlackRock clients<sup>1</sup>

### US and Non-US Corporations

3M  
Akzo Nobel  
Ameren Corporation  
Applied Materials  
AT&T Inc.  
Avon Canada  
Bank of Montreal  
The Boeing Company  
BT Financial Group  
Campbell Soup Company  
Cisco Systems (Switzerland) Investments Ltd.  
Citigroup  
Coca-Cola Enterprises  
Computer Sciences Corporation  
CSX Corporation  
Dell Computer Corporation  
DuPont  
Duke Energy  
Electronic Arts Inc.  
Eli Lilly  
Enbridge Inc.  
Exelon Corporation  
Exxon Mobil Corp  
FedEx Corporation  
General Electric Company

Greyhound Canada  
Henkel AG & Co. KGaA  
Home Depot  
Honeywell  
Imperial Oil  
Intel  
International Paper Co  
Kaiser Permanente  
Kellogg Canada Inc.  
Kimberly-Clark  
Kraft Canada  
Liechtenstein Global Trust  
Macy's, Inc  
Newfoundland Power  
Northrop Grumman Corporation  
Pacific Gas & Electric Corporation  
PepsiCo  
Pfizer Inc.  
Procter & Gamble  
PSEG Services Corp.  
Raytheon Company  
Royal Bank of Canada  
J. Sainsbury Plc  
Sears Holdings Corporation  
Shell Oil  
Siemens Corporation  
Suncor Energy Inc.  
The Swire Group  
Eli Lilly  
Target Corporation  
Unisys Corporation  
United Technologies Corporation  
TKP Investments  
Valero

### Public Funds

Arizona State Retirement System  
California Public Employees' Retirement System  
California State Teachers' Retirement System  
City of Cincinnati Retirement System  
City of Cincinnati Retirement System  
City of Miami Fire and Police Civil Aviation Authority (U.K.)  
Commonwealth of Pennsylvania  
Federal Retirement Thrift Investment Board  
Federal Employees Retirement System  
Florida State Board of Administration  
Iowa Public Employees' Retirement System  
London Pension Fund Authority  
Los Angeles County Employees Retirement Association  
Massachusetts Pension Reserves Investment Management Board  
Minnesota State Board of Investment  
Municipal Employees Retirement System of Michigan  
National Electric Cooperative Association (NRECA)  
Nebraska Investment Council  
New York City Retirement Systems  
New York State Common  
North Carolina Retirement Systems  
Ohio Public Employees' Retirement System  
Oklahoma Public Employees' Retirement System  
OPSEU Pension Trust  
Oregon Public Employees' Retirement System  
Pension Plan of Saskatchewan The Public School & Education Employee Retirement Systems of Missouri  
State of Alaska  
State of Wyoming

State of Connecticut Trust Funds  
State Universities Retirement System of Illinois  
Tennessee Valley Authority Retirement System  
Washington State Investment Board  
Workers Compensation Board of Alberta

### Foundations, Endowments

Anglican Church of Canada  
Army Air Force Exchange  
Boy Scouts of America  
Bureau of Naval Personnel  
Cal Farley Boys Ranch Foundation  
The California Endowment  
Carnegie Mellon University  
Children's Hospital of Philadelphia  
Conrad N. Hilton Foundation  
The Dulwich Schools  
ELCA Board of Pensions  
Greater Glasgow NHS Endowment Fund  
Hewlett Foundation  
Kidney Foundation  
Inns of Court  
J. Paul Getty Endowment  
London School of Hygiene and Tropical Medicine  
The Metropolitan Museum of Art  
Princeton University  
Purdue University  
Rockefeller Foundation  
Shriners Hospitals  
Texas A&M University  
University of Calgary  
University of Colorado  
University of Ottawa  
University of Texas

### Union/Industry

Carpenters of Western Pennsylvania  
Directors Guild of America  
Midwest Operating Engineers  
SF Culinary, Bartenders, & Service Employees Pension Trust  
United Mine Workers of America

