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Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

International Organization of Securities Commissions
C/Oquendo 12
28006 Madrid

Re: Margin Requirements for Non-Centrally Cleared Derivatives

Dear Sir or Madam:

We are grateful for the chance to participate in this consultation exercise. The events of the last few years have demonstrated that many of the risks that might in the past have been seen as no more than theoretical are in fact very real. That understanding justifies a renewed focus by regulators, legislators and market participants to ensure that the lessons of the crisis are learned.

As advisor to many of the world's largest investors and a global institutional investor ourselves we welcome efforts to improve investor protection. In particular, we have long been an active and vigorous proponent of more active and intelligent risk management in foreign currency markets, and of the important role of collateralization in the OTC marketplace.

However, we also recognize that success in investing requires thoughtful balancing of risks with return objectives, and often risk measures designed to mitigate or eliminate risks associated with investing introduce costs and risks of their own.

In this response we are focused on the proposal to require collateralization and margin movements for Foreign Exchange risk management. We believe that this additional investor protection is warranted for this marketplace in general, particularly for investors that do not have professional investment advisers or cannot otherwise avail themselves of other critical risk mitigation tools such as tenor management or counterparty diversification.

However, where investors can employ more comprehensive risk management techniques, we believe imposing mandatory collateralization and margining will remove important choices from institutional investors such as large pensions and other funds, with the unintended consequence that underlying beneficiaries will be exposed to reduced counterparty choice, increased costs, poorer execution and unmanaged foreign exchange volatility. We are in general supporters of collateralization, and have written research in the past proposing broader use of this tool by investors to more effectively manage risk, but would prefer that a degree of discretion be left to sophisticated investors to allow them to design programs that meet their needs.

For these reasons and as further outlined below, we recommend exceptions from the proposed collateralization and margin requirements for institutional investors that are advised by qualified professional asset managers or can otherwise demonstrate the ability to manage currency counterparty risk: not so that these institutions will then avoid (in particular) collateralization, but so that they can use these tools to manage their risks in a customized and specific way.

Our response uses the following structure:

- Russell's role in the FX marketplace, and our standing for commenting on this issue
- Russell's approach to Risk Management
- Margin in OTC markets in principle
- The role of choice in regulation
- Preserving choice while providing protection
- The role of tenor and counterparty diversification in currency exposure management
- Margin practicalities and costs

Russell's Role in the FX Marketplace

It is useful for contributors to consultation exercises to identify who they are, and why they feel justified in providing comments on the issues concerned.

Russell has a more than 75 year history in the investment industry. We work in a wide range of different component parts of the industry, from multi-manager and multi-asset portfolio management, through pension consulting and index construction, to trading a wide range of asset classes for clients on an agency only basis. We manage over $150 billion in direct investment mandates for customers globally, provide advice as consultants to clients with more than $2 trillion total assets, and trading on an agency-only basis for our clients in all major asset and exposure markets in the world, on both an exchange traded and OTC basis, trading more than $1.5 trillion for clients during 2011.

Our involvement in these businesses provides us with excellent insight into the broader context of the challenges that investors are facing.

Of direct relevance to this consultation exercise is our exposure to the currency marketplace. This has been a major focus of our firm, in particular over the last 10 years where we have been active in currency exposure risk management.

Agency execution of foreign exchange

Around 10 years ago we identified that the opaque, principal-dominated structure of the FX market offered enormous benefits to bank participants at significant costs to investment customers. Banks would trade with customers on a principal basis, often with little or no actual principal risk and a significant information advantage over their customers. We found this was producing outcomes that we felt could not be justified. To address this we developed an agency-only trading capability where our role in this is entirely as the clients' agent, seeking execution from a broad range of counterparties. We can offer improved price discovery, and as we never take a principal position of any kind, we therefore have no financial interest in any transactions with our clients or the funds we manage other than the fully disclosed fees we earn.

Currency exposure risk management

Russell provides currency risk management solutions to clients around the world, both on a stand-alone basis and as part of a broader fund management mandate. In this capacity we manage more than $38 billion of exposure. This exposure is typically implemented using currency forwards (with a current average tenor of 51 days), and with a wide range of counterparties to minimize counterparty risk. Again, Russell always acts as agent for the underlying client, and never takes the other side of these transactions.

It is worth noting that although the FX business is an important element of our service, it represents a very small component of our revenue and profits as a whole. Any changes to the current structure of this marketplace would be likely to have a relatively small effect to our financial results as a whole.

Because of our background and experience we believe that we have a unique position in this marketplace and can contribute insight from the perspective of our clients as to how they (and their peers) choose to manage currency risk and the issues involved in that risk management exercise.

Russell's Basic Approach to Risk Management

As with all other components of an investment portfolio, Russell's approach to risk management includes the consideration of a range of risks associated with currency exposures such as:

- As outlined above, Russell identified conflicts of interest where currency execution is delegated to a principal
- Delegation to a single counterparty also introduces counterparty concentration risk
- Foreign exchange transactions also entail typical settlement, counterparty and investment risks, which vary depending on the nature of the transaction (spot or forward), the duration or tenor of forward contracts and the various market factors affecting underlying currency exposure, all of which need to be considered in the context of the overall portfolio objectives and risk tolerances.

