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Mr. David Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: RIN 3038-AC98, AD02 - Notice of Proposed Rulemaking Financial Resources Requirements for Derivatives Clearing Organizations (75 Fed. Reg. 63113)

Dear Mr. Stawick:

This letter contains the response of the International Swaps and Derivatives Association, Inc (“ISDA”) to the Commodity Futures Trading Commission's (the “Commission”) notice of proposed rulemaking (“NPR”) establishing financial requirements for derivatives clearing organizations (“DCOs”), as required by Title VII and Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).

ISDA is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 830 member institutions from 57 countries on six continents. These members include most of the world’s institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter (“OTC”) derivatives to manage efficiently the financial market risks inherent in their core economic activities.

Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business through documentation that is the recognized standard throughout the global market, legal opinions that facilitate enforceability of agreements, promoting the development of sound risk management practices, and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

At the outset, ISDA wishes to commend the Commission for showing leadership in consideration of the financial resource requirements on DCOs and systemically important DCOs (“SIDCOs”). These financial resource requirements are an important contributor to financial stability and we would encourage the Commission to set clearly robust standards building on the earlier (and continuing) work of the Committee on Payment and Settlement Systems (“CPSS”) and the International Organization of Securities Commissions (“IOSCO”). Indeed, the CPSS and IOSCO report entitled “Recommendations for Central Counterparties” published in November 2004 states¹:

Although a CCP has the potential to reduce risks to market participants significantly, it also concentrates risks and responsibilities for risk management. Therefore, the effectiveness of a CCP’s risk control and the adequacy of its financial resources are critical aspects of the infrastructure of the markets it serves. In the light of the growing interest in developing CCPs and expanding the scope of their services, the CPSS and the Technical Committee of IOSCO concluded that international standards for CCP risk management are a critical element in promoting the safety of financial markets.

As a related point, disclosure of DCO financial resource requirements will add to confidence in the financial markets.

Background

Title VII

The Dodd-Frank Act amended section 5b(c)(2) of the Commodity Exchange Act (“CEA”) to expressly confirm that the Commission may adopt rules and regulations on DCO compliance with the core principles added to the CEA by the Commodity Futures Modernization Act of 2000. In developing the proposed regulation we appreciate that the Commission has endeavoured to strike an appropriate balance between establishing general prudential standards and prescriptive requirements.

Core Principle B, as amended by the Dodd-Frank Act, requires a DCO to possess financial resources that, at a minimum, exceed the total amount that would enable the DCO to meet its financial obligations to its clearing members (“CMs”) notwithstanding a default by the CM creating the largest financial exposure for the DCO in extreme but plausible market conditions; and to enable the DCO to cover its operating costs for a period of 1 year, as calculated on a rolling basis. The Commission is proposing to adopt Regulation 39.11 to establish requirements that a DCO will have to meet in order to comply with Core Principle B.

¹ <http://www.bis.org/publ/cpss64.pdf>

Title VIII

Section 805(a) of the Dodd-Frank Act allows the Commission to prescribe regulations for those DCOs that the Council has determined are systemically important and the Commission is proposing to adopt some additional requirements for SIDCOs.

ISDA commends the Commission for its careful consideration of the issues raised and its thoughtful development of the NPR. ISDA has a number of comments on this important issue and welcomes this opportunity to share its thoughts.

Accordingly, this letter contains three parts. The first covers ISDA's comments in relation to the Title VII proposals and the second covers our comments on the Title VIII proposals. The third recommends that the Commission develop rules for DCO and SIDCO resolution.

I. DCOs

Amount of Financial Resources Required

We appreciate that the Regulation 39.11 is premised on achieving compliance with Core Principle B and this principle is not the focus of the consultation. However, we consider that the level of financial obligations required by Core Principle B, which is so fundamental to Regulation 39.11, may be inadequate. Instead, ISDA considers that a DCO must meet a higher safety standard. For example, in the clearing of certain OTC derivatives, such as eligible credit default swaps and interest rate swaps, the industry has already reached a consensus, and ISDA agrees that a DCO should have sufficient financial resources that, at a minimum, enable it to withstand a potential default by *two* of its largest CMs, as measured by the two CMs with largest obligations to the DCO in "extreme but plausible" market conditions².