### Insurance Companies

Aegis Managing Agency Limited  
Aetna Inc.  
American Re  
Aon Corporation  
Ariel Reinsurance Company Limited  
Aspen Insurance Holdings Limited  
Axis Specialty Limited  
Blue Shield of California  
Catlin Group Limited  
Humana Inc.  
MAG Mutual Insurance Company  
Massachusetts Mutual Life Insurance Company  
MetLife, Inc.  
WellPoint Health Networks, Inc.  
Wilton Re  
Zurich Financial Services

### Official Institutions

Asian Development Bank  
Freddie Mac

## As a Fiduciary, We Are Concerned About Changes Impacting Our Clients

Potential unintended consequences of derivatives rulemakings that could be of concern to our clients include:

- Tension between localized regulations and global markets
- Lack of representation of all market participants, specifically in the formation of Central Counterparty Clearing houses (CCP's)
- Lack of clear standards for CCP's leading to proliferation of CCP's and causing operational risk and inefficiencies
- Reduction in investment performance without commensurate reduction in systemic risk due to costs associated with the application of Major Swaps Participant (MSP) requirements to asset management clients
- Exemption from MSP registration leading end-users to deal bilaterally instead of through CCP's and consequently face potentially higher costs in the form of less competitive pricing

# BlackRock's Approach To Principles for Central Counterparty Clearing Houses

We support central clearing and are platform-agnostic. We are, however, principle-based.

BlackRock developed nine principles regarding derivatives market changes and promoting the themes of:

- Risk reduction as it relates to counterparty risk
- Transparent, deep, and liquid markets
- Reduction of operation inefficiencies

The principles and related recommendations are included in the Appendix of this document:

- I. Deep and Liquid Markets
- II. Connectivity
- III. Account Segregation
- IV. Operational Risk Reduction
- V. Market Transparency
- VI. Anonymity
- VII. Robust default fund management
- VIII. Market Structure leadership role
- IX. Counterparty risk reduction

From these principles have arisen numerous initiatives that can be implemented to strengthen the robustness of OTC derivatives, a required and important tool for portfolio management

## BlackRock is Currently Working With Several CCP's

CCP's were built to service the needs of the inter-dealer community and have been very successful in serving that portion of the marketplace

The current model does not contemplate the participation of the buy-side and end-users that is now required

The new market structure paradigm should be inclusive of the buy-side, the end-users, and the sell-side

CCP's	Rates Product	Credit Product	BlackRock Planned Connectivity	BlackRock's Status of Participation
ICE		✓	✓	<ul style="list-style-type: none"> <li>BlackRock is a member of ICE's Trust Advisory Committee</li> </ul>
CME Clearing	✓	✓	✓	<ul style="list-style-type: none"> <li>BlackRock is a Client Advisory Board Member (for Rates) and a Buy Side Founding Member (for Credit)</li> <li>Variation Margin is being calculated daily for Credit in production today, and Interest Rate Swaps</li> </ul>
IDCG	✓		✓	<ul style="list-style-type: none"> <li>BlackRock is a Risk Committee Member</li> <li>We are performing shadow clearing on a daily basis for IRS</li> </ul>
LCH Clearent				<ul style="list-style-type: none"> <li>BlackRock is waiting to evaluate their Futures Clearing Merchant (FCM) model</li> </ul>
Others				<ul style="list-style-type: none"> <li>BlackRock is in discussions with several other CCP's in Europe and the US</li> </ul>

