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July 11, 2011

Mr. John Walsh
Acting Comptroller
Office of the Comptroller of the Currency
250 E. Street, S.W.
Washington, DC 20219

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Mr. Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
1700 G Street, N.W., 4th Floor
Washington, DC 20552

Mr. Gary K. Van Meter
Acting Director
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102

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

Re: Comments on Margin and Capital Requirements for Covered Swap Entities

OCC: Margin and Capital Requirements for Covered Swap Entities [Docket ID OCC–2011–0008] (RIN 1557–AD43)
Board: Margin and Capital Requirements for Covered Swap Entities [Docket No. R–1415] (RIN 7100–AD74)
FDIC: Margin and Capital Requirements for Covered Swap Entities (RIN 3064–AD79)
FCA: Margin and Capital Requirements for Covered Swap Entities (RIN 3052–AC69)
FHFA: Margin and Capital Requirements for Covered Swap Entities (RIN 2590–AA45)
CFTC: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants (RIN 3038–AC97)

Dear Mr. Walsh, Mr. Feldman, Mr. Van Meter, Ms. Johnson, Mr. Pollard and Mr. Stawick:

Fidelity Investments[1] ("Fidelity") appreciates the opportunity to comment on (i) the proposed rule for Margin and Capital Requirements for Covered Swap Entities, jointly published by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency (the "Prudential Regulators") on May 11, 2011[2] and (ii) the proposed rule for Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, published by the Commodities Futures Trading Commission (the "CFTC") on April 28, 2011[3] (collectively, the "Proposed Rules"). The Proposed Rules would, among other things, impose initial and variation margin requirements on registered swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants (collectively, "Swap Entities") in connection with uncleared swaps.[4]

We appreciate and support the Prudential Regulators' and CFTC's efforts to craft rules to protect the OTC swaps market by establishing minimum margin requirements to be posted in connection with uncleared swaps. We believe that the Proposed Rules generally represent a good start in protecting the OTC market, but as discussed in greater detail in the remainder of this letter, we have some significant concerns and therefore recommend that the Prudential Regulators' and CFTC's final rules incorporate the following concepts:

- Swap Entities should be required to post margin to financial counterparties, rather than just collect it—the requirement to post collateral should be two-way.

- The scope of eligible collateral for both initial margin and variation margin should be broadened to include liquid, high-quality debt securities, denominated in any major currency.

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[1] Fidelity Investments is one of the world's largest providers of financial services, with assets under administration of $3.7 trillion, including managed assets of more than $1.6 trillion. The firm is a leading provider of investment management, retirement planning, portfolio guidance, brokerage, benefits outsourcing and many other financial products and services to more than 20 million individuals and institutions, as well as through 5,000 financial intermediary firms.

[2] Proposed Rule: Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27564 (Prudential Regulators, jointly April 12, 2011) (to be codified at 12 C.F.R. pts. 45, 237, 324, 624, and 1221).

[3] Proposed Rule: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23732 (CFTC April 12, 2011) (to be codified at 17 C.F.R. pt. 23).

[4] As used in this letter, the term "swaps" refers equally to CFTC-regulated swaps and Securities Exchange Commission-regulated security-based swaps.

- The definition of "low-risk financial end user" should be broader and, in particular, should capture entities that are subject to significant existing regulation, such as registered investment companies ("RICs") and ERISA and government benefit plans.

- Provisions concerning initial and variation internal models should be uniform, and the criteria for an internal margin model used to calculate initial margin should include a five day liquidation horizon, rather than the proposed ten day liquidation horizon.

- The final rules should be consistent with the final rules adopted by other regulators imposing margin requirements for uncleared swaps.

- The proposed effective date of the Prudential Regulators' final rules does not provide sufficient time for implementation. The effective date should be tied to approval by the relevant agency of margin models submitted by Swap Entities.

Margin Requirements Must be Bilateral

The Proposed Rules contemplate that Swap Entities will be required to collect margin from their counterparties, but not required to post margin to them. We urge the Prudential Regulators and the CFTC to require that Swap Entities also post initial and variation margin to counterparties, an approach that we believe is supported by the standards established under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

Section 4s(e)(3)(A) of the Commodity Exchange Act, added by the Dodd-Frank Act, requires that the Prudential Regulators and the CFTC—in order to offset the greater risk of uncleared swaps to the Swap Entity and to the financial system— impose margin standards that (i) help ensure the safety and soundness of the Swap Entity and (ii) are appropriate for the risk associated with uncleared swaps. The unilateral collection of margin by Swap Entities from counterparties as contemplated in the Proposed Rules would not satisfy these standards or mitigate the risks that the Dodd-Frank Act generally was intended to address. In fact, the unilateral margin requirement could actually make a Swap Entity less financially sound, because a Swap Entity would not be setting aside funds or posting collateral in respect of its own payment obligations, thereby presenting potentially significantly more risk to its counterparties.