We hold the view that this higher safety standard is appropriate for the following reasons:

- A DCO centralizes and concentrates counterparty and operational risks and the responsibilities for risk management. Therefore, it is critical that DCOs have both effective risk control and adequate financial resources. In addition to sufficient capital provided by the CMs, this means stricter and more uniform rules on the posting of collateral to cover counterparty exposures than has been seen in bilateral OTC derivatives markets.
- In the event of a large CM default where the DCO only has the level of financial resources sufficient to enable it to withstand that default, non-defaulting CMs may consider that the DCO's financial resources are largely "used up" and lose confidence in the DCO to the detriment of a stable and orderly market in the product.

² Further, for the purposes of this calculation of minimum financial resources, ISDA believes the DCO should consider its exposure to a CM net of exposures to any relevant affiliates.

- Given that different DCOs are clearing different swap products, a large CM of one DCO is highly likely to be a CM of another DCO. As a result, a single CM default could have implications for multiple DCOs and consequently multiple markets.
- If a DCO defaults, it will itself need to be unwound in what will likely be stressed markets. This has systemic implications. These implications will probably include illiquidity and large spreads in entire categories of products cleared by the defaulting DCO.

However, this heightened financial resource level may not be appropriate for all other OTC or other derivative products. ISDA notes, for example, that due to their heightened liquidity profile, traditional Futures products have a long history of being safely cleared at DCOs with financial resource levels that are much lower than those contemplated for cleared OTC contracts. ISDA would be happy to work with the Commission to determine the appropriate standard for derivatives in other asset classes.

Regardless of a DCO's required level of financial resources, we suggest that in the event of a CM default, the DCO should be permitted a restricted period to recapitalise to the minimum level, with the duration of this period to be determined by the Commission following consultation.

Types of Financial Resources

a. Default Resources

Proposed Regulation 39.11(b)(1) lists the types of financial resources that would be available to a DCO to satisfy the proposed financial requirements of Regulation 30.11(a)(1) as:

- (1) the margin of the defaulting CM;
- (2) the DCO's own capital;
- (3) the guaranty fund deposits of the defaulting CM and non-defaulting CMs;
- (4) default insurance;
- (5) if permitted by the DCO's rules, potential assessments for additional guaranty fund contributions on non-defaulting CMs; and
- (6) any other financial resource deemed acceptable by the Commission.

We consider that types (1), (2) and (3) above are the prudent forms of financial resources. In relation to types (4), (5) and possibly (6), we support a prudent haircut for such elements. In addition, for type (4), we consider that the insurance provider must be of good credit quality or that the insurance be credit enhanced to ensure availability of funds when needed.

In relation to type (5) it should be noted that although the DCO may have a contractual right to assess additional funds from its CMs, it will still have to seek funds from these

CMs at a time of stress, which will cause a (further) liquidity drain on the system. Moreover, in the event of a default, the defaulting CM will likely not be able to pay its assessment and other CMs might also be unable or unwilling to pay. Accordingly, we would support an appropriate haircut for types (4), (5) and (6) of financial assets as determined by the Commission upon review of the relevant DCO. (The appropriateness and level of any such haircut will likely be impacted by the attributes of the DCO, the product being cleared, its membership, and other similar criteria.) In addition, we would suggest that the Commission evaluate the potential impact of multiple assessments from different DCOs on the same CM or affiliate group in a short time-frame, and in conjunction with the relevant prudential regulator for such institutions, monitor the ability of CMs and its related affiliates to meet these potential exposures as part of its ongoing oversight function.

In relation to (6) we consider that the Commission should consult with a range of stake holders and independent experts prior to the adoption of another type of financial resource to ensure its prudent valuation and, if applicable, haircut. In particular, given the concerns on the interconnectedness of affiliate groups expressed above, we encourage the Commission to give prudent consideration to the use of standby Letters of Credit (“L/C”) as an additional financial resource, given that many L/C issuing banks will be an affiliate of a CM.

In a default context, the largest proportion of the financial resources available to the DCO will be initial margin and guaranty funding. Risk is mutualized in the guaranty fund. If initial margin is not sufficient to cover the losses from disposing of a CM's position, the DCO will turn first to the defaulting member's guaranty fund and then to a combination of the DCO's own capital and the guaranty funding provided by the other CMs. If initial margin is set too low, there will be incentive to push volume through the DCO as participants recognize that the risk of large volumes will be subsidized by other CMs through guaranty fund contributions. Thus, inadequate initial margins may deter prudent firms from becoming CMs.