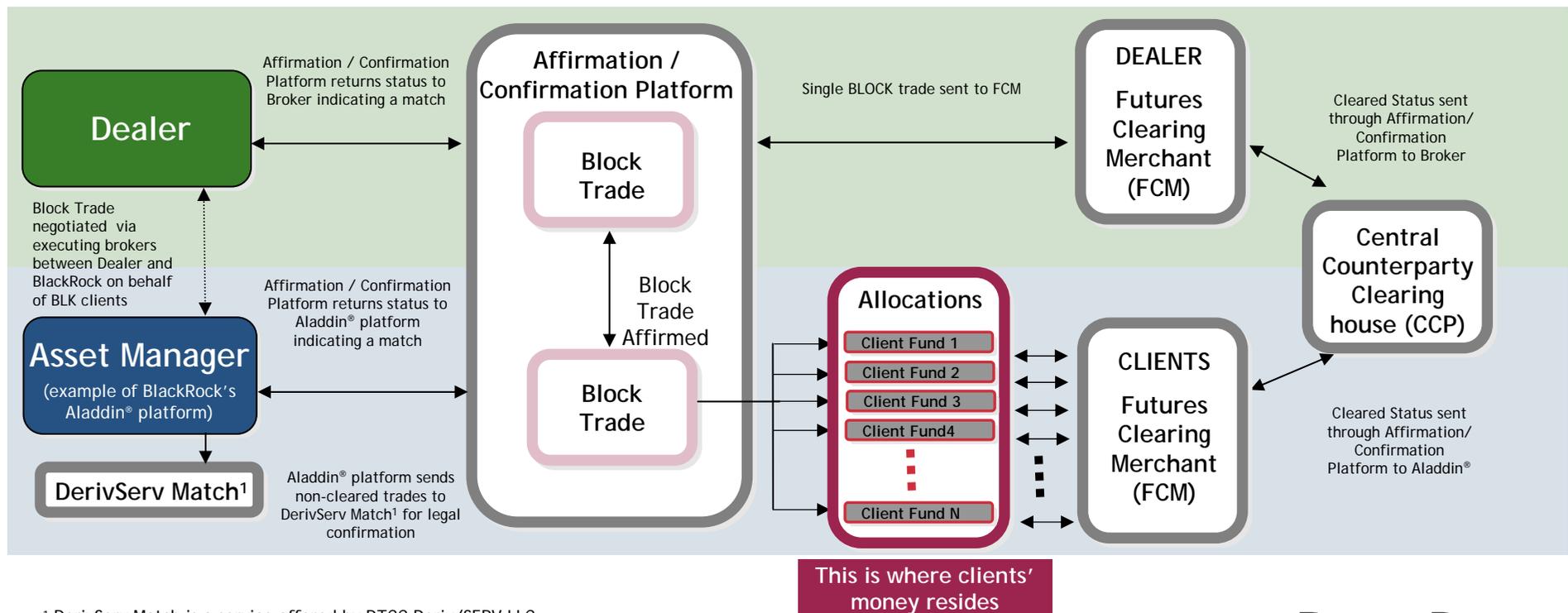
# Implementation Complexity of CCP's

The required use of CCP's to clear trades will add new complexities for asset managers, including:

- On-boarding and connecting thousands of client portfolios to the CCP's
- Inserting the allocation of block trades to the individual client portfolios into the electronic workflow for cleared transactions

The workflow below illustrates the difference between an asset manager vs. a dealer clearing via a CCP

- BlackRock's risk and trading platform, Aladdin®, is an industry leader of technology-driven transparency



<sup>1</sup> DerivServ Match is a service offered by DTCC Deriv/SERV LLC

# Today's Discussion Topics

The Commodity Futures Trading Commission (CFTC) published a list of 30 issue groupings regarding the implementation of the OTC Title of the Dodd-Frank bill

For discussion on the following five pages, we have set out our areas of interest and concern, in order of priority:

- DCO Core Principle Rulemaking, Interpretation & Guidance
- Swaps Execution Facilities
- Segregation & Bankruptcy for both Cleared and Uncleared Swaps
- Definitions (Major Swap Participant)
- Position Limits

# DCO Core Principle Rulemaking, Interpretation & Guidance

As required users of CCP's, continuous buy-side participation in the governance of CCP's is vital