Variation margin represents amounts owed in respect of losses that have already accrued as a result of market fluctuations. While legally a transfer of collateral, variation margin is the functional equivalent of making payments for existing losses that arise from adverse price movements. Imposing a requirement that these amounts be paid to the party "in-the-money" on a daily basis—regardless of whether the party is a Swap Entity—would reduce leverage in the financial system overall and reduce the risks associated with the failure of a particular Swap Entity. The current proposal (i.e., requiring only counterparties to make payments of variation margin) will result in a buildup of exposure and leverage in the financial system and will create the potential for Swap Entities to have obligations in connection with uncleared swaps that they cannot fulfill.

Collateral and credit support arrangements in the current OTC derivatives market serve the important function of reducing unsecured credit risk. By allowing Swap Entities to avoid posting variation margin, the Proposed Rules fail to address one of the most significant risks that we believe the Dodd-Frank Act sought to address: the unsecured credit exposure of the most significant participants in the swaps market. Instead, the current approach puts the financial system and counterparties at more risk, because the Proposed Rules effectively increase the amount of capital in jeopardy, regardless of the true economic risks to the parties. One particularly egregious example of where the amount of margin would not be in line with the true economic risks would be when a Swap Entity is holding a counterparty's initial margin in connection with uncleared swap positions that are out of the money to the Swap Entity (i.e., for which the Swap Entity would have a payment obligation). In that case, capital would be unnecessarily tied up and put at risk should the Swap Entity become insolvent, and there is no policy reason for a Swap Entity to continue to hold collateral of its counterparty without any offset to the extent that the Swap Entity has uncollateralized exposure to such counterparty. On the other hand, requiring Swap Entities to post initial and variation margin to counterparties would both reduce unsecured exposure and unnecessary risk to market participants and the financial system, as a whole.

We expect that the Proposed Rules would also make it more difficult for counterparties to successfully negotiate collateral posting from Swap Entities in connection with uncleared swaps. In the current OTC derivatives market, counterparties often negotiate for bilateral margin requirements (i.e., two-way posting). While we recognize that the Proposed Rules would not prohibit a Swap Entity from agreeing to post collateral to a counterparty going forward, imposing a posting requirement only on counterparties would almost surely put those counterparties at a disadvantage when attempting to negotiate reciprocal treatment.

Finally, we believe that allowing Swap Entities to avoid posting margin to counterparties will provide a perverse incentive for the Swap Entities to increase uncleared trading activity. In the case of cleared swaps, Swap Entities are required to post margin to a derivatives clearing organization. As a result, contrary to the intent of the Dodd-Frank Act, it will be substantially less costly for Swap Entities to engage in uncleared trades than cleared trades. We believe that requiring Swap Entities to post margin to their counterparties in connection with uncleared trades will mitigate the incentive to structure swaps transactions to avoid central clearing, which will better protect the financial system.

Scope of Eligible Collateral Should be Broadened

The Proposed Rules do not allow for the use of non-cash collateral (other than debt obligations of the U.S. Government and, for initial margin, certain agency securities) to satisfy margin requirements for most counterparties. We believe that the scope of eligible collateral for both initial margin and variation margin should be broadened, in part because the limited scope of eligible collateral contemplated in the Proposed Rules might increase systemic risk, rather than reduce it.

As a preliminary matter, the risks implicated by collateral securing uncleared swap positions are not the same risks that exist in the futures market or that will exist in the cleared swaps market. Collateral held at a clearinghouse in connection with a futures contract or a cleared swap must be liquid because the collateral could be used to satisfy obligations owed to any number of customers and could have to be ported to another futures commission merchant. In contrast, the collateral securing uncleared swaps does not have to be portable and cannot be used to satisfy amounts owed to other customers. Further, unlike the traditional futures model, the vast majority of counterparties to an OTC derivative contract are permitted to (and typically do) post non-cash collateral.

