BNY MELLON Northern Trust STATE STREET

July 11, 2011

Via E-mail and internet

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Re: Margin Requirements for Covered Swap Entities

Dear Ladies and Gentlemen,

BNY Mellon, Northern Trust Corporation and State Street Corporation (the "Custodian Banks") are pleased to have the opportunity to provide comments to the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, and the Farm Credit Administration (collectively, the "Prudential Regulators") and to the Commodity Futures Trading Commission (the "CFTC") regarding the proposals by the Prudential Regulators and the CFTC (the "Proposed Rules") to establish minimum margin requirements for registered swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants (collectively, "Swap Entities").[1]

Each of the Proposed Rules includes a requirement that initial margin for a non-cleared swap or non-cleared security-based swap (in either case, an "Uncleared Swap") between one Swap Entity and a counterparty which is also a Swap Entity be segregated and held with an independent custodian which is "located in a jurisdiction that applies the same insolvency regime to the independent custodian as would apply to the covered swap entity."[2] In their respective proposing releases, the Prudential Regulators and the CFTC asked whether this requirement is necessary and appropriate.[3]

While the Custodian Banks believe the use of independent custody for swaps margin provides high levels of protection for each counterparty to a swap, for the reasons set forth herein, we are concerned that including the insolvency regime-related requirement in a final rule would not mitigate risks faced by Swap Entities that enter into Uncleared Swaps and would have undesirable consequences. Accordingly, we respectfully request that the insolvency regime requirement be excluded from the final rulemaking.[4]

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[1] The Proposed Rules implement Sections 731 and 764 of the Dodd-Frank Act Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). *See* Public Law 111-203, 111th Cong., 2d sess. (July 21, 2010). The Prudential Regulators' proposed rule would establish minimum margin requirements for Swap Entities for which one of the Prudential Regulators is the prudential regulator. *See* "Margin and Capital Requirements for Covered Swap Entities," 76 Fed. Reg. 27,564 (May 11, 2011) (the "Prudential Regulators' Proposed Rule"). The CFTC's proposed rule would apply to swap dealers and major swap participants for which there is no prudential regulator, which generally are swap dealers and major swap participants which are not banks. *See* "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants," 76 Fed. Reg. 23,732 (Apr. 28, 2011) (the "CFTC's Proposed Rule"). Comments on the Prudential Regulators' Proposed Rule and the CFTC's Proposed Rule were originally due on June 24, 2011, and June 27, 2011, respectively, but the comment period for each of the Proposed Rules was subsequently extended to July 11, 2011. *See* 76 Fed. Reg. 27,621 (May 12, 2011); 76 Fed. Reg. 37,029 (June 24, 2011).

[2] §___.7(d) of the Prudential Regulators' Proposed Rule; § 23.158(a)(5) of the CFTC's Proposed Rule. We assume that "covered swap entity" for purposes of this requirement, and therefore, the Swap Entity which serves as the reference point for the applicable insolvency regime for the independent custodian, is the Swap Entity which posts the initial margin. We make this assumption based on the text of the Proposed Rules. The lead-in language of §___.7 of the Prudential Regulators' Proposed Rule refers to "[*a] covered swap entity that* enters into a non-cleared swap or non-cleared security-based swap with a swap entity and *posts initial margin* to the swap entity . . .." (Emphasis added.) The CFTC's Proposed Rule similarly refers to "*[e]ach covered swap entity* that *posts initial margin* with a counterparty that is a swap dealer or major swap participant . . .." 17 C.F.R. § 23.158(a)(4) and (5) (proposed) (Emphasis added). However, if the Prudential Regulators interpret the proposed language to refer to the insolvency regime of the secured Swap Entity rather than the posting Swap Entity, the concerns raised in this letter are still relevant.

[3] *See* 76 Fed. Reg. at 27,579, Question 69(a); 76 Fed. Reg. at 23,742.

[4] The Custodian Banks note that there is no statutory requirement in Dodd-Frank that such an independent custodian, whether required or optional, be located in any particular jurisdiction or be subject to any specific insolvency regime.

