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January 18, 2011

David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies; RIN Number 3038-AD99

Dear Mr. Stawick:

Fidelity Investments[1] ("Fidelity") appreciates the opportunity to comment on the Advanced Notice of Proposed Rulemaking (the "ANPR") regarding protection of cleared swaps customers before and after commodity broker bankruptcies, issued by the Commodity Futures Trading Commission (the "Commission") on November 19, 2010.

Pursuant to Section 724 of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the Commission is empowered to develop and implement a regulatory structure to provide for the safety and protection of collateral posted in connection with cleared swaps. Fidelity supports the Commission's objective of protecting the collateral posted by customers in connection with cleared swaps. We believe that by implementing a regulatory structure that provides appropriate protection for this collateral, the Commission will, among other things, reduce systemic risk by bolstering the confidence of swaps market participants that losses related to counterparty risk will be estimable and manageable.

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[1] Fidelity Investments is one of the world's largest providers of financial services, with assets under administration of nearly $3.4 trillion, including managed assets of over $1.5 trillion. The firm is a leading provider of investment management, retirement planning, portfolio guidance, brokerage, benefits outsourcing and many other financial products and services to more than 20 million individuals and institutions, as well as through 5,000 financial intermediary firms.

The ANPR describes four alternatives for protecting collateral, with varying degrees of protection afforded to the parties to a swaps transaction. For the following reasons, which are discussed further below, we strongly recommend that the Commission adopt and implement the full physical segregation model:

- Full physical segregation is consistent with current collateral practices for over-the-counter ("OTC") swaps, whereby counterparties can negotiate the full segregation of posted collateral with third-party custodians.

- Fidelity believes that the primary objectives of Title VII of the Dodd-Frank Act can best be served by implementing the full physical segregation model.[2]

- The practice of segregating customer collateral with third-party custodians helps to mitigate counterparty risk. The other three segregation alternatives are less effective in mitigating this risk, and entirely eliminating the ability for counterparties to require segregation of their collateral will force all swaps market participants to accept exposure to counterparty risk.

- Although we anticipate that many commenters will recommend that the current collateral practices in the futures market are adequate for the swaps market, we disagree. The vast differences in the sizes of these markets as well as the differences in the terms and duration of swaps transactions compared with futures transactions make the baseline model of futures collateral segregation a less than ideal choice for swaps collateral.

Current Swaps Market Collateral Practices

Collateral plays an important role in the OTC derivatives market by reducing both counterparty and systemic risk. The party holding collateral (the "pledgee") is protected from default risk of the party pledging collateral (the "pledgor") to the extent of collateral it holds. The pledgor also benefits from posting collateral, because the overall risk of the transaction is reduced, leading to lower transaction costs for the market as a whole. Of course, the pledgor also has a right to have its collateral returned, following satisfaction of any payment obligations. However, as was demonstrated by the Lehman bankruptcy, posting collateral can represent significant risk to swaps counterparties and the market, because as fears grow that a particular pledgee may become insolvent, pledgors begin to demand a return of that collateral. The less protection of collateral, the greater the sensitivity to counterparty risk—and the greater the overall systemic risk.

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[2] The purpose of Title VII of the Dodd-Frank Act is: "to mitigate costs and risks to taxpayers and the financial system…". S. Rept. 111-176, Section 701.

In the OTC derivatives market, the pledgor can, through negotiation, determine the extent to which it is willing to assume the bankruptcy risk of its counterparty, which could prevent the return of the pledgor's collateral. The pledgor may elect to allow the pledgee to commingle the collateral on the pledgee's books and records, rehypothecate the collateral or otherwise use the collateral as it desires. A slightly more protective approach is that the pledgor can negotiate terms that require its counterparty to segregate pledged collateral from its own assets and from the assets of other customers, and to hold the collateral in its possession. For maximum counterparty risk reduction, the pledgor can require that the collateral be held in a third party custodial account, isolated from the assets and liabilities of the pledgee. The pledgee's right to access collateral under such a structure is generally limited to circumstances involving a pledgor's default. Such increased levels of protection can come at a higher cost to the dealers, which may be passed on to the pledgor, but the pledgor has the freedom to negotiate the extent to which it is willing to accept such higher costs in exchange for the added protection.

The segregated collateral arrangements that customers in the OTC derivatives market are presently free to negotiate allow parties to make decisions and negotiate collateral terms based on each party's creditworthiness, and overall sensitivity to that creditworthiness. That is, a market participant, in deciding whether to negotiate segregated or third party custodial arrangements with respect to collateral it must pledge, can make a decision based on the creditworthiness of its dealer counterparty, any incremental additional cost for greater protection, and willingness to take on counterparty risk. This flexibility should be preserved. In the current OTC derivatives market, many buy-side participants currently have tri-party custodial arrangements in place with dealer counterparties that require segregation of collateral posted to such dealers in connection with swaps transactions.