We believe that effective management of these risks is achieved by deliberate process management, counterparty management and exposure management, and that those tools should be available for investors who choose to use them. We are strong advocates for collateralization of all OTC transactions. In as much as these views benefit our business model the relationship is in fact more expansive: our business model has been designed to help investors manage risks in this way because we believe this can drive the best outcomes for them.

Margin in OTC Markets in Principle

Russell believes that margin plays a critical role in marketplaces. That role is well-highlighted in the consultation document to which we are responding. Managed correctly, margin provides counterparty risk mitigation that provides protection to both sides of the transaction in case of counterparty failure. The document correctly points out that for margin to be an effective risk mitigant, it needs to be both accessible at the time of need and in a form that can be liquidated rapidly in a period of financial stress at a predictable price.

The document also correctly identifies that the effects of margin requirements on liquidity are important and complex. We welcome the fact that these factors will be investigated further as outlined in Part C of the consultative paper. We would note, however, that the consultation paper is written with an eye to major market counterparties. The discussion of the effects of margin requirements is written as though all the market counterparties were securities firms. This ignores the possible effects on clients who participate in this marketplace to manage their risks. Any further work should reflect the effects on clients as well.

We believe that the market exists for all clients. There are two ways that liquidity can be reduced for those clients due to regulatory change:

- The counterparties with whom they trade may be affected by regulations in ways that affect the liquidity that they are able to or are prepared to provide to the marketplace
- The investor may be affected directly by regulatory change in a way that either directly reduces their ability to access a marketplace, or that increases their costs when accessing that marketplace in a way that makes it less practically effective as a solution

These can be thought of as liquidity effects due to constraint of supply and due to constraint of demand. What is important to note is that the latter is not true demand reduction – the investor would still (ceteris paribus) want to access the market, but is constrained by a new higher cost level or administrative burden from doing so.

The effect of both of these impacts, however, is that the risks that were managed by the investor are no longer being managed to the same extent. This is not a costless outcome for the ultimate beneficiary.

On the whole, however, Russell believes that margin plays an important role.. We move margin for customers every day due to margining obligations in a wide range of marketplaces, and are aware of the logistical implications and practicalities involved. We will discuss those logistical and practical implications later in this document.

As previously mentioned, we are enthusiastic supporters of collateralization, and have the view that all OTC contracts should be collateralized as a matter of good practice and risk management.

We do, however, oppose the blanket extension of compulsory collateralization and margining to the FX markets, and specifically to FX swaps and forwards with a tenor of less than 12 months.

The Role of Choice in Regulation

A good initial presumption of regulation is that competent investors should be free to enter into investment arrangements that they deem to meet their needs without excessive restriction providing that there are no broader market structure implications raised by those transactions and providing that processes and structures are in place to ensure fair dealing and honesty between market participants.

Regulations that restrict investor choice for competent investors impose a real cost on those investors, as they force the following problems:

- Increased cost of regulation compliance functionality
- Reduced availability of counterparties and potential sources
- Suboptimal investment strategies being adopted by necessity where optimal approaches are too costly or not available

The decision to restrict investor choice should not be taken lightly.

This is particularly true when the question being considered relates to the risk management and mitigation processes relevant to the collateralization and margining issues. Removing the ability to determine the appropriate application of these tools in the risk management process from investors as part of a scheme designed to protect those investors may not be the best approach.

Preserving Choice while Providing Protection

Our main focus is on this key issue of choice.

We wish to ensure that institutional investors who choose to adopt appropriate structures to allow them to manage risk through use of a range of currency forwards, swaps and other similar OTC vehicles continue to be able to do so, as long as appropriate protection is in place to ensure that the decisions involved are being made in an informed and appropriate fashion.

The risk that is being protected against in this case is the risk of counterparty failure. There is a range of ways that well informed and well advised investors can protect themselves against that risk: compulsory margining and collateralization is only one of them, and is one of the more constraining and expensive

possible approaches. By ensuring that the client has an adequate advisory structure in place they can adopt the range of solutions that match their needs and beliefs. These solutions include collateralization, and may well include some form of margining: details of the correct combination of solutions should where practical be left to the well-advised investor to determine.

Preserving this choice in this instance has genuine financial and prudential value for those clients who have appropriate advisory structures in place. Removing that option is not in the interests of those clients, nor of their beneficiaries.

The Role of Tenor and Counterparty Diversification in Currency Exposure Management

Tenor management is an important tool in the counterparty risk management process.

The markets have evolved to a relatively clear view on the relationship between increasing tenor and risk. Bank counterparties typically require bi-lateral collateralization on contracts that have tenors of greater than 12 months. Shorter term exposures with high quality institutions tend to be treated differently, and do not require collateralization or margining. Shorter term contracts represent the majority of the exposure in the marketplace, with 65% of exposure having a maturity of less than one year in the 2010 BIS Triennial Central Bank Survey.