While the Proposed Rules do not restrict the type of collateral nonfinancial end users could post when credit exposure is below the relevant thresholds, the definition of nonfinancial end user, as proposed, is relatively narrow in scope and therefore will not apply to most counterparties. Further, as the result of existing contractual and legal investment restrictions (e.g., restrictions on the types of securities in which a RIC can invest), the inability of a financial end user to post non-cash collateral would force entities in some circumstances to post only U.S. dollars for both initial and variation margin, which unnecessarily limits the available investment options. The scope of eligible collateral permitted for initial margin and for variation margin should at least include any highly-liquid, high-quality debt security, denominated in any major currency.

Fidelity believes that the limited type of eligible collateral that would be permitted under the Proposed Rules would effectively concentrate risk in the financial system. The requirements set forth in the Proposed Rules could result in an amount of collateral needed for margin equal to a substantial percentage of the existing market for those securities. Accordingly, capital may be allocated to securities where it might not otherwise go. That could create undesirable volatility in the price and yield of those securities, as market participants buy and sell the securities in connection with collateral needs.

Counterparties to an uncleared swap contract have an incentive to mitigate any credit risk that they have to the other party and, therefore, to monitor actively the type and amount of collateral transferred to secure the other party's obligations. Historically, these collateral arrangements have worked well in the OTC derivatives market. In fact, situations in which counterparties have been in jeopardy of not being paid have typically resulted from the payment being unsecured, or collateral not being segregated with a third-party custodian, rather than due to the type of collateral posted to secure the obligation. Further, we note that the requirement for a Swap Entity to collect initial margin and the requirement to value margin and swap positions on no less than a daily basis will already mitigate the risks of unsecured exposure to the Swap Entity and the system more generally.

Definition of "Low-Risk Financial End User" Should be Broader

Under the Proposed Rules, an entity would qualify for treatment as a low-risk financial end user only if (i) its swaps fall below a specified threshold for "significant swaps exposure"; (ii) it predominantly uses swaps to hedge or mitigate the risks of its business activities; and (iii) it is subject to capital requirements established by one of the Prudential Regulators or a state insurance regulator. Fidelity suggests that this definition be revised in the final rule so that it focuses on criteria that are more relevant to systemic risk, such as the credit quality of the relevant financial end user. In that connection, we suggest that RICs and ERISA and government benefit plans should automatically qualify as low-risk financial end users in the revised definition. RICs and ERISA plans already are subject to comprehensive regulatory frameworks that require, among other things, the entities to act in a prudent manner and to limit the amount of leverage they maintain. For example, RICs are not highly leveraged as a result of coverage requirements under the Investment Company Act of 1940, and therefore do not engage in the type of high risk activities perceived by many to have contributed to the financial crisis. Also, ERISA plans are subject to stringent statutory and regulatory requirements, including prudence and diversification rules, professional management standards and on-going transparent reporting obligations. Similarly, based on other applicable rules and principles, government benefit plans are subject to many of the same requirements and constraints applicable to ERISA plans. These regulatory requirements serve to limit the types of risks that might be relevant to a determination that an entity is "high risk".

In addition, Fidelity supports the suggestions submitted to the Prudential Regulators and the CFTC by the Asset Management Group of the Securities Industry and Financial Markets Association in its July 11, 2011 comment letter regarding the Proposed Rules (the "AMG Comment Letter") with respect to the definition of "low-risk financial end users." Those suggestions include focusing the "low risk" definition in the final rule on leverage rather than on whether the financial end user (i) enters into swaps for hedging purposes or (ii) is subject to capital requirements established by a Prudential Regulator or state insurance regulator. Fidelity further agrees with the suggestion in the AMG Comment Letter that the threshold permitted for uncollateralized exposure to low-risk financial end users should be increased.

Provisions Concerning Initial and Variation Internal Models Should Be Uniform, and the Initial Margin Model Should Use a Five Day Liquidation Horizon

The Proposed Rules permit a Swap Entity to select from two alternatives for calculating its initial margin requirements. Under the Prudential Regulators' internal margin model alternative, a Swap Entity would calculate the amount of initial margin required from a counterparty using an internal risk management model that meets certain criteria and is approved by the relevant Prudential Regulator. One criterion in the Proposed Rules would require the internal risk model to estimate the one-tailed 99% confidence interval for an increase in value of the swap over a holding period of at least ten days. We believe that the ten day period is too long and that a five day period would be more appropriate.

There are significant differences between cleared swaps and uncleared swaps with respect to accessing collateral. Unlike the margin posted in connection with a cleared swap, in most situations margin posted to a counterparty in respect of an uncleared swap can be recognized by a non-defaulting counterparty almost immediately through termination of the transaction and set-off. Further, uncleared swaps will not implicate porting or shared risk among the other clearing members and counterparties, as would be relevant to a cleared swap transaction.

