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

Association Européenne des Institutions Paritaires
European Association of Paritarian Institutions

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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
Spain

Re: Comments on Second Consultative Document: Margin requirements for non-centrally cleared derivatives, issued by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions (February 2013)

The American Benefits Council (the “Council”), the Committee on Investment of Employee Benefit Assets (“CIEBA”), Pensions Europe (“PE”), 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 (the “Second 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 International Organization of Securities Commissions (“IOSCO”) (and collectively with BCBS, “BCBS/IOSCO”) issued for comment a Consultative Document titled “Margin requirements for non-centrally-cleared derivatives” (the “First Consultative Document”). The Global Pension Coalition submitted comments on the First Consultative Document in a September 28, 2012 letter to the Working Group (the “First Comment Letter”). After considering the comments received in response to the First Consultative Document and the results of the Working Group’s quantitative impact study on margin requirements for non-centrally cleared OTC derivatives, BCBS/IOSCO issued the Second Consultative

Document in February 2013. The Global Pension Coalition appreciates the opportunity to provide its views on the very important issues addressed in the Second Consultative Document.

I. The Global Pension Coalition and its Membership

The Global Pension Coalition represents a very significant portion of the largest defined benefit and defined contribution pension plans in the U.S., Canada and Europe. The pension plans represented by the Global Pension Coalition provide retirement benefits for over a hundred million individuals in more than a dozen countries.

Pension plans, including those represented by the Global Pension Coalition, are unlike many other derivatives market participants. Pension plans exist solely to provide retirement security for pensioners, and their use of derivatives is primarily[1] limited to hedging market risks which could jeopardize such retirement security. Because they serve this critical function, pension plans are highly regulated institutions that, among other statutory requirements, must be very prudently managed. As a result, pension plans are among the most highly creditworthy and stable long-term of "buy-side" investors. This stands in notable contrast to many other derivatives market participants that use uncleared derivatives to take risks for business and competitive reasons.

Furthermore, as highly creditworthy and liquid counterparties, with low or practically no leverage, pension plans provide a crucial source of stable liquidity to the derivatives markets. Accordingly, pension plans' participation in the derivatives markets actually reduces systemic risk, and their continued participation in derivatives markets is welcome and needed by other market participants. If pension plans stopped participating in these markets or participated to a lesser degree, such markets would be less liquid and, therefore, riskier. For these reasons, we strongly believe that the systemic risk reducing characteristics of pension plans must be taken into consideration as global regulators adopt margin requirements for uncleared derivatives.

The Global Pension Coalition is grateful for BCBS/IOSCO's continued efforts to coordinate international standards for uncleared swaps margin. We agree that consistent international regulation of derivatives margining is essential to smooth and efficient markets, and we welcome the opportunity to comment on the Second Consultative Document.

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[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.

II. Comments[2]

A. Pension Plans Should Not Be Subject To Uncleared Margin Requirements

We favor several Elements set forth in the Second Consultative Document. Most importantly, we agree with the principle that margin should be required (1) only for uncleared derivatives between two counterparties, each of whom is either a financial institution or a non-financial institution that poses significant systemic risk,[3] and (2) only as appropriate to the counterparty risks posed by the specific transaction. Pension plans present virtually no risk to their counterparties or to the broader financial system, and thus, it would be inconsistent with the Second Consultative Document's proposed risk-based approach to subject pension plans to uncleared swaps margin requirements.[4]

The Second Consultative Document's justification for not applying margin requirements to uncleared transactions involving counterparties that are not financial institutions or systemically significant is that (1) such transactions are viewed as posing little or no systemic risk and (2) such transactions are exempt from central clearing mandates under most national regimes.[5] Pension plans meet both of these requirements. First, as explained above, pension plans are exactly the type of counterparties whose swap activity does not increase systemic risks. In fact, pension plans' derivative activities can be viewed as reducing systemic risk because they are perhaps the safest of counterparties, providing a stabilizing force to the markets and prudent diversification for dealers. Second, pension plans are exempt from central clearing mandates under many national regimes. Indeed, European regulators have determined to exempt pension plans in the near term from mandatory clearing requirements in recognition of the soundness of plans and in order to avoid a disproportionate cost impact.[6] Further, no capital charges will be imposed on banks for their uncleared derivatives trades with pension scheme arrangements.[7]

The Second Consultative Document also bases uncleared margin requirements on the counterparty risks posed by such transactions. We agree with this risk-based

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[2] We recognize that the Second Consultative Document poses questions to commenters. Our supplemental comments are generally responsive to these questions.

