



Pension Investment
Association of Canada
Association canadienne des
gestionnaires de caisses de retraite



Association Européenne des Institutions Paritaires
European Association of Paritarian Institutions

Association Internationale de droit belge - aisbf - 1919

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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
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Re: Comments on Consultative Document: Margin requirements for non-centrally-cleared derivatives, issued by the Working Group on Margining Requirements of the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions (July 2012)

The American Benefits Council (the “Council”), the Committee on Investment of Employee Benefit Assets (“CIEBA”), the European Federation for Retirement Provision (“EFRP”), the European Association of Paritarian Institutions (“AEIP”), the National Coordinating Committee for Multiemployer Plans (“NCCMP”), and the Pension Investment Association of Canada (“PIAC”) (together, the “Global Pension Coalition”) appreciate this opportunity to provide comments to the above referenced consultative document regarding margin requirements for uncleared swaps.

In July 2012, the Working Group on Margining Requirements of the Basel Committee on Banking Supervision (“BCBS”) and the Board of the International Organization of Securities Commissions (“IOSCO”) (together the “Working Group”) issued a Consultative Document titled “Margin requirements for non-centrally-cleared derivatives” (the “Consultative Document”). The Global Pension Coalition appreciates the opportunity to provide its views on the very important issues addressed in the Consultative Document.

The Global Pension Coalition represents a very significant portion of the largest private defined benefit and defined contribution pension plans in the U.S., Canada and Europe as well as the companies that sponsor those pension plans. The pension plans represented by the Global Pension Coalition provide retirement benefits for over a hundred million individuals in more than a dozen countries. Unlike some other market participants that may take risks with derivatives for business and competitive reasons, pension plans do not have such business or competitive motivations and exist solely to provide retirement security for pensioners and utilize derivatives primarily¹ to hedge market risks which could jeopardize such retirement security.

In addition to being important to millions of pensioners throughout the world, pension plans provide a crucial source of stable liquidity to the derivatives markets and their continued participation in these markets is welcome and needed by other market participants. Because they are highly creditworthy and liquid counterparties, with low or practically no leverage, pension plans actually reduce systemic risk by their participation in the derivative markets. If pension plans stopped participating in these markets, such markets would be less liquid and, therefore, riskier.

We believe that these systemic risk reducing characteristics of pension plans need to be taken into consideration as global regulators adopt margin requirements for uncleared swaps. The Global Pension Coalition is grateful that the international regulators are seeking to coordinate their margin standards for uncleared swaps because we strongly believe that consistent international regulation of derivatives margining is essential to smooth and efficient markets. Accordingly, we appreciate the opportunity to comment on the Consultative Document.

We favor several Elements set forth in the Consultative Document. First, we agree that when margin is required it should be a two-way obligation, at the option of the pension plan. Pension plans need the ability to mitigate counterparty risk through collateral posting the same way a financial institution protects and manages the same risks. Second, we believe, as set forth in the Consultative Document, that the type of permitted collateral for uncleared swaps should be broad enough to ensure that there is sufficient eligible collateral available to market participants. Finally, we strongly support the principles of collateral protection set forth in the Consultative Document and plans believe that buy-side clients should be offered the option to segregate collateral by pledging such collateral through a third-party custodian of their choosing subject to arrangements that fully protect the posting party if their counterparty enters bankruptcy.

However, the Consultative Document lacks clarity in several important areas, such as what types of entities would be subject to uncleared swap initial margin requirements. We do not support subjecting all entities defined as “financial entities” to the same margin requirements without regard for the entity structure and systemic risk profile. As discussed below, we respectfully submit that pension plans should be

¹ Although pension plans in some jurisdictions may at times use derivatives to gain market exposure, as described above, the predominate use is for hedging purposes. In some other jurisdictions, pension plans are expressly prohibited from using derivatives to gain market exposure.

excluded from any uncleared swap initial margin requirements. We are also recommending changes to the specifications for calculating initial margin.

Given the importance of the Consultative Document's suggested framework to pension plans and other market participants, once the Working Group issues its ultimate recommendation, the Global Pension Coalition strongly encourages all regulators to incorporate the appropriate aspects of the final BCBS/IOSCO approach, as outlined below.

SUMMARY

We support the goals of protecting the financial system from systemic risk. Imposing margin requirements, particularly on riskier counterparties, will help toward achieving that goal. However, requiring initial margin of highly regulated, highly creditworthy, lightly leveraged and prudently managed counterparties such as pension plans, which use swaps primarily for hedging, will unnecessarily increase the cost of hedging for pension plans without providing a meaningful benefit to the stability of global financial markets. In fact, if such margin requirements result in pension plans exiting or reducing their participation in the derivatives markets, such margin requirements could actually increase systemic risk globally.