- The buy-side and the end-users should have input regarding CCP processes, such as:
  - New Product approval
  - Default Management
  - Risk Management
    - Variation Margin calculation methodology
    - Curve construction
    - End-of-day (EOD) pricing
    - Collateral management

We recommend adequate representation of key market participants on the respective CCP committees is essential

# Swaps Execution Facilities

**We recommend caution imposing pre-trade transparency without balancing liquidity**

**Real price discovery is essential to establish SEFs that are viable for buy-side utilization**

- Price discovery requires behavior elements associated with confidence in the platform's ability to provide liquidity and competitive pricing

**Price transparency alone is inversely correlated to the transparency of liquidity depth**

- We support post-trade transparency with the appropriate time delays
- Pre-trade transparency currently exists in multiple venues thus imposing it in the SEF environment without a natural evolution could potential result in lack of liquidity

**We recommend availability of multiple exchange venues and are concerned about vertical orientation**

- Supports competition that will:
  - Help generate breadth and depth of viable products
  - Drive operational efficiencies lowering transaction costs
- Supports an open architecture model that will allow:
  - Connectivity to multiple exchange venues
  - Straight through processing (STP) connectivity to dealers

# Segregation & Bankruptcy for both Cleared and Uncleared Swaps

We recommend individual segregated accounts that afford each client the maximum legal protection in the case of FCM or other client default

- This would create parity for cleared and uncleared swaps, at least as to the ability to manage default risk

The current futures model of an omnibus client account held at the FCM exposes clients to the risk of default by other clients of the FCM

- OTC transactions are currently structured so the client can manage counterparty default risk directly
- Clearing should not result in greater default risk at the FCM level than exists for OTC transactions today

Individual accounts should have portability (to another FCM) with account positions and related collateral

- Treatment of client assets in the event of FCM or CCP bankruptcy needs the same legal certainty as uncleared transactions

## Definitions (Major Swap Participant)

Further refinement of the definition of MSP is needed through regulatory action

- Definition needs to be clarified to be applicable at the fund level, not the fund manager
- While the statute excludes pension plans, the application to pooled investment vehicles for such plans should be clarified

Application of MSP status needs to carefully balance systemic risk concerns with potential for reduced investment performance

- Requires analysis of purpose/use of OTC derivatives in an investment strategy

Role of intermediary asset managers for MSP-designated funds and in some cases MSP separate accounts requires a regime that is operationally achievable

End-user exclusion from clearing requirements needs to be narrowly defined both to address potential systemic risk and for operational simplicity

# Position Limits

**We recommend any position limits set by regulators or CCP's be based on risk-based metrics**

- Any categorical limits not aligned as such could drive investment activity offshore, reducing liquidity and transparency of US markets and hindering investment returns
- Internal risk management already imposes position limits consistent with investment strategies
- Risk management includes both establishing a position and liquidating a position

**Any position limits set by regulators or CCP's must be feasible to implement**

- Independent account controller exemptions should be retained—concerns about abuse can be addressed through enhanced reporting and audit
- Real-time look through is not feasible with current available industry tools



# Appendix

# Principles for CCPs (Page 1 of 4)

## I. Deep and Liquid Markets

Market structure changes should be geared to develop deep and liquid markets in exchange cleared product offerings.

- Standardization of products and fungible contracts
- Provide a deep product offering
- Fee structures supportive of cleared settlement
- Transparent end of day (EOD) pricing

## II. Connectivity

Central clearing houses must be electronically connected to major ECNs, affirmation/confirmation platforms. Central clearing houses must also influence adoption of electronic connectivity and distribution of data for business processes that indirectly impact the clearing trade cycle.

- Provide electronic connectivity that supports straight through processing (STP) for the trade cycle
- Proactively connect to all major ECNs that are used in the market for execution of contracts that are eligible for clearing
- Proactively connect to confirmation / affirmation platforms across multiple counterparties and directly with CCP's via an API

## III. Account Segregation

Central Clearing houses along with their clearing member firms should support account segregation structures that segregate client funds from the risk of clearing member default and default risk associated with another client default.