When entering into a swap, a party takes on potential credit risk to the extent that its counterparty is unable to meet its payment obligations. This counterparty risk is in addition to the economic risks of the swaps transaction itself. The segregated collateral arrangements are intended to mitigate this counterparty risk. Physical segregation serves to hedge against counterparty credit risk and allows the parties to the transaction to focus on the true economic risks of the swaps transaction. Implementing a regulatory structure that removes the option for counterparties to negotiate the segregation of collateral would decrease the level of protection to counterparties, and potentially lead to increased systemic risk, as counterparties with little or no appetite for counterparty risk would take steps to mitigate that risk as it becomes manifest. In other words, some pledgors will be more likely to unwind collateral arrangements more quickly with particular pledgees if the collateral protection framework is weakened.

The Customer Protection Objectives of the Dodd-Frank Act and Increased Risk of Omnibus Collateral Arrangements

The Dodd-Frank Act's mandate for centralized clearing and the attendant collateral requirements are intended to reduce systemic risks by inserting a central counterparty to each

transaction, in an attempt to mitigate the potential counterparty risks. It would, therefore, be contrary to this intent to force market participants to take on greater counterparty credit risk by eliminating their ability to require counterparties to segregate posted collateral.

We believe that eliminating the practice of segregating collateral posted to a dealer, a futures commission merchant (an "FCM") or a derivatives clearing organization (a "DCO") is also contrary to the Commission's goal of enhancing customer protections in the derivatives market. The Dodd-Frank Act has presented the Commission with an opportunity to evaluate the protection of collateral in the derivatives market and to implement a structure that will provide appropriate safeguards to customer funds, which will also help minimize systemic risk.

Section 724(c) of the Dodd-Frank Act adds a new Section 4d(f) to the Commodity Exchange Act dealing with the protection of collateral of swaps customers of FCMs. Of the four alternatives described in the ANPR, we believe that full physical segregation is most consistent with the requirements of Section 4d(f), which requires that the assets of a swaps counterparty delivered as collateral not be commingled with the assets of an FCM or used in connection with any other customer of the FCM. We also believe that the omnibus collateral arrangements proposed in the other three alternatives described in the ANPR (legal segregation with commingling, moving customers to the back of the waterfall, and the baseline model), may actually increase rather than reduce systemic risk, as each of these models would limit a swaps counterparty's ability to have its collateral physically segregated once delivered by an FCM to a DCO. Implementing any of these three models would eliminate pledgors' ability to take steps to shield their collateral from the risks created by other customers of their FCMs, risks to which market participants are not exposed today.

Mandatory clearing for the swaps market is intended to "spread" the risk of a counterparty's default in a way that reduces systemic risk. Clearing creates a safety net that spreads the risk of a dealer or FCM default to the other dealer and FCM members of a DCO that have the capital base to absorb and manage such risk. We recognize that this approach may increase the overall ability for the system to absorb default risk. However, for the reasons described above, we believe that reducing the certainty surrounding the availability and safety of collateral by granting broad rights to share in pooled collateral is ultimately risk creating, not risk mitigating.

Cost Estimates Regarding Collateral Segregation

Although certain market participants have asserted that the costs of adopting full physical segregation of customer collateral could be significant, we believe that such claims are premature. Proper analysis of potential additional costs first requires establishing a cost baseline—that is, there must be a common understanding as to what the incremental costs are that might reasonably result from a requirement to segregate customer assets. Only after

identifying a cost baseline and potential incremental costs can one measure the potential impact of the added costs. We believe that the appropriate cost baseline consists of the costs that are incurred today within existing tri-party custodial arrangements.[3] Any incremental costs of full physical segregation beyond this cost baseline would be a fair measure of the potential additional costs that the market might face in implementing full physical segregation of collateral for cleared swaps. Using the costs incurred in connection with existing tri-party custodial arrangements as a baseline from which the costs for full physical segregation of customer collateral should be measured would also give recognition to the similar collateral protections provided to uncleared swaps transactions under the Dodd-Frank Act.

As noted above, swaps dealers often segregate the assets of their customers, either internally or through the use of tri-party custodial arrangements. A dealer must determine on a daily basis the value of each customer's trades as well as the value of the customer margin that the dealer, either directly or through a custodian, is holding for each of its customers. In doing so, a dealer determines daily whether a particular customer must deliver additional collateral or whether the dealer is holding excess collateral that may be returned to the customer. We believe that full physical segregation of customer assets could be implemented effectively by requiring that FCMs, who are the same entities as the dealers today, provide to the DCOs the daily reports currently being provided to their customers. A DCO could effectively segregate customer assets by relying on the reporting information received by it from its FCM members, and would not need to create independent methods for valuing the assets of each customer of each FCM member. Therefore, we believe that a DCO would be able to segregate the assets of each separate customer of their FCM members on the books and records of the DCO without incurring significant new administrative burdens.[4]

We believe that segregation consistent with current FCM practice, which allows - but does not mandate - using third party custodians, may only result in *de minimis* additional costs relative to a baseline of what currently exists in the OTC derivatives market.[5] To the extent there

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[3] In contrast, the existing exchange traded futures market would not represent an appropriate cost baseline, given the substantial differences between the swaps and futures markets.