We believe that, under a risk-based approach to initial margin, pension plans present virtually no risk to dealers and thus should not be required to post initial margin with respect to uncleared swaps. Unnecessary initial margin requirements could cause pension plans to alter their investment decisions simply to ensure that they can cover initial margin requirements. This may create a barrier to entry to the swap markets for pension plans that does not exist today and, therefore, limit their hedging options. This change could effectively preclude pension plans from hedging and mitigating risks, such as the funding risk for a pension plan.

The Consultative Document suggests a general framework consisting of seven concepts (referred to as “Elements”) to be addressed in uncleared swap margin rules to be proposed later by the Working Group. The framework addresses, very generally, the following topics and provides some conceptual discussion of each:

- Which transactions should be subject to margin requirements
- What types of entities should be subject to margin requirements
- Methods for calculating initial and variation margin
- Types of acceptable collateral
- Protection of collateral collected as initial margin
- Treatment of inter-affiliate transactions²
- Interaction of national regimes in cross-border transactions

² We are not providing any comments on Element 6 at this time.

These issues are of great importance to our members, to the workers and retirees relying on pension plans, and to the economy. We look forward to working with the Working Group and all regulators to ensure that any new rules strengthen financial regulations in a manner that enhances retirement security. It is critical that the new rules not be developed in a way that unintentionally weakens such security.

1. All Uncleared Margin Rules Should Be Consistent With The Working Group's Final Rules. Market Participants Should Be Allowed To Comment On The Working Group's Quantitative Impact Study

The Global Pension Coalition believes that all regulators should allow market participants to comment on the Working Group's Quantitative Impact Study and, for rules already proposed, should repropose their uncleared margin rules consistent with the Working Group's final proposal.

The Consultative Document provides only a framework for uncleared swap margin requirements. "Importantly, the framework discussed in the Consultative Document does not represent a final proposal."³ There is little doubt that the Consultative Document will be followed by a proposal that incorporates the knowledge that the Working Group gathers from the comments on the Consultative Document. Market participants deserve an opportunity to comment on the final rule proposal ultimately settled on by the Working Group prior to any regulator proceeding with uncleared margin requirements.

Indeed, the Working Group intends to conduct a Quantitative Impact Study that will inform its final proposal. The Working Group believes the study "will provide incremental information that will be informative and useful for balancing the need to impose margin requirements to reduce systemic risks and promote central clearing against the liquidity costs stemming from these requirements."⁴ It is essential not only that all regulators consider the Quantitative Impact Study in their rulemaking, but also that the public be afforded the opportunity to comment on the study prior to proceeding with their own uncleared swap margin requirements.

2. Scope Of Coverage

a. Element 1⁵ – Extending Uncleared Margin Requirements To All Uncleared Derivatives Is Inconsistent With a Risk-Based Mandate

³ Consultative Document, p. 5.

⁴ Consultative Document, p. 31.

⁵ The Consultative Document is organized by Elements 1-7. Each Element sets out a "key principle" accompanied by a "proposed requirement" describing how the key principle would be implemented. The Consultative Document also asks a number of specific questions, some of which we specifically address.

The key principle for Element 1 is that “[a]ppropriate margining practices should be in place with respect to all derivative transactions that are not cleared by CCPs.”⁶ The proposed requirement is that the margin requirements would apply to all uncleared swaps.⁷

Although we do not disagree that market participants should have credit support agreements, margin should not be required in all cases. As discussed in more detail below, we believe that pension plans should be excluded from uncleared swap initial margin requirements under a risk-based approach.

This type of risk-based approach is also consistent with the treatment of pension plans’ swap activities in Europe. At the European level, a (temporary) exemption from mandatory clearing requirements of swaps has been included in the European Markets Infrastructure Regulation (“EMIR”).⁸ This exemption ensures that pension scheme arrangements, as defined therein, can continue to hedge their risks without a disproportionate impact on costs as long as no solution has been found to post variation margin in a form other than cash. In addition, the credit valuation adjustment charge that will be imposed on banks for bilateral uncleared derivatives trades will not apply to trades between banks and pension scheme arrangements during the period of the abovementioned exemption. With this exception, European lawmakers have recognized the creditworthiness of pension scheme arrangements and have made it clear that the positive effect from the EMIR clearing exemption should not be negated by capital charges for banks.

It is for these same reasons that no initial margin requirements should be imposed on pension plans for uncleared swaps.

b. Element 2 – Pension Plans Should Not Be Subject to Initial Margin Requirements Due to Their Unique And Extremely Low Risk Profile

Element 2 sets forth a key principle that “financial firms and systemically-important non-financial entities” should “exchange initial and variation margin as appropriate to the risks posed by such transactions.”⁹ The proposed requirement adds that margin should be exchanged in “minimum mandatory amounts,” which is apparently intended to mean that swap dealers cannot extend credit to their counterparties “for the sole purpose of funding initial margin requirements.”¹⁰ Thus, Element 2 suggests that

⁶ Consultative Document, p. 7.