[3] Second Consultative Document, p. 7.

[4] 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.

[5] *See* Second Consultative Document, p. 7.

[6] 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. We note, however, that in some other jurisdictions, including the United States, pension plans are not exempt from the central clearing mandate. *See* 7 U.S.C. § 2(h)(7).

[7] 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.

approach and believe that such an approach ultimately would result in pension plans not being required to post initial margin because they are highly regulated, highly creditworthy, low leveraged and prudently managed counterparties whose swaps are used primarily[8] for hedging and, as such, pose virtually no risk to their counterparties. For example, current practice in OTC markets is that dealers rarely, if ever, require pension plans to post an independent amount (*i.e.* initial margin) to transact in the OTC markets.[9] In fact, members of the Global Pension Coalition even collect one-way independent amounts from their dealer counterparties for some transactions. Therefore, we believe that, under a risk-based approach, pension plans should not be subject to uncleared margin requirements.

The most effective way to ensure that pension plans are not unnecessarily subjected to uncleared margin requirements would be for the final consultative document to clearly state that pension plans are not "covered entities."[10] The key principle for Element 2 of the Second Consultative Document is that "[a]ll *covered entities* (i.e. financial firms and systemically-important non-financial entities) that engage in non-centrally cleared derivatives must exchange initial and variation margin *as appropriate to the counterparty risks posed by such transactions*."[11] The uncleared margin requirements proposed in the Second Consultative Document would apply only to transactions between covered entities. Given that pension plans (1) pose little or no systemic risk; (2) are exempt from central clearing mandates under many national regimes; and (3) have been deemed by dealers as low-risk counterparties that do not pose material default risk, there is a clear basis upon which to distinguish pension plans from the financial institutions and systemically significant entities that will be "covered entities."[12] Drawing such a distinction will result in an uncleared margin regime that comports with existing market practices and that provides clear and uniform requirements. For these reasons, we strongly encourage BCBS/IOSCO to exclude pension plans from the "covered entities" definition in the final consultative document.

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

[9] While not determinative, it is noteworthy that dealers, who conduct the extensive credit analysis needed to protect themselves against a client default, have concluded that pension plans are low-risk counterparties that do not pose material default risk.

[10] The Second Consultative Document defines "covered entities" as including financial firms and systemically-important non-financial firms, but leaves the precise definition of "financial firm" and "systemically-important non-financial entity" to be determined by the "appropriate national regulation." *See* Second Consultative Document, p. 9.

[11] *See* Second Consultative Document, p. 6 (emphasis added).

[12] Central banks, sovereigns, multilateral developments banks and the Bank for International Settlements are all expressly excluded from the "covered entity" definition. *See* Second Consultative Document, p. 9.

B. Pension Plans Alternatively Should Be Given A Higher Phase-In Threshold

If for any reason BCBS/IOSCO is unable to expressly exclude pension plans from the "covered entities" definition, then we believe pension plans alternatively should be afforded a higher permanent phase-in threshold. Element 8 of the Second Consultative Document would prescribe a phase-in period for the exchange of initial margin beginning on January 1, 2015 and ending on January 1, 2019. The phase-in for initial margin would be tied to the notional amount of uncleared swaps in which a counterparty was engaged as of the month-end of the last three months of a year, beginning with 2014. The proposed initial threshold notional amount for the last three-months of 2014 is €3 trillion, meaning that each counterparty's notional amount must exceed the threshold in order for the two-way initial margin requirement to apply to an uncleared swap. If either counterparty falls beneath the notional amount, initial margin would not be required to be exchanged. The proposed final notional amount for the phase-in is €8 billion, beginning in 2019.