A five day liquidation horizon would be at the high end of current requirements of derivatives clearinghouses, which are typically three to five days. Choosing a liquidation horizon longer than five days would unnecessarily penalize market participants who enter into uncleared swap transactions and would not reflect the liquid nature of the collateral being posted. Additionally, because certain swaps will not be able to be cleared, counterparties will not have any discretion with respect to such swaps.

Final Rules Must Be Consistent Between Regulators

The Dodd-Frank Act requires that the Prudential Regulators, the CFTC and the Securities and Exchange Commission (the "SEC") establish and maintain margin requirements that are comparable, to the maximum extent practicable.[5] While we applaud the Prudential Regulators' and the CFTC's efforts to keep the proposed rules consistent, we note that there are a number of

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[5] *See* 7 U.S.C. § 6s(e)(2)(A), 6s(e)(3)(D).

differences. We believe that even slight differences between how the various regulatory regimes treat margin for uncleared swaps will exacerbate the difficulties of complying with multiple regulatory regimes. Further, we believe that having different rules will lead to unnecessary confusion among market participants, and will place additional and disproportionate burdens on buy side participants who will have to develop a number of different models to facilitate trading with Swap Entities governed by different regulators.

One of the more substantial differences between the Prudential Regulators' proposed rule and the CFTC's proposed rule relates to how the amount of initial margin is calculated. Apart from the direct costs to counterparties that would occur as the result of the Proposed Rules because of changes that would be needed to collateral arrangements, technology and infrastructure, there will be additional burdens caused by differences between the two regimes and among different Swap Entities. Counterparties will need to understand the rationale for the amount of initial margin required, the prices for swaps offered by different Swap Entities and the implications of executing trades with different counterparties. That analysis will take additional time and resources, should different regulators implement varying rules.

We recommend a final rule that allows the Swap Entity's counterparty to choose between the Swap Entity's model and the Prudential Regulators' proposed standardized ‘‘lookup’’ table for initial margin, provided that the number of categories contemplated in the table are increased and the level of margin required is lowered. If the final rules include an option similar to the standardized ‘‘look up’’ table in the Prudential Regulators' proposal, there would be less room for disagreement among counterparties and regulators regarding the correct margin levels. We suggest that the standardized "look up" table, be consistent among the Prudential Regulators and the CFTC, so that end users who choose this option do not have to evaluate and monitor different margin models.

We expect that the costs imposed on the market as the result of diverging regulatory regimes will outweigh any benefit that might result from the differences. We strongly recommend that the Prudential Regulators, the CFTC and the SEC work together to ensure that there are no substantive differences between the regulatory margin regimes.

Transition Time Necessary to Effect New Requirements

The Prudential Regulators' proposed rule would apply the new margin requirements to uncleared swaps entered into by a Swap Entity after the effective date of the Prudential Regulators' rule, which is proposed to be 180 days after publication of a final rule in the Federal Register. A 180 day period is insufficient to establish the proper operational and legal framework in light of the resources necessary to implement these and other impending regulatory requirements. This would be a particularly significant concern should the Prudential Regulators and the CFTC not issue final rules nearly simultaneously.

Making the required changes in each existing contractual relationship for a significant number of accounts, portfolios and funds will require individual negotiation and approval. Additional time will be required for the Proposed Rules because a counterparty can only review and understand a Swap Entity's initial margin model after a Swap Entity develops the model and the relevant agency approves it. Therefore, we suggest incorporating an effective date that is based on the date when the relevant agency approves all margin models that have been submitted by Swap Entities and believe that a sixty-day period following such regulatory approval would be sufficient.[6]

In addition, we suggest that the effective date of the Proposed Rules with respect to any category of swaps or market participants should not come before the regulatory scheme for clearing swaps is in place and the market has established the ability to clear such category of swaps for such participants. The margin requirements for uncleared swaps under the Proposed Rules are substantial and are meant to work in conjunction with an effective swap clearing system in order to minimize systemic credit risk. Until that clearing infrastructure is in place, it would be unnecessarily burdensome to make the margin requirements effective and subject market participants to the requirements when they do not have the ability to clear.

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We appreciate the opportunity to comment on the Proposed Rules. Fidelity would be pleased to provide any further information or respond to any questions that the Prudential Regulators' or the CFTC's staff may have.

Sincerely,

[6] Provided that the date is no earlier than the date on which the relevant rules to which the model applies have otherwise become effective.