⁷ *Id.*

⁸ Regulation (EU) No. 648/2012 of the European Parliament and of the Council of 4 July, 2012 on OTC derivatives, central counterparties and trade repositories. In this letter, where reference is made to such exemption, or alternatives thereto, “pension plans” should be read to mean “pension scheme arrangements” as defined in EMIR Article 372a of the proposed Capital Requirement Regulation (the European implementation of Basel III). “Pension scheme arrangements” within the meaning of EMIR includes not only pension plans, but also legal entities set up for the purpose of investment of such institutions (acting solely and exclusively in the interest of the pension plan).

⁹ Consultative Document, p. 14.

¹⁰ Consultative Document, p. 14, n. 9.

margin requirements should be risk-based and should apply to “financial firms,” a term that is not defined.

We agree that uncleared swap initial margin requirements should be risk-based. Pension plans are highly regulated, highly creditworthy, low leveraged and prudently managed counterparties that use swaps primarily¹¹ for hedging and pose virtually no risk to their dealer counterparties. Accordingly, under a risk-based approach, we believe it would be reasonable for regulators to conclude that pension plans should not be required to post initial margin on their uncleared swaps. In fact, pension plans rarely, if ever, post an independent amount (*i.e.* initial margin) to transact in the OTC markets.¹²

The Consultative Document would apply uncleared swap initial margin requirements to “financial firms.” Although that term is not defined, the ordinary meaning of the term “financial firm” (at least prior to enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act in the United States) would mean banks and other large firms with a financial business, such as hedge funds and mutual funds, but not pension funds. To the extent BCBS and IOSCO intend the term “financial firm” to include pension plans, we think such a broad approach is not consistent with a risk-based standard. As noted above, some other market participants may take risks with derivatives for business and competitive reasons. These types of counterparties’ derivative activities can add to systemic risk. Pension plans do not have such business or competitive motivations and exist solely to provide retirement security for pensioners and utilize derivatives primarily to hedge risks that could jeopardize such retirement security; thus, they pose minimal if any risk, certainly far less risk than “other” financial firms.

Question 12 in the Consultative document asks whether there are “specific exemptions that would not compromise the goal of reducing systemic risk and promoting central clearing that should be considered.”¹³ We believe that an exemption for pension plans from initial margin requirements on uncleared swaps is the kind of exemption that will not compromise those goals. As previously noted, pension plans are highly regulated, highly creditworthy, low leveraged and prudently managed counterparties that use swaps primarily for hedging. Pension plans are exactly the type of counterparties whose swap activity does *not* increase systemic risks. Pension plans’ derivative activities can be viewed as reducing systemic risk because (i), as perhaps the safest of counterparties, they provide prudent counterparty diversification for dealers and (ii) pension plans’ long term perspective gives them the opportunity to be a stabilizing liquidity source to the markets during times when there is a short term lack of liquidity. Notably, recognizing the soundness of pension plans, European regulators have determined to exempt pension plans from mandatory clearing requirements to avoid a

¹¹ See, *supra*, note 3.

¹² Exhibit A summarizes the key reasons that U.S.-regulated ERISA plans present virtually no counterparty risk. Exhibit B summarizes the key reasons that Canadian pension plans present virtually no counterparty risk. Exhibit C summarizes the key reasons that pension plans established in Europe Union member states present virtually no counterparty risk.

¹³ Consultative Document, p. 16.

disproportionate cost impact.¹⁴ Further, no capital charges will be imposed on banks for their uncleared derivatives trades with pension scheme arrangements.¹⁵ Further, exempting pension plans from uncleared swap initial margin requirements will not compromise the goal of promoting central clearing.

The intent of promoting central clearing is to reduce systemic risk by mitigating exposure to risky counterparties for standardized products. However, not all swaps will be clearable. In fact, for some period of time, *many* swaps will not be clearable. Some pension plans have obligations that can only be effectively hedged with customized transactions that are not clearable. Thus, onerous margin requirements will impede the ability of such pension plans to hedge their liabilities, increase costs and ultimately reduce long term returns for pension plans. The current trend is that plan sponsors are terminating defined benefit pension plans and shifting investment risk back to individuals; adding additional cost burdens will likely lead to the inability of plan sponsors to effectively hedge pension liabilities in a cost effective manner and could lead to further plan sponsor actions shifting risk to individuals. We do not believe the result of the uncleared swap margin proposals should be to take away the ability of pension plans to cost-effectively use customized hedges for plan liabilities.

