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Wayne Byres
Secretary General
Basel Committee on Banking Supervision
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David Wright
Secretary General
International Organization of Securities Commissions
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Re: Margin Requirements for Non-Centrally-Cleared Derivatives

Dear Mr. Byres and Mr. Wright:

State Street Corporation ("State Street") appreciates the opportunity to provide comments on the Consultative Document titled "Margin Requirements for Non-Centrally-Cleared-Derivatives" published by the joint Working Group on Margining Requirements ("WGMR") of the Basel Committee on Banking Supervision ("BCBS") and the International Organization of Securities Commissions ("IOSCO").[1]

State Street is one of the world's leading providers of financial services to institutional investors including investment servicing, investment management and investment research and trading. With $22.4 trillion in assets under custody and administration and $1.9 trillion in assets under management at June 30, 2012, State Street operates in 29 countries and more than 100 geographic markets.

[1] Margin Requirements for Non-Centrally-Cleared Derivatives, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, July 2012, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD387.pdf

State Street strongly supports the efforts of regulators to reach global agreement and consistency in relation to margin for non-centrally-cleared swaps, and agrees with the WGMR on the benefits of such margin, both to reduce systemic risk and to promote central clearing. We also appreciate the acknowledgement by the WGMR that the benefits of margin requirements need to be balanced against their liquidity impact, and support proposals in the Consultative Document to establish thresholds to mitigate this impact.

Furthermore, it is critical that regulators consider the combined impact of new swaps margin requirements and numerous other new regulatory initiatives, such as AIFMD and UCITS V in the EU, as well as new global Basel III requirements, do not impede the efficient function of global cash, securities and derivatives markets.

Our comments today, however, focus on several concerns we have with the proposed approach described in the Consultative Document.

First, we strongly urge the WGMR to exempt foreign exchange swaps and forwards from the proposed margin requirements. Applying mandatory margin requirements to non-centrally-cleared foreign exchange swaps and forwards is unnecessary, will not reduce systemic risk, will significantly increase scarcity of available eligible collateral, and will disrupt crucial and well-functioning foreign exchange markets.

Second, we strongly support the use of third party custodians as a highly effective means to protect provided margin, and disagree with the comments in the Consultative Document suggesting such arrangements may not provide suitably prompt access to assets for swaps counterparties. In addition, we suggest the WGMR provide some clarity regarding the treatment of cash collateral held under such third party custody agreements.

Finally, we suggest the WGMR provide, consistent with the overall goals of its proposals, additional guidance and greater flexibility for low-risk, real-money asset managers, such as US mutual funds and EU UCITS.

More detailed commentary for each of these areas follows.

Treatment of Foreign Exchange Swaps and Forwards

State Street strongly opposes mandatory margin for foreign exchange forwards and swaps.

Such transactions are distinctly different than other types of swaps, involving the straightforward exchange of currencies on fixed and pre-determined terms in a highly transparent and liquid global marketplace. The vast majority of foreign exchange forwards and swaps are short-dated, resulting in minimal credit risk between counterparties. While settlement risk is an important consideration with foreign exchange swaps and forwards, it has largely been addressed, at the urging of regulators, through creation of the CLS Bank International. As a result, foreign exchange forwards and swaps do not significantly contribute to the interconnectedness or systemic risk concerns the margin rules are intended to address.

Applying mandatory margin rules to foreign exchange forwards and swaps could, however, have significant negative effects on the global economy. Foreign exchange forwards and swaps are a critical source of funding and liquidity in the global marketplace, and foreign exchange markets are critical to the global payments system, supporting all cross-border trade and investment. Applying unnecessary margin rules to foreign exchange forwards and swaps would undermine the ability of foreign exchange markets to support this critical global activity.

In addition, given the size of global foreign exchange markets and the volume of foreign exchange forwards and swaps, applying unnecessary margin rules and the associated segregation regimes would greatly increase the demand for high quality collateral, exacerbating the liquidity impacts the WGMR is seeking to minimize.

As a result, State Street urges the WGMR to exclude foreign exchange swaps and forwards from the global agreement on margin requirements for non-centrally-cleared derivatives.[2]

Third Party Custody

State Street strongly supports the use of third party custody arrangements to protect provided margin, and disagrees with the suggestion in the Consultative Document that access to assets held by third party custodians may be "limited or practically difficult."

