BLACKROCK

ViewPoint

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OTC Derivative Market Reforms: An Investor Perspective

In the wake of the financial crisis, legislators and regulators around the world have initiated a variety of proposals aimed at reducing the systemic risks posed by OTC derivatives. BlackRock supports the development of a regulatory framework which promotes the following themes:

- ► Risk reduction as it relates to counterparty risk
- ► Transparent, deep and liquid markets
- ► Reduction of operational inefficiencies

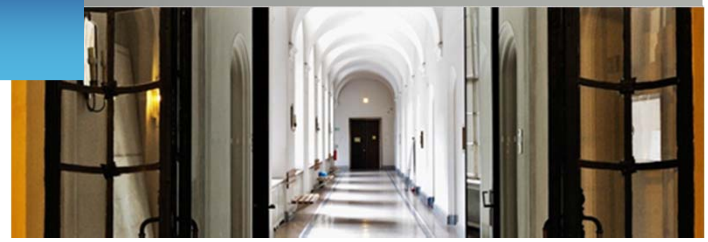
This paper further develops the *ViewPoint* published in February 2010 entitled “Reducing Risk in the Global Financial System: A Proposal for OTC Derivatives Market Reform” which examined provisions designed to address structural weaknesses in the derivatives market. As discussed at that time, BlackRock supports the creation of regulated, central counterparty clearinghouses and the development of enhanced trade reporting. This new paper summarizes the current regulatory proposals under consideration, offers our views on their efficacy, and highlights design issues that should be addressed before new rules take effect.

Regulatory Proposals in the U.S. and Europe

While reform of the OTC derivative market is of interest globally, this paper focuses on current initiatives in the U.S. and Europe. It is important to note that efforts made by policymakers elsewhere broadly reflect actions taken within these two jurisdictions. Given the interconnectedness of derivatives markets, we believe it is critical that regulators develop a consistent framework in order to avoid regulatory arbitrage.

U.S.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Act”), signed into law on July 21, 2010, establishes a comprehensive, new regulatory framework for OTC derivatives. The Act divides authority between the Commodity Futures Trading Commission (“CFTC”) and the Securities and Exchange Commission (“SEC”). It classifies derivative instruments within its scope as either “swaps,” which are subject to primary regulation by the CFTC, “security-based swaps,” which are subject to primary regulation by the SEC, or “mixed swaps,” which are subject to joint regulation by the two agencies. It also creates two categories of newly regulated market participants, *swap dealers* and *major swap participants*.



Subject to key exceptions, the Act mandates the use of central counterparty clearing houses (“CCPs”) for OTC derivative contracts. It requires that clearing organizations submit for review to the CFTC or SEC the names of all derivatives or classes of derivatives that they intend to accept for clearing. The agencies must determine within 90 days of receiving the submissions whether the instruments are subject to the requirement.

> BlackRock supports the development of a regulatory framework which promotes risk reduction, transparent, deep and liquid markets, and reduction of operational inefficiencies.

As with other parts of the Act, many critical details pertaining to derivatives will be determined by the CFTC and SEC during the rule-making process. This process is currently underway and we expect completion within the 360-day period following the legislation’s enactment. BlackRock has been directly engaged with U.S. regulators during the rule-making period, participating in formal meetings and roundtables, presenting at panels, and responding to requests for written comments.

Europe

On September 15, 2010, the European Commission released a proposal entitled “Regulation on OTC Derivatives, Central Counterparties, and Trade Repositories.” The proposal is currently under separate consideration by the Council of Ministers and the European Parliament. Their political agreement, expected in the second half of 2011, will establish a regulatory framework for derivatives across Europe. Like the Dodd-Frank Act, this proposal requires central clearing for OTC derivative products.

The European Securities Markets Authority (“ESMA”), a new agency due to be established on January 1, 2011, will be responsible for drafting more specific, binding technical standards. We anticipate that the new rules will be in place by the end of 2012, as dictated by the G-20 commitments on financial reform.