Although we support the concept of a gradual phase-in of uncleared margin requirements, if pension plans are not expressly excluded from the "covered entities" definition, we strongly encourage abandoning the "one-size-fits-all" phase-in period in favor of something that is more consistent with the Second Consultative Document's overall risk-based approach to uncleared margin requirements. As discussed above, pension plans are among the most highly regulated of participants in the uncleared derivatives markets.[13] This regulation ensures that pension plans are prudently diversified, conservatively managed, minimally leveraged and financially transparent (to regulators). Furthermore, pension plan managers are held to the highest fiduciary standards and can be held liable for significant financial penalties for failure to comply with relevant provisions of applicable law.

Therefore, unlike financial institutions and entities that pose significant systemic risk, the theoretical risk of a bankruptcy of a pension plan is very remote. In fact, some jurisdictions have no provisions of law that would allow a pension plan to file for bankruptcy or reorganization to avoid financial obligations to its counterparties.[14] And in the U.S. and Canada, for example, even the voluntary termination of a pension plan would not relieve the plan of its financial obligations to counterparties.[15]

Given these stark differences between the risk profiles of pension plans and financial institutions and systemically significant entities, it would make little sense for the final consultative document to insist on a one-size-fits-all phase-in of initial margin requirements. We believe that any final phase-in should be adjusted to account for the very low risk posed by pension plans, and that such an approach would be consistent with the general risk-based approach underlying the Second Consultative Document's

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[13] *See supra*, note 4.

[14] *See supra*, note 4.

[15] *See supra*, note 4.

application of uncleared margin requirements. Specifically, we believe that for pension plans, the final phase-in (i.e., for 2019 and beyond) of the threshold for the notional amount of uncleared swaps in which a counterparty was engaged as of the month-end of the last three months of a year should be €350 billion exclusive of hedging positions.

C. Pension Plans Alternatively Should Be Permitted Unlimited Initial Margin Thresholds

As noted above, we strongly believe that pension plans should be expressly excluded from the "covered entities" definition. If for any reason BCBS/IOSCO is unable to do so, then we believe that a pension plan that exceeds the applicable phase-in thresholds for initial margin should be able to agree with its counterparty on an applicable initial margin threshold, as opposed to such threshold being limited by an arbitrary cap.[16] Element 2 of the Second Consultative Document would apply a €50 million threshold to the amount of initial margin required to be exchanged by the covered entities. This €50 million threshold would be applied at the level of the consolidated group to which the threshold is being extended and would apply to all uncleared derivatives between the two consolidated groups.

We generally support the notion of providing counterparties with thresholds to reduce or eliminate the amount of initial margin required. However, we believe that the imposition of another one-size-fits-all threshold would be a departure from the general risk-based approach underlying the Second Consultative Document's application of uncleared margin requirements. Again, we believe the uniquely low-risk characteristics of pension plans warrant exceptional treatment, as an arbitrary maximum limit on such thresholds likely would not reflect the actual counterparty risks posed by the parties' transactions. Instead, pension plans and their counterparties should be permitted to determine on a case-by-case basis the appropriate threshold for initial margin collection from pension plans. Consistent with the remainder of Element 2, those individually determined thresholds can be reported to home supervisors and host supervisors, as appropriate.

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

III. Supplemental Comments

The Global Pension Coalition appreciates the opportunity to provide its views as to why pension plans, as some of the most highly regulated, highly creditworthy, minimally leveraged and prudently managed participants in the derivatives market, are properly excluded from uncleared margin requirements. Even if not subject to uncleared margin requirements themselves, our members nonetheless will be impacted by the fact that many of their counterparties will be subject to uncleared margin requirements. For this reason, we are pleased to offer the following supplemental comments on various proposed Elements in the Second Consultative Document:

A. Element 1 – Scope Of Coverage

Element 1, as implemented through its requirement, would exclude physically-settled FX forwards and swaps from the scope of uncleared derivatives that would be subject to margin requirements. The Second Consultative Document asks whether physically-settled FX forwards and swaps should be exempted only from initial margin requirements (with the applicability of variation margin to be determined by either supervisory guidance or national regulation). The Second Consultative Document also asks whether physically-settled FX forwards and swaps with different maturities should be subject to different treatments.

The Global Pension Coalition supports excluding physically-settled FX forwards and swaps from uncleared margin requirements.[17] We note that this treatment would be generally consistent with the treatment of such products under U.S. regulations, where last year the U.S. Department of Treasury concluded that physically-settled FX forwards and swaps have distinctive structural characteristics that make them less risky than other types of uncleared derivatives and that the market for such products is already transparent and liquid.[18] For these reasons, we strongly agree with BCBS/IOSCO that physically-settled FX forwards and swaps are appropriately excluded from the scope of products subject to uncleared margin requirements.