Alternatively, Pension Plans Should Be Permitted Unlimited Initial Margin Thresholds

Much of the discussion of Element 2 focuses on initial margin thresholds and various ways thresholds could be used. We support the notion that thresholds should be permitted to reflect the risks posed by specific counterparties. As noted above, we strongly believe that pension plans should be completely exempt from initial margin requirements for uncleared swaps and believe a risk based approach to margin supports such a result. However, if pension plans are subject to uncleared swap initial margin requirements, dealers should be able to provide initial margin thresholds for pension plans.¹⁶ Further, the rules should not provide arbitrary maximum limits on thresholds; dealers should be permitted to make a case-by-case determination based solely on counterparty risk.

Although not entirely clear, the Consultative Document seems to suggest that only prudentially-regulated entities should be permitted initial margin thresholds. Similar treatment should be extended to pension plans, because funding requirements imposed on

¹⁴ Article 89 of Regulation (EU) No. 648/2012 of the European Parliament and of the Council of 4 July, 2012 on OTC derivatives, central counterparties and trade repositories.

¹⁵ Article 37a of the proposed Capital Requirements Regulation, the European implementation of Basel III, that states that the credit valuation adjustment charge should not be applied to transactions with pension scheme arrangements as defined in EMIR.

¹⁶ If pension plans were subject to initial margin requirements, some members of the Global Pension Coalition would advocate that regulators establish predetermined, high thresholds for pension plans to prevent banks from lowering thresholds simply because they desire to have additional capital for reasons unrelated to any risk of a pension plan counterparty.

pension plans¹⁷ are comparable to prudential capital requirements and pension plans must be prudently managed and diversified. If the regulators limit the availability of initial margin thresholds, under a risk-based approach, pension plans should be treated the same as or better than entities that are subject to prudential regulation.

c. Element 2 – If Pension Plans Are Treated As “Financial Entities,” Subject to Initial Margin Requirements, Uncleared Swap Initial Margin Should Be A Two-Way Obligation

Element 2 would require both parties to a swap to post initial margin to one another (*i.e.*, two-way margin). We strongly believe that pension plans should be exempt from initial margin requirements. If pension plans are, however, under regulatory mandate, subject to uncleared swap initial margin requirements, initial margin should be a two-way requirement. Because of their fiduciary responsibilities, funding obligations, and the importance of their mission, pension plans are particularly attentive to counterparty risk. Pension plans pose significantly less counterparty risk to dealers than dealers do to pension plans. Moreover, as illustrated by the 2008 financial crisis and MF Global and Peregrine, pension plans can be subject to significant risks.

Accordingly, to the extent that pension plans are required to post initial margin, we support the notion that dealers also should be required to post equivalent initial margin unless the pension plan opts not to require initial margin from dealer. If pension plans are not completely exempted from uncleared swap initial margin rules, as we believe they should be, global regulators should adopt the Element 2 approach of requiring both parties to a swap to post initial margin to each other. However, a pension plan should have the option not to require the dealer to post initial margin based on the pension plan’s risk analysis of the relevant dealer and potential costs.

3. Calculating And Collecting Initial Margin

a. Element 3 – Requirements For Initial Margin Models Should Be Revised

Element 3 sets forth requirements for models used to calculate initial margin. Specifically, the Consultative Document would require initial margin models to set initial margin to reflect extreme but plausible potential changes consistent with a one-tailed 99-percent confidence interval over a 10-day liquidation period. Notably, the Consultative Document does not provide any explanation for requiring a 10-day liquidation period to calculate initial margin. The Consultative Document would also require initial margin models to be approved by the dealer’s prudential regulator.

We believe a 10-day liquidation period substantially overstates the risk of many uncleared swaps and will create unnecessarily high initial margin requirements,

¹⁷ For example, in the U.S., ERISA plans are subject to stringent funding requirements pursuant to the Pension Protection Act of 2006. Canadian and European pension plans are similarly subject to stringent funding requirements.

particularly since models must use a 99-percent confidence interval and be calibrated to a period of financial stress.¹⁸ Element 3 should instead require a 3 to 5 day liquidation period in initial margin models, which is sufficient to allow close-out, offset or other risk mitigation for uncleared swaps.

In addition, Element 3 would only permit initial margin models to account for diversification, hedging or risk offsets within the same asset class and covered by a single master netting agreement. We believe that initial margin models should permit risk offsets across instruments and asset classes. Common trading practices recognize the risk-reducing relationship between cash positions and derivatives on related underliers or a combination of derivative types, each targeting a different component of the individual risks presented by the cash position. The calculation of initial margin should give full recognition to the risk mitigating benefits arising from related trades across derivatives risk categories as well as across related derivatives and cash positions.