Moreover, inadequate initial margins will also lead to an increase in the guaranty fund. An oversized guaranty fund will negatively impact post-default portability of clearing customer positions, as it will disincentivize non-defaulting CMs from accepting the transfer of the defaulting CM's customer positions given the funding costs associated with the resultant increase in their guaranty fund contributions.

Given this, it is our view that initial margin should be sufficient to hedge and liquidate each CM's positions under extreme but plausible market conditions. We agree that initial margins should consider the time to liquidate positions, potential concentration of positions and the performance of positions during the liquidation process. Very robust initial margins together with a prudent guaranty fund will ensure the DCO will be able to withstand severe stress on markets combined with defaults of CMs.

Finally, we note that the imposition of unlimited or unknown/unquantifiable liability on the part of clearing members may exacerbate systemic risks significantly and should be avoided, if not prohibited.

b. Operating Resources

We think that it is appropriate that a DCO hold substantial equity capital and that this should be sufficient to cover its operating costs and likely exit costs during any liquidation. This capital should be separate from any DCO equity contribution to the required default resources discussed above. Thus, if defaults exhaust a DCO's default-related resources and it is unable or unwilling to recapitalize itself on a timely basis, then it must in addition have sufficient resources to permit an orderly wind-down of its business.

Computation of the Financial Resources Requirements

We agree with Proposed Regulation 39.11(c)(1) which requires a DCO to perform stress testing on a monthly basis in order to make a reasonable calculation of the financial resources it needs to meet the requirements of proposed Regulation 39.11(a)(1). It is important that the determination of exposures ought to be made in respect of a stressed market. We also consider that "reverse stress tests" should also be required for determining the size of the financial resources package. (In contrast to orthodox stress tests, reverse stress tests start from a hypothesized outcome (such as a DCO breaching regulatory capital requirements or DCO insolvency) and then ask what events could lead to such an outcome.)

We also agree with the proposed role of the Commission to review the stress test methodology and, if appropriate, require changes. Of particular note, we do not think self-certification of compliance with the financial resources requirements or of margin calculations is adequate.

We accept that a DCO must have discretion in determining the methodology it uses to make the calculation to comply with the requirements as this will enable the stress tests to be tailored to the specific business of a particular DCO. This is important as the exposures of one DCO, which clears swap product "A" are likely to be different than another DCO which clears swap product "B".

Moreover, we consider that a DCO's methodology must be transparent. There should be public disclosure of the stress tests and their results.

Finally, the calculation of initial margin must ensure a safety standard that is "robust", which should mean in this context that an exception should not occur on average more than once a year. This entails:

- a confidence level that is greater than 99% for whatever holding period is prudent for that asset class;

- regular DCO back-testing of its initial margin calculation; and
- periodic public disclosure by the DCO of its back-testing methodology and results.

We believe that the minimum prudent holding period for any asset class is five days unless a DCO can demonstrate through repeated practice that close out for portfolios of an asset class can be achieved in a shorter period. Longer periods will be appropriate for less liquid asset classes.

Given that quiet market periods can produce imprudently low estimates of margin under a confidence-interval-based calculation, we further recommend that the Commission sets minimum standards for the period of data used in margin calculations and that these calculations are validated with respect to stressed market conditions.

Valuation of Financial Resources

Proposed Regulation 39.11(d)(1) would require a DCO, no less frequently than monthly, to calculate the current market value of each financial resource used to meet its financial resources obligations under proposed Regulation 39.11(1). In addition to this, a DCO must perform the valuation at other times as appropriate, because market values may fluctuate and proposed Regulation 39.11(a) requires the DCO to be able to meet its obligations on a rolling basis. We consider that the valuations should be made every day by the DCO and delivered to the Commission for review each day also.

Liquidity of Financial Resources

We support Regulation 39.11(e)(1) that requires a DCO to have sufficiently liquid financial resources to enable the DCO to fulfill its obligations as a central counterparty during a one-day settlement cycle. We assume the intention of the regulation is that financial resources are available as cash within one day (and not that settlement in a default context must occur in one day). The liquidity of the financial resources available to the DCO is critical as if the DCO does not have adequate liquid resources to manage the default of a large CM then any request for further contributions from CMs will be a further liquidity drain on the system and may exacerbate the crisis by causing cascading defaults in other (otherwise solvent) CMs.

One possible solution here would be for the Commission to mandate that a high proportion of DCOs' financial resources must be invested in one of a narrow range of very liquid and very safe instruments.