No Mitigation of Risks

In its rule proposal, the CFTC explained that the requirement regarding the jurisdiction of the custodian "would facilitate quicker recovery of margin assets."[5] The Custodian Banks do not believe that the proposed requirement would accomplish the objective of facilitating the return of margin assets. In fact, while the location of the custodian may be significant, the location of the posting Swap Entity would seem to have little relevance to achieving this objective.

As an example, in the event of the insolvency of the independent custodian the return of margin assets would be facilitated by rules of an insolvency regime that are protective of the posting Swap Entity. One insolvency regime may be more protective than another. But it does not follow that an insolvency regime applicable to the independent custodian in the same jurisdiction as the posting Swap Entity would be more protective than an insolvency regime applicable to an independent custodian located in another jurisdiction. To the extent the goal is to require the custodian's jurisdiction to be one that is protective of the posting Swap Entity, that goal would be better accomplished in other ways, such as by permitting the use of custodians in jurisdictions the laws of which have been determined to be favorable to the posting Swap Entity.

Perhaps the requirement that the posting Swap Entity and the independent custodian be located in the same jurisdiction is designed to eliminate cross-border risk in facilitating the return of the margin assets to the posting Swap Entity. However, even in that case the significance of the cross-border risk is questionable in comparison to the critical issue of which insolvency regime is actually more protective of the posting Swap Entity.

If the insolvency regime of the independent custodian is generally more protective of the posting Swap Entity, the cross-border risk analysis becomes one of determining whether, in the insolvency regime of the jurisdiction of the independent custodian, local creditors and customers are favored over foreign creditors and customers. Although that may be the case for foreign *cash deposits* in insolvency regimes in certain jurisdictions (including the United States), as a general matter our experience in the case of *securities* held by a custodian is that in the insolvency regime applicable to the custodian there is no material distinction in the treatment of local versus foreign creditors and customers.[6]

Undesirable Consequences

At the same time, the proposed requirement appears to have a number of undesirable consequences. One such undesirable consequence is the burden that would be placed on the

[5] 76 Fed. Reg. at 23,739. The Prudential Regulators did not specifically articulate the reason for the requirement regarding the jurisdiction of the custodian. The Prudential Regulators stated generally that requiring segregation of initial margin "is necessary to (i) offset the greater risk to the covered swap entity and the financial system arising from the use of swaps and security-based swaps that are not cleared and (ii) protect the safety and soundness of the covered swap entity." 76 Fed. Reg. at 27,579.

[6] The principle of non-discrimination between local and foreign creditors is embodied in section 13 of the UNCITRAL Model Law of Cross-Border Insolvency. Since being promulgated in 1997, the Model Law has been adopted in seventeen countries, including the United States when it enacted chapter 15 of the U.S. Bankruptcy Code.

parties to determine where the posting Swap Entity and the independent custodian are "located." Determining the location of an entity that may be organized or registered in one jurisdiction but has offices or operations in one or more other jurisdictions is often a complex inquiry. For the rule to be workable at all, the regulation would need to provide significantly more guidance as to how the location of a party is to be determined. To the extent that the inquiry requires a factual determination, such as where a person's principal office is located, where its central administration is conducted or what jurisdiction bears the closest relationship to the contract - all standards for determining location that are found in domestic laws and international treaties[7] - such a determination would require further due diligence and impose additional costs on the parties.[8]

A similar burden would arise in determining what insolvency regime would apply to each of the posting Swap Entity and the independent custodian and whether the insolvency regime applicable to each is the same. This determination is complicated when more than one insolvency regime could apply to the same entity.[9] The requirement that the posting Swap Entity and the independent custodian make these determinations as to the applicable insolvency regime *ex ante* as a condition to the Swap Entity entering an Uncleared Swap with another Swap Entity would place an extraordinary burden on the parties, and would be fraught with significant risk and uncertainty, without much greater guidance from the regulation. But, even with additional guidance, in a number of situations application of the Proposed Rule would impose significant due diligence costs on the parties.