ESMA will designate the types of contracts subject to the clearing obligation and will oversee trade repositories, data centers where transaction details are reported. Under the current proposal, a derivatives product will be mandated for clearing when it is classified as 'eligible.' There are two methods through which this classification can be assigned:

- *Bottom-Up Approach*: A CCP decides to clear a class of derivatives and is authorized to do so by its regulator. ESMA can then impose mandatory clearing for that class of derivatives and designate a start date for the clearing obligation.
- *Top-Down Approach*: ESMA mandates that a class of derivatives will be eligible for clearing beginning on a certain date.

BlackRock, serving as a fiduciary for clients and an advocate for investors, has been actively engaged with both political institutions and domestic policymakers in Europe, promoting prudent reform of the OTC derivative market.

Market Design and Implementation Issues

During the rule-making phase, the precise standards governing the derivatives market will be set. Investors should be particularly concerned about: (i) governance of central clearing, (ii) reporting requirements, (iii) collateralization requirements, (iv) customer collateral protection, and (v) exemptions from clearing.

Governance of Central Clearing
In our view, central clearing organizations should take a leadership role in designing initiatives that support efficient and transparent OTC clearing. During the rule-making process, it is

OTC Derivatives and Central Clearing

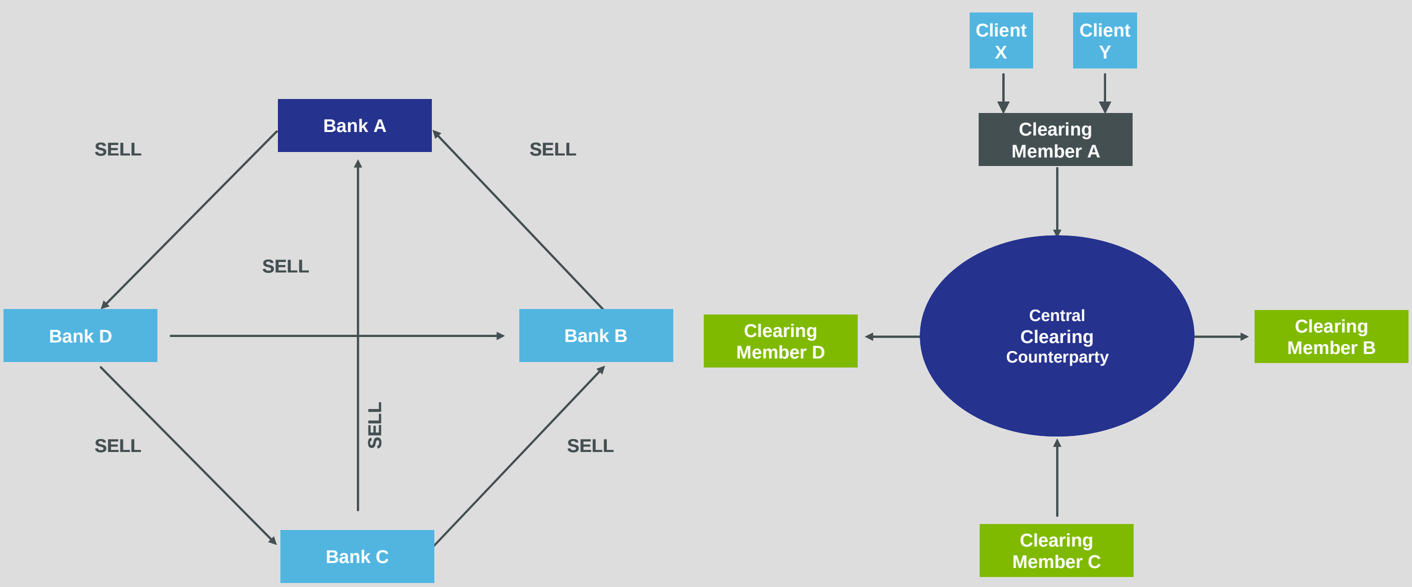
Central clearing refers to the process of managing a transaction after the buy and sell orders have been matched and before the transaction settles. Sitting between the two parties in a transaction, a central counterparty clearing house ("CCP") is responsible for clearing trades, collecting and maintaining margin, overseeing delivery and trade settlement, and reporting trade data. Figure 1 illustrates the role of a clearinghouse in reducing counterparty risk through the offsetting, or netting, of equal and opposite positions. A CCP's primary purpose is to manage the risk that could arise if one counterparty is not able to make the required payment when it is due.