This market-driven distinction demonstrates that investors appear to have reached a rough consensus on the relative relationship between tenor and risk. By carefully controlling the tenor mix within their exposure set investors can reduce or increase the risk to which they're exposed.

Tenor diversification can, and should, be combined with counterparty diversification to ensure appropriate risk mitigation. Institutions who trade long dated (non-spot) exposures with only a small group of counterparties (or even a single one) are clearly concentrating the risk of counterparty failure, and investors should therefore establish a broad network of counterparties, and carefully allocate their risks across that network to ensure appropriate protection through diversification. Russell, for example, has established trading relationships with a large panel of banks on behalf of our clients, to ensure that we are able to harvest the benefits of this counterparty diversification for them.

Investors (or their advisors) who combine tenor management and counterparty diversification are able to perform very effective risk management, without necessarily incurring the costs of moving collateral or margining. It is likely for most or all of these sophisticated investors that there will be some form of collateralization used, and Russell certainly is of the view that collateralization is important, in particular as the counterparty to these trades is likely to be a highly complex financial institution with very diverse and unpredictable risks: however, as long as there is appropriate advice in place, and as long as there are clear and meaningful disclosures, the exact nature of that collateralization, and the use of margining and other techniques should where possible be left within the discretion of that investor.

It should also be noted that there are mechanisms in place to move exposure away from counterparties that become the subject of concern. A process known as NPV (net present value) allows the current gain or loss in a contract to be calculated in current money terms, and the contract closed out with the payment of the resulting money. This early-break mechanism allows investors very fine-grained control over their exposures even in rapidly changing market environments, although in such environments exercising that control may require more skill, and may be more costly.

Margin Practicalities and Costs

There will be significant negative impacts on pension funds if they are required to post margin on currency swaps and forwards.

It is important to remember that the primary role of these instruments is risk mitigation. Almost all investors now have significant exposure to international assets, and this exposure carries with it a commensurate currency risk. This risk can contribute volatility to the portfolio, and is generally regarded as an essentially uncompensated risk. Currency swaps and forwards are primarily used to reduce the fund's exposure to this risk, rather than to take speculative positions. They do, of course, create an exposure to the counterparty in the transaction, in by doing so create a credit risk exposure which itself has no inherent return. These uncompensated risks do have consequences.

Enforcing a margin requirement would potentially cause problems for end clients, in particular in relation to the instruments they would be able to hold. The requirement to participate in margining and collateral movement would generally require the end client to hold higher levels of cash than they would otherwise choose to – this would represent an investment drag on the fund. They might also choose to hire a firm that offers a collateral management service, which would coordinate the collateral movement between different investment manager accounts and bank counterparties. Hiring a collateral manager would require an additional fee, and this cost combined with the cost of over-allocation to liquid cash-like assets materially disadvantages clients.

A worse situation might be faced for smaller clients, who are typically invested by means of pooled vehicles, which are unlikely to be able to be used for collateral purposes. It is quite likely that this would result in many of these clients simply ceasing to manage their currency risk because of this.

The results of compulsory margining and collateralization, then, would be suboptimal. While there would be some degree of greater protection for clients without an appropriate advisory and decision structure in place, this could come at the price of a likely lower propensity to mitigate the currency risks involved in global investment. Although this might be a reasonable tradeoff for clients without an appropriate advisory and decision structure in place, for clients who are well advised by an asset manager (whether internal or external) the risk would already be one that was being managed, while the costs would be real, and the likelihood of increased exposure to currency risk high.

We would also note that the proposed possible levels of initial margins appear to be significantly higher than what we would consider reasonable. The initial margin on a EUR/USD futures contract traded on the CME is around 2% of the notional value of the contract for investors that are considered as hedgers – this is materially lower than the proposed level for FX in the current discussion.

Conclusion

We would summarize our views on this topic in the following way:

- We believe that it is vital to recognize that most end-investor activity in the FX market is designed to mitigate the risk of currency volatility in underlying portfolio holdings. Restrictions on accessing this market will tend to reduce the degree to which these risks can be mitigated and managed by the investors concerned. While the mitigation of those risks by the use of the FX markets clearly creates an uncompensated credit exposure, it is important that the underlying goal of the exercise be kept in mind.
- We believe that investor protection can be enhanced by the introduction of compulsory margining and collateral requirements on investors who have neither the experience to manage their currency risk nor independent advisors in place to provide advice on the risk management tools needed. However, making this compulsory on all investors would create serious problems for certain end-clients who would not be able to comply with this regulation due to the structure of their plans, or the economic effect of the regulation, and who would therefore be forced to discontinue their hedging programs, thereby exposing their underlying beneficiaries to greater currency risk than before.
- We believe that there are other tools than compulsory margining and collateralization available to mitigate the risk of holding currency forwards. Investors who do have independent advice in place, and who are therefore able to understand the details of the risk management tools that the Foreign Exchange market provides, should not be required to comply with compulsory margining and collateral management requirements, as the risks these are designed to mitigate may be more effectively managed and mitigated using a tailored combination of those and other risk management tools.

We would be delighted to answer any questions that you might have on this response, or the issues involved.

Best Regards,

Brian C. Golob
Global General Counsel
Russell Investments