In any case, the Commission should make the relevant assessment of the liquidity of the DCO's financial assets as DCO self-assessment may give rise to an imprudent incentive structure.

Reporting Requirements

As noted above, we strongly support regular reporting to the Commission on (i) amount of financial resources and (ii) the value of each financial resource available to meet those requirements. Further, we consider it is critical that proposed regulation 39.11(f)(2) requires a DCO to provide the Commission with sufficient documentation that explains both the methodology it used to calculate its financial requirements and the basis for its determinations regarding valuation and liquidity. This proposed Regulation also requires that a DCO provide the Commission with copies of any agreements establishing or amending a credit facility, insurance coverage or which otherwise supports its conclusions.

Regulation 39.11(f)(2) also provides the DCO with a 17 business day time limit to file the report, but a DCO would also be able to request an extension of time from the Commission. In order to promote further certainty and confidence, we believe that should a DCO desire to seek an extension from the 17 day time limit, it should do so at least 7 business days before the time limit will expire. The Commission should impose fines for any late filing.

II. SIDCOs

Amount of Financial Resources Required

DCOs centralize and concentrate counterparty and operational risks and the responsibilities for risk management, as discussed above. A SIDCO also does this, but the stakes are raised as the default of a SIDCO has highly negative implications for the stability of the whole financial system. Therefore, it is critical that SIDCOs' risk control and financial resources are of the highest order, and are seen as such. However, we encourage the Commission to consider whether the appropriate size of a SIDCO's financial resources should be determined following an assessment by the Commission of the specific risks posed by the relevant SIDCO and the individual products it clears, rather than set to a uniform level which may be either insufficient or overly conservative.

Moreover, any incentive to use DCOs instead of SIDCOs will tend to make the former more systemic. Therefore we suggest that the Commission periodically reassess DCOs to ascertain whether they have become "systemically important".

To further reduce systemic risk, we also suggest that to the extent that a SIDCO relies upon the availability of a standby liquidity facility to meet its financial resources commitments, a significant proportion of the size of the liquidity facility be mandated to be provided by banks which do not have affiliate CMs at the relevant SIDCO.

Valuation of Financial Resources

We agree with the imposition of a prudent haircut on “assessment powers” noting that while they may be an efficient means of providing a back-up source of funding, they are not resources on hand but rather promises to pay from CMs. In this context, we discount the significance of any “general interest in maintaining the viability of the DCO going forward” and the possible incentive of a non-defaulting CM to pay an assessment depending on the size and profitability of its positions. As mentioned previously, we stress the need for ongoing monitoring of the ability of CMs and affiliate groups to meet their assessment obligations across all DCO/SIDCOs to which they are a member.

We would also encourage the Commission to impose additional and more frequent disclosures for SIDCOs, including disclosure of their exposures and balance sheets.

III. DCO/SIDCO resolution plan

A plan for the mitigation of DCO stress and the procedure for resolving a failing DCO were not proposed in this NPR. However, ISDA wishes to emphasize it is imperative that a comprehensive plan to address DCO stress is agreed ex ante. Such a plan might include consideration of whether an alternative DCO is able to clear a particular product and also the requirement for some level of interoperability across DCOs (including compatible operational systems and procedures) so that non-defaulting portfolios can be ported relatively seamlessly to another DCO rather than having to unwind large portfolios over the course of a relatively short period which could result in further market dislocation. A credible DCO/SIDCO resolution plan is vital for financial stability, particularly given that a DCO or SIDCO may be the principal venue for clearing a product, and, in the absence of adequate continuity planning, DCO stress might preclude the functioning of the market for that product, while SIDCO stress might preclude the functioning of the entire financial system.

As a related point, the Commission should consider the availability of credible alternative clearing arrangements in setting DCO financial resources requirements. If no alternative source is available, it is all the more important that a DCO is highly robust and hence higher requirements may be prudent.

Conclusion

The public policy rationale for the Dodd-Frank Act is to reduce risk, increase transparency and promote financial markets by, inter alia, imposing financial resource requirements on DCOs and SIDCOs to enable them to perform their central risk management function, as mandated by the Dodd-Frank Act. ISDA believes that public policy objective is best served by the Commission imposing prudent and appropriately conservative financial resources requirements on DCOs and SIDCOs.

ISDA appreciates the opportunity to provide these comments. Should you require further information, please do not hesitate to me or my staff.

Sincerely,

A handwritten signature in cursive script that reads "Robert C. Pickel".

Robert Pickel
Executive Vice Chairman