Clients that are not direct members of a CCP may access the clearing organization through a clearing member, who, depending on the CCP model, operates as either a principal or an agent for the trade. In the event of a clearing member default, client portfolios with sufficient segregated collateral could port to an alternative clearing member subject to the agreement of the new clearing member.

Figure 1: Clearinghouse as a central counterparty

OTC Derivatives

Centrally Cleared Derivatives



If Bank A defaults, all other banks are at risk from the knock on effect – not just Bank D

If Clearing Member A defaults, all other banks are protected by the CCP Clients X and Y could port their positions and collateral to Clearing Member B, C or D

Source: BlackRock, Inc.

critical that regulators solicit input from the dealer *and* investor communities to ensure that the needs of both groups are met. We believe that regulators should require investor representation on the operating committees of clearing organizations, which are responsible for approving new products and managing risks and defaults. As users of cleared products, investors are well equipped to explain why particular products might be useful and how the risks associated with such products could be prudently managed. Furthermore, the inclusion of the investor perspective will also help to ensure that clearinghouses require appropriate, but not unduly burdensome, margin for new products.

Reporting Requirements

The financial crisis highlighted the fact that there was insufficient information about the OTC derivatives market available to regulators. To address this issue, market participants, with the support of the regulatory community, committed to establishing and utilizing trade repositories. These centralized registries will maintain electronic databases of open derivative transaction records, ensuring that industry supervisors have the information necessary to manage systemic risk. Both U.S. and European policymakers are currently examining data level reporting requirements. It is important to note that even if a class of derivatives or a market participant is deemed ineligible for central clearing, it is not necessarily exempt from reporting requirements. BlackRock supports the establishment of trade repositories.

We are engaged with regulators in an attempt to ensure that considerations related to trade reporting, such as timing (pre-trade, real-time, or post-trade), liquidity, and anonymity, are adequately addressed. For instance, real-time reporting requirements may result in less favorable execution opportunities for clients, as their counterparties need time to hedge the risks taken on by the trade. Absent sufficient time to lay off risks, counterparties will widen spreads. While we believe it useful for market participants to have access to trade data such as size and price, the timing of the release of that information could have a negative impact on liquidity. Furthermore, public release of this information should protect the identity of trading partners to ensure that the strategies of specific investors are not broadcasted widely throughout the market.

Collateralization Requirements

Centrally cleared products will be subject to both initial and variation margin. Initial margin is a deposit posted to cover an estimated, potential future loss. Acceptable non-cash collateral, as well as cash, can be used to cover this requirement. Although the list of acceptable non-cash collateral varies from one CCP to another, it is generally restricted to highly liquid, stable instruments such as government bonds. Variation margin, which is exchanged between clearing members and clearing houses on a daily or intraday basis, is a payment made based upon price movements of the derivatives contracts held. Variation margin is a zero-sum game; a payment is offered by one side of a trade and received by the other to collateralize previous price movements. Under current proposals, variation margin must be paid in cash.

Given the opportunity costs associated with holding cash, we favor regulation that permits the use of high quality, liquid non-cash instruments as collateral. In the absence of this option, investors employing derivative strategies will be forced either to sell off long-term assets or to use repurchase agreements (“repos”) or other alternatives in order to provide funding. BlackRock is working with regulators and CCPs to broaden the scope of instruments that constitute acceptable collateral for both initial and variation margin without weakening the stability of the market.

Customer Collateral Protection

A key consideration related to the establishment of the CCP model is whether collateral posted by multiple clients will be held in individual, segregated accounts or aggregated into a single omnibus account. This matter has been a subject of vigorous debate among dealers and investors. Currently, bi-lateral swap agreements include segregation of collateral while futures agreements utilize omnibus accounts. The use of omnibus accounts exposes any one customer to the risk of default by another customer or by the clearing member. While dealers argue that use of the omnibus model will reduce the likelihood of CCP default and will control costs, investors point out that alternative solutions will provide greater protection while retaining operational efficiency.