Similarly, we do not believe that the maturity of a physically-settled FX forward or swap should be determinative in deciding whether uncleared margin requirements should apply.

B. Element 3 – Requirements For Initial Margin

1. Initial Margin Models Should Be Revised to Allow for Shorter Liquidation Periods, Broader Offsets

Element 3 sets forth requirements for models used to calculate initial margin. Consistent with the proposal in the First Consultative Document, the Second Consultative Document would require initial margin models to set initial margin to reflect extreme but

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[17] *See* Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 77 Fed. Reg. 69694 (Nov. 20, 2012).

[18] *See* 77 Fed. Reg. at 69696–69699.

plausible potential changes consistent with a one-tailed 99-percent confidence interval over a 10-day liquidation period.[19] Like the First Consultative Document, the Second Consultative Document does not provide any explanation for requiring a 10-day liquidation period to calculate initial margin.

The Global Pension Coalition continues to believe a 10-day liquidation period would substantially overstate the risk of many uncleared swaps and would create unnecessarily high initial margin requirements, particularly since models must use a 99-percent confidence interval and be calibrated to a period of financial stress.[20] Accordingly, we suggest that 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, we believe 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 upon request.[21] 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, we believe that those initial margin models should also be open for review by market participants in all material respects.

We believe it would be consistent with regulators' market transparency goals that such initial margin models be transparent to plan fiduciaries and auditors to ensure proper

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[19] *See* Second Consultative Document, p. 11. Additionally, if variation margin is exchanged less frequently than daily, then the Second Consultative Document would require the minimum horizon to be set at 10 days plus the number of days in between which variation margin exchanges. *Id*. This is the same as the requirements proposed by the First Consultative Document. *See* First Consultative Document, p. 17.

[20] *See* Second Consultative Document, p. 11.

[21] 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).

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.[22]

2. Dealers Should Not Be Permitted to "Cherry-Pick" the Most Favourable Initial Margin Terms

We continue to support uncleared margin requirements that would prevent dealers from switching "between model- and schedule-based margin calculations in an effort to 'cherry pick' the most favourable initial margin terms."[23] Dealers should be required to take a consistent approach over time.

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] As we stated in our First Comment Letter, 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 at least until T+1. As a reference, T+3 is the settlement cycle for long-term bonds that may have to be liquidated in order to provide initial margin.

We believe that in order to avoid unnecessary disruptions to the market, counterparties should be afforded 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 would tie up funds that otherwise could be used to generate income for retirees. We suggest that the regulators permit a commercially reasonable time of four local business days after entering into a swap before requiring initial margin to be posted.[25] For the same reasons, we also suggest that parties not be required to make variation margin calls until four local business day after the swap is executed and not be required to post variation margin until four local business days after the swap is entered into.

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[22] *Id.*

[23] *See* Second Consultative Document, p. 13; First Consultative Document, p. 19.

[24] *See* Second Consultative Document, p. 13.

[25] Especially for market participants who, like pension funds, do not keep cash idle, we believe four local business days after entering into a swap would be more reasonable.

C. Element 4 – Eligible Collateral for Margin

Element 4 provides broad guidelines regarding collateral eligibility, a non-exhaustive list of eligible collateral, a prescriptive schedule for haircuts and diversification.[26] Like the First Consultative Document, the Second Consultative Document lists as eligible collateral cash, high quality government and central bank securities, high quality corporate bonds, high quality covered bonds, equities included in major stock indices, and gold.[27] Although the list in the First Consultative Document is not intended to be exhaustive, we still recommend adding to the list interests in money market mutual funds and certificates of deposit.