The use, uniformity and effectiveness of tri-party custody agreements for derivative collateral arrangements have increased significantly in the last several years.[3] These agreements universally include provisions for segregating margin on the custodian's records, custodian acknowledgement of the collateral taker's lien, frequent and direct reporting of account balances to the collateral taker, and explicit provisions for the delivery of margin to the certifying party without the approval or consent of the collateral giver. These last provisions include certification language that leaves no discretion to the custodian in delivering margin to the certifying party, typically within one business day after receipt of the certification.

Under current tri-party custody agreements, custodians do not have the right to re-hypothecate margin or other assets held on behalf of their clients or collateral takers. Instead, they typically have a custodial lien on assets for their fees and expenses, which is waived or subordinated with respect to margin in a tri-party custody agreement. Under the terms of a tri-party custody agreement, the custodian is contractually bound to follow the instructions of the certifying party, may not allow its customer to direct the disposition of the margin without the collateral taker's agreement, and is fully liable to the collateral taker for its failure to follow the terms of the tri-party custody agreement. Any concerns regarding the ability of a custodian to satisfy its obligations to the collateral taker in the event it fails to follow the terms of a tri-party custody agreement should be addressed through prudential supervision of the custodian.

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[2] See September 28, 2012 comment letter from the Global Foreign Exchange Division of the Global Financial Markets Association for more details.

[3] Note that the U.S. CFTC has recently decided to permit the use of third-party custodian arrangements for initial and excess margin posted with an FCM in relation to cleared swaps, taking a position contrary to its current interpretation of the rules related to futures (which is also under review). Note also that the U.S. Congress has enacted legislation requiring the option of third-party custody of initial margin for all uncleared swaps, a provision expanded upon in pending U.S. regulatory proposals.

In response to the WGMR's question regarding possible "concentration risk" amongst custodians, we note that there are a significant number of major banks that provide custody services globally. Custody banks are among the most highly capitalized and highly rated in the financial services industry. Several of the largest have also been designated as global systemically important banks and face enhanced prudential, reporting and resolution requirements.

From an operational perspective, non-cash assets are segregated from the custodian's own assets and are typically held in book entry form in central securities depositories. They are therefore bankruptcy remote from the custodial bank. For cash collateral, custodial banks typically offer a variety of cash investment options, including bank deposits, segregated cash management accounts, and short-term investment funds, which allow swaps counterparties the ability to manage exposure to the custodial bank and diversify risk.

We urge the WGMR to clarify that properly structured third-party custody arrangements are highly effective in providing protection of posted margin.

In addition, we suggest the WGMR provide additional guidance regarding the treatment of cash held under third-party custodial arrangements offered by banks. As noted above, such cash can be held as a bank demand deposit, making it immediately available to the counterparties, subject to the terms of the swap and the tri-party custody agreement. Such deposits are reflected on banks' balance sheets, appearing as bank liabilities to the depositor and as bank assets subject to investment under the bank's asset liability management procedures. Depositors universally take some element of bank credit risk when placing deposits with a bank, which are minimized by the bank's prudential regulation. Prohibiting banks from treating cash collateral in tri-party custody accounts as traditional banking deposits would lead to higher costs for counterparties availing themselves of the protections offered by third-party custody, with no corresponding benefit in risk reduction. We suggest the WGMR clarify that the use of bank deposits for cash collateral under third-party custody arrangements does not constitute "re-use" of collateral by a custodial bank offering third-party custody services.

Asset Managers

Pooled investment funds, including "real-money" managers such as US registered mutual funds and EU UCITS funds, regularly use swaps for a variety of purposes, including hedging, managing cash, adjusting durations, or otherwise managing the fund's portfolio. Such registered funds hold significant assets and are subject to stringent regulatory requirements and limitations. As a result, such registered funds are generally considered low risk credit counterparties in the marketplace.

Absent regulatory clarification, such funds could face unique challenges in complying with the emerging new margin requirements for non-centrally-cleared swaps. For example, we urge the WGMR to confirm that margin requirements will apply at the individual fund level, rather than somehow aggregated at the adviser level. In addition, we note the WGMR is considering allowing higher initial margin thresholds for "prudentially regulated entities," due to such

entities' lower credit risk. We recommend the WGMR extend this treatment to other lower risk counterparties subject to stringent regulation, such as registered funds. Finally, we suggest the WGMR provide sufficient flexibility to allow, under suitable local regulations, other types of counterparty protection in lieu of margin when appropriate, such as the liens on assets of investment funds.

Once again, State Street supports the goals of the Consultative Document, and believes global coordination of margin requirements will be critical to the success of the emerging new regulatory framework for swaps. We appreciate having the opportunity to comment on the proposed approach, and are available to answer any questions.

Sincerely,

Stefan M. Gavell