[4] We do not think implementation of a full physical segregation model or Section 724(c) of the Dodd-Frank Act would require the use of separate depositories or third party custody arrangements to give effect to customer asset segregation. Full physical segregation of customer assets could be achieved by requiring a DCO to maintain on its books and records segregated accounts on the same basis as its FCM member, once the FCM passed through customer collateral to the DCO. We believe that the Commission can, through rulemaking, clarify that customer assets delivered by an FCM to a DCO be held as customer property, and that each customer would retain ownership of such assets for purposes of the bankruptcy laws applicable to FCMs.

[5] We understand that some commenters may be suggesting that a significant element to any potential costs will be the fact that FCMs or dealer counterparties will not have access to or the ability to utilize posted customer collateral. We believe such an argument is misplaced. As we have discussed, under the current OTC derivatives market, unless a customer negotiates an alternative arrangement, dealers are free to commingle, rehypothecate and otherwise use

are incremental additional costs, however, by allowing DCOs to rely on information provided by their FCMs, we do not believe such costs would be prohibitive or overly burdensome. Further, we believe that some of these costs might decrease quickly over time because of, for example, improvements in technology and operational processing. Regardless of the how costs are defined, the impact of such costs requires careful study.

Why the Existing Futures Market is not an Appropriate Model

We anticipate that some commenters will observe that the omnibus collateral proposals are consistent with the way collateral is currently managed in connection with exchange traded futures, and argue that the same approach should be applied to the OTC derivatives market. However, omnibus collateral arrangements used in connection with futures trading are distinguishable. The size of the futures market is dwarfed by the size of the swaps market.[6] Omnibus collateral arrangements for cleared swaps would significantly increase default exposure among FCM customers based on both the number of market positions and the aggregate size of swaps positions that would ultimately be cleared as well as the longer duration of some swaps transactions as compared to futures transactions.

Clearing will undoubtedly result in increased standardization of swaps terms. Nevertheless, the potential complexity and variation of terms of swaps represent potential risks that are different from those associated with exchange traded futures. The nature of the exchange traded market allows FCMs to calculate a customer's collateral requirements based on the customer's entire portfolio across both markets and products. Even as swaps become more standardized, portfolio margining may not be possible for all swaps transactions. Important differences among swaps products and markets are likely to remain. The risk profiles among types of swaps may differ significantly, and the use of omnibus arrangements for swaps may not adequately reflect these differences.

Omnibus arrangements also would significantly increase a customer's exposure to the FCM if the FCM maintains insufficient capital. Clearing is intended to assure that all members

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posted customer collateral. The market presently understands that, to the extent a customer negotiates limitations on the dealer's use of posted collateral, either through mandatory segregation or the use of third party custodians, there is a cost to the dealer that is passed through to its customer. Therefore, there should be no real difference from the FCM's or dealer's perspective between a segregation and omnibus model.

[6] The Bank for International Settlements estimated that, as of the end of the second quarter of 2010, the outstanding notional amount of OTC derivatives contracts totaled approximately $583 trillion and the outstanding notional amount of futures contracts traded on organized exchanges totaled approximately $23 trillion. Bank for Int'l Settlements, BIS Quarterly Review: International Banking and Financial Market Developments, statistical annex at A121 and A126, tbls.19 and 23A (Dec. 2010), available at http://www.bis.org/statistics/derstats.htm.

of a DCO assume responsibility for the defaults of an individual member of the DCO. This effort to disperse market risk is beneficial to all participants in the OTC swaps market. In contrast, we believe that any approach that would ultimately require an individual customer to be responsible for the shortfall of another customer is not consistent with the Commission's objective of increasing customer protections. Therefore, we appreciate that the Commission is taking a deliberative approach in developing the best model for swaps collateral protection, rather than defaulting to historical practice in the futures markets.

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We appreciate the opportunity to comment on the ANPR. Fidelity would be pleased to provide any further information or respond to any questions that the Commission or the staff may have.

Sincerely,

cc: Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott D. O'Malia, Commissioner
Amanda Radhakrishnan, Director, Division of Clearing and Intermediary Oversight
Robert B. Wasserman, Associate Director, Division of Clearing and Intermediary Oversight