A third undesirable consequence is that the rule would create barriers for posting Swap Entities and independent custodians. Even if it can be easily determined where a party is located and to which insolvency regime it is subject, the effect of the rule would be to limit the number of independent custodians with which a Swap Entity is able to post margin. Such a limitation would lessen price competition for the custodial business of Swap Entities, thereby creating an anti-competitive effect. Limiting the number of independent custodians at the same time their use becomes mandated seems to be a negative outcome unless important policy or market benefits are being realized. We do not believe that is the case here.[10]

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[7] *See, e.g.,* section 9-307 of the Uniform Commercial Code, Article 10 of the United Nations Convention on the International Sale of Goods (1980), and Article 5(h) of the United Nations Convention on the Assignment of Receivables in International Trade (2001).

[8] The interpretation of location - the "center of main interest"- of a company in a company group that is arguably centrally managed has proven especially problematic under section 17 of the UNCITRAL Model Law of Cross-Border Insolvency and under the European Union's Insolvency Regulation.

[9] For example, in the United States a registered broker-dealer could arguably be subject to an insolvency proceeding under the Securities Investor Protection Act, subchapter III of chapter 7 of the U.S. Bankruptcy Code or Title II of Dodd Frank. A nonbank subsidiary of a bank holding company could be subject to chapter 7 or 11 of the U.S. Bankruptcy Code, Title II of Dodd Frank or even a state court receivership or liquidation. A Swap Entity with multinational operations could be subject to both a main and a non-main insolvency proceeding, such as where a foreign entity is subject to an insolvency proceeding in its "home" jurisdiction but could also be subject to a proceeding under chapter 15 of the U.S. Bankruptcy Code.

[10] Of course, it might be argued that in such a case custodians that wish to enter the market will create custodial entities that are located in the same jurisdiction and are subject to the same insolvency regime in order to compete for the business in that jurisdiction. However, doing so will not be without costs to the custodian. Recovering those costs, for example, by charging higher fees, would place that custodian at a competitive disadvantage in relation to other custodians already operating in the jurisdiction. Moreover, we question whether encouraging that kind of entity rationalization for custodians is desirable if for

Conclusion

Dodd-Frank and the Proposed Rules already contain a number of provisions that would provide protection to posting Swap Entities, such as the prohibition on rehypothecation of margin assets by the independent custodian. Other regulatory guidance, such as the recently issued "Interagency Supervisory Guidance on Counterparty Credit Risk Management," also addresses issues related to the use of third-party custodians.[11] It is not necessary for a rule also to require that the posting Swap Entity be located in the same jurisdiction and be subject to the same insolvency regime as the independent custodian. Such a requirement would not achieve the goal of facilitating the return of the margin assets to the posting Swap Entity and would have undesirable consequences.

Once again, we appreciate the opportunity to provide comments to the Prudential Regulators and the CFTC on this issue in the Proposed Rules. We would also be pleased to have the opportunity to discuss this matter further with staff of the Prudential Regulators and the CFTC.

In addition to contacting the signatories below, please feel free to contact Gary Sims at The Bank of New York Mellon Corporation on +1.212.635.1688, or Simon Zornoza at State Street Corporation on +1.617.664.1541, if you should have any questions.

Sincerely,

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commercial, tax, regulatory or other reasons such entity rationalization would not be desirable. Doing so would be especially problematic if the requirement left the posting Swap Entity with less protection given the insolvency regime to which the posting Swap Entity is itself subject.

[11] See June 29, 2011 Interagency Guidance, page 14-15, which suggests policies and processes for monitoring margin agreements involving third-party custodians 1) identify the location of the account to which collateral is posted, or from which it is received, 2) obtain periodic account statement or other assurances that confirm the custodian is holding the collateral in conformance with the agreement, and 3) understand the characteristics of the account where the collateral is held (for example, whether it is a segregated account), and the legal rights of the counterparty or any third-party custodian regarding this collateral.