As an asset manager representing investors, BlackRock advocates the use of a model that provides greater collateral protection for investors than an omnibus account. We would support the use of three distinct structural models under consideration by regulators today:

- *Individual segregated accounts*: This model, in which individual, segregated accounts would be held at the CCPs, would likely offer investors the highest levels of protection. In the event of default by the clearing member, this approach would provide a known and clear path to the transfer of positions, accompanied by the necessary margin, of non-defaulting customers. Individual segregation at the customer account level may increase operational complexity.
- *Legally segregated, operationally commingled (“LSOC”) accounts:* This model seeks to capture the advantage of individual segregation without disrupting operational processes. Like the individual segregated account model, this model would require the clearing member to pass through gross margin as received from its customers. If the clearing member were to become insolvent, due to the default of a customer, the CCP would have sufficient information (and sufficient collateral value) to identify the non-defaulting

customers and to facilitate the orderly transfer of open positions to another clearing member. As in the individual segregated account model, the non-defaulting customers would be protected from defaults by fellow customers or the clearing member.

- *Default Waterfall Sequence*: Another solution would be to change the order of loss liability in the default waterfall at a CCP so that the customer collateral pool is last in line, rather than first, for bearing any losses. Enhanced customer protection would result from the low probability that a default event would be so severe that the other funds in front of the customer pool would be insufficient. This approach would require minor changes to the current model and the CCP default waterfall concept.

BlackRock is also working with CCPs in Europe on an alternative to physically transferring collateral for initial margin. A pledge arrangement whereby collateral is segregated at the client's custodian and to which the clearing member and clearing house have a lien in the event of a default would have significant benefits for clients. Along with the reduction in counterparty risk, this arrangement would also reduce the costs associated with the physical transfer of cash and non-cash collateral.

Exemptions from Central Clearing Requirement

While BlackRock supports the clearing of eligible OTC derivatives through regulated CCPs, we believe that certain types of contracts should not be subject to compulsory clearing.

- *Highly Customized Derivatives Contracts*: Some derivatives products are highly customized and complex and thus, do not fit within the central clearing model. In our view, bi-lateral trading of these OTC contracts should be permissible. However, contracts exempt from the clearing requirement should be subject to trade reporting and collateralization rules comparable to those that apply to centrally-cleared products.

- *Stable Value Funds and Book Value Contracts*: The Dodd-Frank Act specifically mandates a joint CFTC/SEC study to determine whether book value contracts, which are integral to stable value funds, should be subject to the regulatory regime established for derivatives. Stable value funds are offered as an investment option to millions of participants in 401(k) and other types of savings plans. On November 7, 2010, BlackRock submitted a letter providing detailed information on this product and a rationale for the exclusion of it from the derivative classification. In summary, stable value funds are composed of high quality, diversified fixed income securities combined with book value contracts. Plan sponsors pay providers a fixed annual basis point fee for these contracts and contract providers are protected by a number of plan-specific provisions. In reviewing these contracts, they are quite dissimilar to swap contracts. In addition, plan participants have benefitted and continue to benefit from investing in stable value funds, as the income earned in these vehicles typically exceeds the income earned by alternative money market or cash sweep investment options. Finally, a regulatory decision to unwind these funds may have unintended impacts on the capital markets for both short and intermediate duration fixed income securities.

- *FX Forward Contracts*: As mandated by the Dodd-Frank Act, the U.S. Treasury has the option to exclude deliverable FX forward contracts from the regulatory regime established for OTC derivatives. European regulators have indicated that they will wait for U.S. resolution on this issue before promulgating rules themselves.

  BlackRock believes that, while the central clearing of deliverable FX forward contracts may be attractive to certain participants and fund types, it is not necessarily appropriate for all types of FX investment activity and therefore, it should not be mandatory in the near-term. Passive hedging strategies are, for example, employed both for separate accounts and pooled funds, the latter often in the form of hedged share classes or feeder funds. The clients are seeking full exposure to underlying fixed income or equity assets without the associated currency risk. The original tenor of these contracts is typically less than four months. Were central clearing of all FX forwards to become mandatory, institutional and retail clients could face a significant performance drag through the requirement to post cash variation margin. Alternatively, were these investors to decide to no longer hedge currency risks, they could face greater volatility of returns relative to the core underlying asset holdings.