Further, Element 3 would require that initial margin models be approved by a relevant supervisory authority. Although we agree that initial margin models must be approved by the relevant regulator, initial margin models and calculations should be consistent with commonly accepted market practices and dealers should be required to disclose the methodologies, inputs and key assumptions underlying such calculations. Accordingly, the information above pertaining to initial margin models should be available for review by end-user counterparties such as pension plans upon request.¹⁹ At more than \$700 trillion notional value, the size and importance of the swaps market makes transparency critical. In addition, if regulators permit dealers to use internal margin models available for licensing by central clearing parties or third-party vendors, plans believe that those initial margin models should also be open for review by market participants in all material respects.

We note that regulators have sought centralized clearing of swaps to promote greater transparency of the swap market. We believe it would be consistent with such transparency goals to require initial margin models. Dealers will utilize initial margin models as the basis for a claim for funds from pension plans. We believe it would be consistent with regulators' market transparency goals that such initial margin models be transparent to plans' fiduciaries and auditors to ensure proper reconciliation and financial accountability. Such transparency also serves a regulatory purpose. Although regulators will approve initial margin models of dealers, regulators typically do not have the resources to monitor how such models are actually employed (e.g., accurately and consistently). Allowing transparency of such models provides greater confidence to the markets and could help avoid a crisis based on a later determination that a model which was approved by a regulator was in fact not properly employed.²⁰

¹⁸ See Consultative Document, p. 17.

¹⁹ Recent events involving large multi-national banks, such as the London Interbank Offered Rate situation, highlight the need for transparency. See, e.g., *In re Barclays PLC*, CFTC Docket No. 12-25 (June 27, 2012).

²⁰ *Id.*

b. Element 3 – The Initial Margin Look-Up Table Is An Appropriate Alternative To An Initial Margin Model

Element 3 provides an alternative method for calculating initial margin that uses a look-up table based upon the notional value of a swap.²¹ We believe that the look-up table is a far better than other approaches that would far overstate the risks of many uncleared swaps and be unworkable because dealers will have a difficult time identifying a “similar” futures contract or cleared swap.²²

We also support that dealers “should not be allowed to switch between model- and schedule-based margin calculations in an effort to ‘cherry pick’ the most favorable initial margin terms.”²³ Dealers should be required to take a consistent approach over time.

c. Element 3 –Parties Should Be Permitted a Commercially Reasonable Time After Executing a Swap Before Posting Initial and Variation Margin

Element 3 provides that “[i]nitial margin should be collected at the outset of a transaction.”²⁴ This collection timeframe is too aggressive and will lead to significant operational disruptions, errors and costs as a result of industry-wide collateral operational limitations. Any standard that requires dealers to collect margin “on or before the date it enters into” a swap cannot even be effectuated in a simpler, highly mature derivatives marketplace such as futures markets. Initial margin is never called by a dealer until T+1.

Pension plans, like other parties, need a commercially reasonable time to operationally move money to a new counterparty or a new third party custodian. Under all proposed approaches, a pension plan may have to establish new arrangements with new counterparties or custodians and set aside collateral several days before the plan even knows with certainty that the swap will be executed. This will tie up funds that otherwise could be used to generate income for retirees. We suggest that the regulators permit a commercially reasonable time of two local business days after entering into a swap before requiring initial margin to be posted. For the same reasons, we also suggest that parties not be required to make variation margin calls until the local business day after the swap is executed and not be required to post variation margin until two local business days after the swap is entered into.

4. Element 4 – The Definition Of Eligible Collateral Is Appropriately Broad

Element 4 would define eligible collateral and provide other guidelines regarding haircuts and diversification.²⁵ The Consultative Document lists as eligible collateral cash,

²¹ See Consultative Document, pp. 18-19, App. A.

²² As a general matter, a main reason that an uncleared swap will not be cleared is because it is not similar to any cleared product.

²³ Consultative Document, p. 19.

²⁴ *Id.*

²⁵ See Consultative Document, p. 22.

high quality government and central bank securities, high quality corporate bonds, high quality covered bonds, equities included in major stock indices, and gold. Although the list in the Consultative Document is not intended to be exclusive, we recommend adding to the list interests in money market mutual funds and certificates of deposit.

We strongly favor the approach in the Consultative Document of expanding the types of permitted collateral. We believe the types of permitted collateral should be broad enough to ensure that there is sufficient eligible collateral available to all market participants. We are also concerned that a more narrow menu of collateral choices ultimately would decrease diversification in pension plans' investment portfolios and could serve to increase overall funding risks.

5. Element 5 – Plans Believe That Collateral Should Be Held By A Third Party Custodian, Be Bankruptcy Remote From A Defaulting Counterparty, And Not Be Rehypothecated Or Reused

Element 5 would require parties to exchange gross margin and sets out three principles for uncleared swaps: 1) initial margin must be individually segregated; 2) initial margin should be held in a way that fully protects the posting party from the bankruptcy of a defaulting counterparty; and 3) collateral cannot be rehypothecated or reused.²⁶ Plans strongly support these margin protecting principles, if requested by a client, and also recommend that such protections be expanded to variation margin.