- Account structures that support segregation of client funds (collateral, margin) from funds of the clearing member firm
- Ideally account structures that support segregation of client funds by individual clients eliminating clearing member and other client insolvency risk

## IV. Operational Risk Reduction

Market structure changes that support operational risk reduction by streamlining and automating operational processes as well as reducing counterparty exposure should be made a priority.

- Provide cross product netting for margin requirements
- Position compression: Instantaneous netting of offsetting positions reducing each contract to one end of day position
- Support for both block trading and ability to support allocations of block trades with the ability to clear partial blocks or allocations as they are allocated
- Trade date clearing reducing counterparty and market risk
- Reduce operational complexity by eliminating legacy OTC legal confirmations
- Reduce operational complexity by netting periodic payments, settlement amounts and gains/losses into a single daily variation margin payment
- Affirmations/Confirmations should be efficient and standardized across CCP's with minimum required fields to identify economics of trade and counterparty

## V. Market Transparency

Market transparency on size of market and pricing of products must be achieved through maintaining liquid markets for cleared products, credible end of day (EOD) pricing, and transparent and competitive margin requirements.

- End of day (EOD) settlement prices must be provided electronically on a timely basis
- Methodology used to determine end of day settlement prices should be transparent and readily available
- Methodology used for margining calculations should be transparent with intra-day calculation capability
- Participation by clients to clear via central counterparties should be based on materiality of positions in order to maintain true transparency of overall market exposure

## VI. Anonymity

Client anonymity between clients must be maintained. The Central Clearinghouse is counterparty to all clients and counterparty information for the opposite side of a trade must be kept anonymous unless there is a non-standard market situation. This is separate and distinct from concentration of assets by counterparty.

- Trade information should be treated as highly confidential and client /counterparty anonymity must be maintained once the trade is novated to the central counterparty
- Act as central counterparty to all trades and maintain anonymity between clients
- Interconnectivity for the various market participants in the clearing flow cycle should be market driven and not structurally driven

## VII. Robust default fund management

Central Clearing houses must have proactively managed, robust default fund management that protects client assets from defaulting clearing members. Central clearing replaces reduction in client to client counterparty exposure with a concentration of exposure to the clearing house by all clients, as such the default fund management must be strong.

- Portability of client positions and margin from defaulted or insolvent member to a solvent member must be done on a timely basis with minimum disruption
- Central counterparties must have robust default fund structures. CCP's mitigate individual counterparty risk that will now be concentrated with the central clearers
- Robust credit risk management of clearing members to ensure financial health of the clearing house
- Clearing member requirements should ensure adequate clearing member deposits and robust back-up liquidity facilities

## VIII. Market Structure leadership role

Central Clearing houses must take a leadership role in designing and guiding initiatives required to support efficient and transparent over-the-counter (OTC) cleared products.

- Pro-actively bring market structure enhancements and new initiatives to industry groups, regulatory agencies and other constituents' that directly or indirectly impact the trade cycle for cleared OTC derivatives. Some examples include reducing the settlement period to T+1, need some more 40 Act Fund inclusion, etc.
- Management approach should be inclusive of assessing and solving the needs for all market participants regarding market structure changes. e.g. 40 Act Funds collateral restrictions, ERISA Fund's EULA indemnity restrictions, etc.
- Governance structures and working groups should be inclusive of buy side representation
- Optimization, consistency and clarity of trade flow process across CCP's and between cleared versus non-cleared transactions should be achieved
- Clearly defined project plans and management to allow buy-side to manage integration with CCP's and with clients

## IX. Counterparty risk reduction

Market structure changes that help in the reduction of counterparty risk and fragmentation by acting as central counterparty to all trades, reducing trade settlement time and maintaining robust default fund management to protect against counterparty default.

- Act as anonymous central counterparty to all trades
- Instantaneous netting of offsetting cleared contracts and completely fungible contracts within the CCP's