  While spot FX contracts, which tend to settle two business days after trade date, will not be subject to central clearing, regulators have yet to define what tenor of contract will face mandatory clearing. Moving to collateralization for all FX forward contracts would represent a significant challenge to the viability of active and passive FX overlay strategies. These strategies typically have not required an upfront capital commitment, which has allowed these funds to remain fully invested in the underlying assets.

  BlackRock is working with regulators and market participants in an attempt to ensure that if central clearing and the subsequent movement of collateral is mandated for this class of derivatives, it is targeted at longer tenor FX forward contracts. Additionally, we advocate that more stringent collateral requirements for bi-lateral trades, rather than arbitrary settlement cut-offs, are used to encourage the transition to central clearing.

Special Considerations for LDI Strategies

Liability driven investment ("LDI") strategies seek to match assets against future liabilities and use OTC derivatives to reduce funding volatility. LDI mandates are low risk, single-directional and, for the most part, fully invested mandates. Some aspects of central clearing may have a disproportionate impact on such mandates. For instance, LDI investors typically hold large allocations to government debt and minimal allocations to cash. The requirement to post cash as variation margin could have a material adverse impact on the performance of these investors. Likewise, LDI investors typically hold interest rate swaps and inflation swaps with offsetting risk profiles. Currently, when both products are held bi-laterally with the same counterparty, collateral and counterparty risk are on a net basis. But if, for example, inflation swaps are not deemed eligible at the outset of mandated clearing, these products will remain bi-laterally traded while eligible interest rate swaps are cleared. This fragmentation would result in increased counterparty risk and the payment of collateral on a gross basis. Clearing houses are working to broaden eligibility for clearing, but given the tight deadlines imposed by regulators, may not be able to offer a full product scope when mandated clearing is initiated. The ability to clear both interest rate and inflation swaps at outset will minimize increases in margin and in risk. Finally, due to the long-term nature of many instruments used by LDI investors — for example, some interest rate swaps have up to 50 year maturities — higher than average margin requirements may be imposed.

BlackRock is working with CCPs and clearing members in an attempt to ensure that margin-setting is risk-based and that fees and servicing charges do not excessively impact clients employing LDI strategies. We are also working with CCPs to broaden the scope of products eligible to be cleared to include swaptions and inflation swaps.

The current design of the bi-lateral OTC market infrastructure ensures client segregation, limited initial margin requirements (while fully collateralizing exposures under ISDA agreements), and the ability to net offsetting collateral movements within an account. LDI funds, like all funds, will benefit from the reduction in systemic risk provided by central clearing. However, it is important that these improvements do not come at the cost of the benefits of the existing system.

Implementation

Many of the proposed new rules, if adopted, will require significant changes to the infrastructure of the derivatives market. Market participants will need time to re-engineer technology, develop new procedures, and make behavioral adjustments. As such, it is critical that regulators provide investors with sufficient time to prepare for changes before they are implemented.

Conclusion

BlackRock supports initiatives to strengthen oversight of the OTC derivatives market. We are actively engaged both in the U.S. and Europe, working directly with regulators, central clearing houses, and clearing members to shape policy that provides optimal client protection while minimizing practical implementation costs. In our communication with these groups, we emphasize the following themes:

- Investor representation in the governance of central clearing
- The development of enhanced trade reporting
- The acceptance of high-quality, liquid non-cash assets as collateral
- The need to maintain customer collateral protection
- The exclusion of certain products, such as highly customized derivative contracts, from compulsory clearing
- The exclusion of stable value funds and FX forward contracts, from the regulatory regime governing OTC derivatives

Given the interconnectedness of the OTC derivative market, we believe that it is critical that policymakers balance the needs of dealers and investors and take an internationally-coordinated approach in order to develop a fair, consistent regulatory framework.

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