The Consultative Document makes clear that existing collateral protections available in over-the-counter swap markets should not go away. These existing protections include segregation of both initial and variation margin with a third party custodian and restrictions on rehypothecation and reuse of collateral. These types of collateral arrangements protect investors, reduce systemic risk, and aid regulators in overseeing the liquidation of a dealer because collateral can be identified faster and with greater certainty in a dealer bankruptcy.²⁷ The benefits of these arrangements have been recognized by the European Union in its rules for cleared swaps that require central clearing parties and clearing members to offer segregation of margin to their customers.²⁸ The Consultative Document is also consistent with provisions in Dodd-Frank that provides non-dealer counterparties the option to elect to have their initial margin held by a third-party custodian.²⁹

²⁶ See Consultative Document, p. 25.

²⁷ The U.S. SEC also notes that requiring segregation with a third-party custodian “may impose a disproportionate impact on U.S. SEC-registered broker-dealers in comparison to banks, as a result of the differences in regulatory capital treatment of the initial margin deposited with third party custodians.” Consultative Document, p. 26. We believe that uncleared swap margin requirements must be designed to protect the counterparties to a transaction. If broker-dealers are disadvantaged relative to banks, then the SEC should consider other relief for its broker-dealers. It would not be appropriate to attempt to mitigate such disproportionate impact at the expense of the very market participants that the uncleared swap margin rules are designed to protect.

²⁸ Regulation (EU) No 648/2012 of the European Parliament of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, Article 39.

²⁹ Dodd-Frank §§ 724 and 764.

7. Element 7 – International Rules Must Be Consistent

Element 7 proposes a framework whereby entities would only be subject to margin requirements of their home jurisdiction and market participants would not be subject to duplicative requirements where margin requirements between jurisdictions are comparable.³⁰ We believe this proposed Element highlights the importance of consistent international regulation to avoid flight to the most appealing jurisdiction. However, only the uncleared margin rules of the jurisdiction where a transaction occurs should apply and there should be clarity and consistency as to where a transaction is deemed to have occurred. Importantly, we believe that (i) there should only be a single jurisdiction for each transaction; (ii) such jurisdiction's regulations should be the only one that applies to such transaction; (iii) regulators should be consistent and clear how such jurisdiction is determined; and (iv) parties to a transaction should be able to contractually agree as to what is the jurisdiction of such transaction, provided it is a jurisdiction of one of the counterparties and provided that such jurisdiction is recognized by the regulator of the other counterparty.

By ensuring that there is a single jurisdiction for each transaction, regulators will be supplying market participants with legal certainty as compared to an unintended consequence of legal risk. Legal risk is part of systemic risk and regulators could inadvertently contribute to systemic risk by adopting conflicting regulations from different jurisdictions which apply to a single transaction. For example, pension plans are concerned about being placed in a situation where they may pay margin based on one jurisdiction's rules only to be later told by their dealer counterparty that they need to collect additional margin as a result of another jurisdiction's rules. Had the relevant pension plan known before the transaction that there would additional margin requirements imposed on it, it may not have done the transaction. If international regulations are consistent, applying the law of a single jurisdiction will provide legal certainty and greatly reduce pension plans' compliance burden and, accordingly, transaction costs.

If international regulations are not consistent, we believe that pension plans should be able to avail themselves of the best protections that exist globally and should not be limited by the rules of their home jurisdiction where those rules provide less protection than another jurisdiction. For example, if a U.S. pension plan desires to avail itself of collateral protections that are offered only in Europe and enters in a transaction in Europe with a counterparty to avail itself of such protections, local European regulation should prevail and the U.S. pension plan should not lose such protections solely because they are not offered in the U.S.

8. Uncleared Margin Rules Should Only Take Effect After The Clearing System Is In Place And Initial Margin Models Have Been Approved

³⁰ See Consultative Document, pp. 28-30.

Question 1 in the Consultative Document asks what would be an appropriate phase-in period for uncleared swap margin requirements.³¹ The framework in the Consultative Document will create higher initial margin requirements for uncleared swaps than those applicable for cleared swaps, particularly where initial margin is not calculated using an initial margin model. It will take some time for the clearing requirements to be implemented. If uncleared swap margin requirements take effect before the clearing infrastructure is in place, pension plans will have no option but to pay the higher margin requirements under the uncleared swap rules until cleared swaps are available. Similarly, if the uncleared swap margin rules take effect before initial margin models are approved, which timeframe is highly uncertain given the various regulators' resource constraints, pension plans will be forced to post initial margin in accordance with the look-up table, which is expected to impose higher margin requirements than initial margin models.

