Association of Institutional INVESTORS™

March 15, 2013

Secretariat of the Basel Committee on Banking
Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland
Sent by email to: baselcommittee@bis.org

Secretariat of the International Organization of
Securities Commissions
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Spain
Sent by email to: wgmr@iosco.org

Re: Margin Requirements for Non-Centrally Cleared Derivatives

Ladies and Gentlemen:

The Association of Institutional INVESTORS (the "Association") appreciates the opportunity to comment on the second consultative document titled, "Margin Requirements for Non-Centrally Cleared Derivatives,"[1] 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").

The Association includes some of the oldest, largest, and most trusted investment advisers in the United States. Our clients are primarily institutional investment entities that serve the interests of individual investors through public and private pension plans, foundations, and registered investment companies. Collectively, our member firms manage ERISA pension, 401(k), mutual fund, and personal investments on behalf of more than 100 million American workers and retirees. Our clients rely on us to prudently manage participants' retirements, savings, and investments. This reliance is built, in part, upon the fiduciary duty owed to these organizations and individuals. We recognize the significance of this role, and our comments are intended to reflect not just the concerns of the Association, but also the concerns of the companies, labor unions, municipalities, families, and individuals we ultimately serve.

[1] Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, *Margin Requirement for Non-Centrally Cleared Derivatives: Second Consultative Document*, February 2013; *available at* http://www.bis.org/publ/bcbs242.pdf [hereinafter Second Consultative Document].

Exempting Physically-Settled FX Forwards and Swaps from Initial Margin Requirements

The Association is supportive of the positions espoused by the Global Foreign Exchange Division ("GFXD") of the Global Financial Markets Association ("GFMA") in their letter submitted in response to the first consultative document issued by BCBS and IOSCO in July 2012,[2] as well as in their letter submitted in response to the Second Consultative Document, related to foreign exchange ("FX") transactions. We agree that physically-settled FX forwards and swaps are qualitatively distinguishable from other OTC derivatives and therefore should be exempted from any rules mandating the exchange, collection, or posting of initial margin between transacting parties on a mandatory basis.

Initial margin requirements are intended to "reduce contagion and spillover effects by ensuring that collateral are available to offset losses caused by the default of [a] derivatives counterparty."[3] The most significant systemic risk concern associated with FX transactions is settlement risk, which is already addressed through multi-currency cash settlement systems like CLS. Unlike, for example, interest rate swaps, credit risk is a relatively minor concern for FX transactions, particularly for the short-dated FX forwards and swaps that comprise the vast majority of the market. As a result, initial margin for such FX transactions is unnecessary.

The Association believes there are also potentially significant unintended consequences that would result from applying mandatory margin rules to FX transactions. Foreign exchange forwards and swaps provide liquidity to the global marketplace, supporting cross-border trade and investment. Applying unnecessary initial margin requirements would discourage trading in these products, adversely affecting critical global trade and cross-border activities. Additionally, the segregation regimes associated with the margin rules could also increase the demand for high-quality collateral, further reducing liquidity in the market.

Re-Hypothecation and FX Transactions

The Second Consultation Document's proposed margin framework also discusses the re-hypothecation of collateral. Generally, it argues that the risk that the party posting initial margin will be exposed to loss if its counterparty defaults is mitigated by generally prohibiting the re-use (or "re-hypothecation") of collateral held as initial margin. The WGMR asks for comments, however, regarding whether re-hypothecation should be permitted in certain circumstances, such as where: (i) collateral can only be re-hypothecated to finance/hedge customer, non-proprietary positions, (ii) the pledgee treats re-hypothecated collateral as customer assets, and (iii) the applicable insolvency regime allows customer first priority claims over the pledged collateral.[4]

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[2] Letter from James Kemp, Managing Director, Global Foreign Exchange Division, GFMA to the Basel Committee on Banking Supervision Bank for International Settlements and the International Organization of Securities Commissions (Sept. 28, 2012), *available at:* http://www.bis.org/publ/bcbs226/ggfd.pdf.
[3] Second Consultative Document at 12.
[4] Second Consultative Document at 19.

Given the sophistication of participants in these markets, the Association believes parties required to post initial margin should have the choice to decide whether to restrict re-hypothecation. In certain situations, for example, a firm may have requirements in place that enable it to absorb losses on margin, and may determine it is appropriate to permit re-hypothecation in order to trade in a cost-effective manner.

Parties should also be able to elect for required initial margin to be held by a third-party custodian. The Association believes such arrangements effectively protect posted margin. Under current tri-party custody agreements, custodians may not re-hypothecate margin or other assets held on behalf of their clients or collateral takers. Rather, the custodian is contractually obligated to follow the instructions of the certifying party and may not allow its customer to direct the disposition of the margin without the collateral taker's agreement. The custodian is also fully liable under these arrangements to the collateral taker for its failure to follow the terms of the tri-party custody agreement. Many of the Association's members believe these arrangements, while potentially more costly, should be required to be offered by dealers as an option going forward. Further, under the United States' Dodd-Frank Act, such arrangements must be available as an option to a counterparty, at the counterparty's request.[5]

Conclusion

The Association supports WGMR's goals of creating a coordinated, appropriate margin regime and believes such a regime is critical to the success of the international swaps regulatory framework. We appreciate having the opportunity to comment on the second consultative document and look forward to working with the WGMR as it completes its work. Please feel free to contact me with any questions you may have on our comments at jgidman@loomissayles.com or (617) 748-1748.

Very truly yours,

John Gidman,
President, Association of Institutional INVESTORS

[5] *See* Section 724 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), Pub. L. No. 111–203, 124 Stat. 1376 (2010).