D. Element 5 – Treatment of Collateral Provided as Initial Margin

Element 5 provides three principles for the treatment of gross initial margin exchanged by parties to an uncleared swap: (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 re-hypothecated, re-pledged or reused.[28] These principles are nearly identical to the principles proposed in the First Consultative Document; accordingly, the Global Pension Coalition continues to strongly support these margin protecting principles and recommends that such protections be expanded to variation margin.[29]

The Second Consultative Document also asks whether Element 5 should be revised such that collateral could be re-hypothecated in certain limited circumstances.[30] Specifically, the Second Consultative Document asks whether re-hypothecation should be permitted if: (1) collateral can only be re-hypothecated to finance/hedge customer, non-proprietary position; (2) the pledge treats re-hypothecated collateral as customer assets; and (3) the applicable insolvency regime allows customer first priority claim over the pledged collateral.[31]

We believe that the re-hypothecation of collateral would unnecessarily elevate counterparty risks and thereby elevate systemic risks. We do not believe that re-hypothecation of collateral should be permitted in any circumstances. Accordingly, we strongly support adopting Element 5 without further revision to allow for re-hypothecation of pledged collateral.

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[26] *See* Second Consultative Document, pp. 16, 25.

[27] *See id*, First Consultative Document, pp. 22, 33.

[28] *See* Second Consultative Document, p. 18.

[29] *See* First Consultative Document, pp. 24-26.

[30] *See* Second Consultative Document, p. 19.

[31] *Id*.

E. Element 6 – Treatment of Inter-Affiliate Transactions

Element 6 provides that local supervisors should be responsible for determining whether uncleared margin requirements should apply to inter-affiliate swaps.[32] The Second Consultative Document provides a background discussion that enumerates the problems with imposing margin requirements on inter-affiliate swaps, namely that such requirements are not currently customary and the imposition of such a requirement likely would create additional liquidity demands for firms engaging in such transactions.[33]

Even though plans likely would not be engaging in inter-affiliate swaps, the Global Pension Coalition agrees that numerous issues would arise if uncleared margin requirements were imposed on inter-affiliate swaps and encourages BCBS/IOSCO to discourage any such requirements.

F. Element 7 – Interaction of National Regimes in Cross-Border Transactions

Element 7 provides 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.[34] Just as we indicated in our First Comment Letter, we continue to believe this Element highlights the importance of consistent international regulation to avoid flight to the most appealing jurisdiction.

The Global Pension Coalition supports the enumerated circumstances outlining how bank counterparties would determine which jurisdiction's margin regime should apply. We respectfully request that subsequent explanations of such cross-border transactions include examples that involve counterparties other than banks and provide a clear and unambiguous explanation of the phrase "margin regime," which we believe should be interpreted broadly to include related concepts like collateral protection regimes.

G. Element 8 – The Phase-in of Margin Requirements

Subject to our specific comments above, we believe that a graduated implementation of the initial margin requirement would provide market participants with sufficient time to make any necessary operational enhancements and to plan for any liquidity constraints.[35]

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32 *Id.*

33 *Id.*

34 *See* Second Consultative Document, pp. 19-21.

35 We are generally supportive of the proposed timeline for implementing uncleared margin requirements. Accordingly, we have not responded to the questions posed by BCBS/ISOCO on this Element.

We appreciate your consideration of our views.

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

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.[36]
- "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.[37]
- 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.[38]
- 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.[39]
- 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

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[36] ERISA section 404(a)(1)(B).

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

[38] ERISA section 403(a).

[39] *See* Form 5500.

it does not need to regulate these plans.[40] Similarly, pension trusts are exempt from registration as "investment companies" with the SEC.[41]

- 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.

[40] *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).

[41] 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."[42] 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.[43]
- 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.[44] 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.[45]
- Pension plans are generally prohibited from borrowing.[46]
- 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.

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

43 *E.g.*, PBA s 22(2).

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

45 *E.g.*, PBA ss22(4) and 22(8).

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

- 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.[47]
- 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.

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47 *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 Directive[48] 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 fund coverage ratios do not fall below certain minimum levels. European pension plans are therefore conservatively managed and very creditworthy. European pension funds are constrained by regulation to use swaps solely for risk management purposes. Article 18(d) of the European IORP Directive 3 restricts pension funds from using OTC derivatives for any purpose other than to manage risks associated with their long-term liabilities.

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. Pension funds do not speculate with derivatives. They even are not allowed to do so under on Article 18d of the IORP Directive (2003/41/EC) that requires that pension funds may only use derivatives for risk mitigation purposes.

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)

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[48] 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).

increasing the premiums; (ii) no indexation; and/or (iii) decreasing payments to the pensioners.

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.