We recommend that implementation of all uncleared swap margin rules be delayed to coordinate with the clearing system and the approval of internal margin models by global regulators. We also ask that uncleared swap margin rules be phased in to permit market participants time to put in place the necessary arrangements once the rules are final. We suggest, at a minimum, a delay of at least 180 days after the clearing rules take effect before uncleared swap margin rules take effect. Our strong hope, however, is that the global regulators will exempt pension plans from initial margin requirements for uncleared swaps for the reasons stated herein.

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We appreciate your consideration of our views.

American Benefits Council
Committee on Investment of Employee Benefit Assets
European Federation for Retirement Provision
The European Association of Paritarian Institutions
The National Coordinating Committee for Multiemployer Plans
The Pension Investment Association of Canada

³¹ Consultative Document, p. 5.

EXHIBIT A

Below is a summary of some of the key reasons U.S.-regulated ERISA plans present virtually no counterparty risk.

- ERISA plans are required to be prudently diversified. In entering into swaps for plans, ERISA requires that plan fiduciaries act solely in the interest of the plan's participants and beneficiaries and with the care, skill, prudence, and diligence that a prudent person familiar with such matters would use.³²
- "Investment managers" for ERISA plans are required to be regulated entities (registered investment advisers, banks, or insurance companies) that are (1) subject to the highest standard of care under US law, (2) liable for significant financial penalties for failure to comply with relevant provisions of ERISA, and (3) liable in many instances for the acts of other fiduciaries.³³
- ERISA plan assets are required to be held in trust for future payment, subject to the oversight of a trustee which is typically a US regulated bank or, in the case of a multiemployer plan, an independent trust jointly managed and subject to specified fiduciary rules.³⁴
- Because of the regulatory structure that applies to ERISA plans, ERISA plans typically have minimal (if any) leverage.
- ERISA plans are subject to stringent funding requirements pursuant to the Pension Protection Act of 2006.
- ERISA plans are financially transparent; they typically have third-party custodians report their net asset value to dealers on a monthly basis and are required by law to report their holdings annually to the Department of Labor.³⁵
- ERISA plans are not operating entities subject to business-line risks and competitive challenges.
- There is no provision under any law for ERISA plans to file for bankruptcy or reorganization to avoid their financial obligations to counterparties. Even the filing of bankruptcy by an ERISA plan sponsor or the involuntary termination of the plan does not relieve a plan of its financial obligations to counterparties since the plan is transferred to the Pension Benefit Guaranty Corporation.
- ERISA plans are typically (and correctly) not treated the same as unregulated investment entities in CFTC regulations. For example, Rule 4.5 excludes certain ERISA plans from the definition of a "commodity pool" and operators of most ERISA plans from the definition of "commodity pool operator." The CFTC has relied on ERISA's "pervasive" regulation of plans and plan fiduciaries as a reason

³² ERISA section 404(a)(1)(B).

³³ ERISA sections 3(38) (investment manager requirements), 404(a) (fiduciary standards), 405 (co-fiduciary liability), 409 (fiduciary liability), 502 (ERISA enforcement).

³⁴ ERISA section 403(a).

³⁵ See Form 5500.

it does not need to regulate these plans.³⁶ Similarly, pension trusts are exempt from registration as “investment companies” with the SEC.³⁷

- Based on a survey of over a dozen major dealers by one of our members, ERISA plans have in all cases met their financial swap obligations to dealers despite the bankruptcy of Fortune 500 plan sponsors, the market crash of 2008, and every other significant financial event since the adoption of ERISA in 1974.

³⁶ See *Commodity Pool Operators; Exclusion for Certain Otherwise Regulated Persons From the Definition of the Term “Commodity Pool Operator,”* Final Rules, 50 Fed. Reg. 15,868, 15,869 and 15,873 (1985); 58 Fed. Reg. 6,371, 6,373 (1993).

³⁷ Section 3(c)(11) of the Investment Company Act of 1940 (“Investment Company Act”).

EXHIBIT B

Below is a summary of some of the key reasons Canadian plans present virtually no counterparty risk. Note that Canadian pension funds may be regulated by provincial or federal laws and regulations so certain of the factors below may not apply to all pension plans.

- Pension plans are subject to a prudent portfolio investment standard. For example, the administrators of pension plans subject to the laws of Ontario are required to "exercise the care, diligence and skill in the administration and investment of the pension fund that a person of ordinary prudence would exercise in dealing with the property of another person."³⁸ In doing so, the administrator must use all relevant knowledge and skill that it possesses, or ought to possess, in the administration and investment of the pension fund.³⁹
- Pension plans are subject to investment restrictions, concentration limits and other restrictions mandated by law.
- Pension plans must establish and file with the appropriate regulators a detailed statement of investment policies and procedures, including with respect to the use of derivatives, options and futures.⁴⁰ Such document outlines the plans expectations with respect to diversification, asset mix, expected returns and other factors.
- Administrators of pension funds are subject to strict prohibitions concerning conflicts of interest. Similar prohibitions are also imposed on employees and agents of the administrator.⁴¹
- Pension plans are generally prohibited from borrowing.⁴²
- The assets of pension plans are held in trust by licensed trust companies or other financial institutions and are separate from the assets of their sponsors.
- Funding shortfalls may be funded by the pension plan's corporate or government sponsor, by increasing contributions of pensioners or by lowering benefit payments, depending on the nature of the plan.
- Pension plans must regularly file an actuarial valuation with the appropriate regulators.
- Pension plans are transparent to members and regulators. Provincial legislation requires that pension plans file a detailed annual financial statement accompanied by an auditor's report.⁴³

³⁸ *E.g.*, Pension Benefits Act, RSO 1990, c P.8 ("PBA"), s 22(1).

³⁹ *E.g.*, PBA s 22(2).

⁴⁰ Pension Benefits Standards Regulations, 1985, SOR/87-19, s 7.1.

⁴¹ *E.g.*, PBA ss22(4) and 22(8).

⁴² Income Tax Regulations, CRC c 945, s 8502(i).

- Pension plans are not operating entities subject to business-line risks and competitive challenges.
- The governance of Canadian pension plans is subject to statutory requirements and guided by best practices.
- There is no provision under any Canadian law for pension plans to file for bankruptcy or reorganization to avoid their financial obligations to counterparties or other creditors. Additionally, the voluntary termination of a plan does not relieve the plan of its financial obligations.

⁴³ *E.g.*, Pension Benefits Act, RRO 1990, Reg 909, s 76. In addition, an auditor's report is required for pension plans with \$3 million or more in assets.

EXHIBIT C

Below is a summary of some of the key reasons pension plans established in a European Union member state present virtually no counterparty risk.

European pension funds are subject to regulation and extensive regulatory oversight, including the IORP Directive⁴⁴ and the national Pension acts of their home countries. Article 18 of the IORP Directive imposes broad investment regulations on pension plans that are intended to assure the security and affordability of occupational pensions. These regulations are designed to enable pension plans to meet their obligations to beneficiaries and creditors.

European pension funds are also subject to an extensive set of rules regarding their solvency and liability coverage ratio. The regulatory framework ensures that pension funds' coverage ratios do not fall below certain minimum levels. European pension plans are therefore conservatively managed and very creditworthy.

European pension funds are users of long dated interest rate and currency and inflation swaps for purposes of limiting investment risk. Their liabilities (*i.e.*, the pension cash flows) are hedged against inflation and interest rate risks, to offer protection for - ultimately the pension beneficiaries. European pension funds are constrained by regulation to use swaps solely for risk management purposes. Article 18(d) of the European IORP Directive (2003/41/EC) restricts pension funds from using OTC derivatives for any purpose other than to manage risks associated with their long-term liabilities. European pension funds do not speculate with derivatives and are not allowed to do so.

The policy of pension funds is usually determined by a board of trustees, consisting of an equal representation of employers and employees. Pension funds are structured as foundations or similar entities, with key characteristics being that these are not-for-profit and independent entities, without shareholders. Mandatory participation typically is an inherent feature of many pension funds in EU countries. This implies that an employer, or a group of employers, has the requirement to offer a pension scheme to its employees. For employees, participation in such a pension scheme is compulsory. This compulsory system for pension funds works on the basis of solidarity and risk sharing among participants. Any return on investment will be to the sole benefit of the future pensioners.

Due to the compulsory nature of pension funds in combination with their conservative long-term investment strategy, the theoretical risk of a bankruptcy of a pension funds is very remote. The pension fund can mitigate such risk, for instance, by (i) increasing the premiums (ii) no indexation and/or (iii) decreasing payments to the pensioners.

⁴⁴ Directive 2003/41/EC, Jun. 3, 2003, on the activities and supervision of the institutions for occupational retirement provision, OJL 235, 23/9/2003, (<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:235:0010:0021:EN:PDF>).

In addition, national rules and regulations will often provide for an extensive set of rules in relation to pension funds investments to avoid that the coverage ratio of pension funds will fall below certain minimum levels. Pension funds are stable long term investors with a high degree of solidarity offering a low-priced product for the pensioners, which are:

- highly creditworthy;
- highly regulated;
- low leveraged; and
- very prudently managed.

Pension funds, as well as the authorised entities responsible for managing such institutions and/or set up for the purpose of investment thereof, present virtually no counterparty risk.