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March 21, 2011

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

Re: RIN 3038-AC98 - Notice of Proposed Rulemaking: Risk Management Requirements for Derivatives Clearing Organizations ("DCOs") (76 Fed. Reg. 3698)

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") regarding the regulations to implement derivatives clearing organization ("DCO") core principles as amended by 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 800 member institutions from 54 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, 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.

ISDA welcomes this opportunity to share its comments with the Commission and looks forward to assisting the Commission and its staff in implementing an appropriate framework for DCO risk management, consistent with the core principles set forth in the Dodd-Frank Act, with a view to enhancing market liquidity, reducing risk and fostering financial stability.

Background

The DCO core principles were first added to the Commodity Exchange Act in 2000. Compliance with the core principles is required for an entity to be registered and to maintain registration as a DCO. The Dodd-Frank Act amended the DCO core principles and expressly confirmed that the Commission may adopt implementing rules and regulations in respect of them. In this NPR, the Commission proposes to adopt regulations to implement six DCO core principles.

ISDA commends the Commission for its careful consideration of the issues raised by the adoption of regulations to implement the core principles and applauds the majority of the DCO risk management requirements proposed in the NPR. This response focuses on aspects of particular proposals where we think there is scope for improvement.

Accordingly, this letter contains four parts. The first covers our comments in relation to certain proposals to implement the Participant and Product Eligibility principle. The second contains our comments on particular proposals to implement the Risk Management Requirement principle. The third covers ISDA's comments on some of the proposals to implement the Settlement Procedures principle. The fourth contains our comments regarding certain proposals to implement the Default Rules and Procedures.

1. Clearing Member ("CM") Eligibility

We acknowledge that the Commission seeks to permit fair and open access to central clearing and has thus proposed minimum capital requirements for DCO clearing members ("CMs") that are significantly less than the capital requirements that DCOs currently require CMs to meet in these product markets.

We think that broadening access to central clearing is a worthy policy position *as long as* the associated risks are addressed to ensure that the potential benefits of broader access are realized and the substantial risks of central clearing in OTC derivatives markets are not significantly exacerbated. In this context, we urge the Commission to consider the importance of the following:

(a) "Call Risk" Management

In OTC derivatives markets CMs generally participate in numerous DCOs and product markets. Consequently, it is very important that regulators and DCOs are able to discover

and manage capital "call risk" arising from the possibility that an entity is a CM in multiple DCOs. For example, it is possible that the $50 million minimum net worth under the proposed rules is used repeatedly by a CM to meet the eligibility requirements of multiple DCOs. Consequently, there is a risk of inadequacy in a CM's capital cover for all of the DCOs at which it is a member in light of the potential impact of multiple assessments from different DCOs on the same CM or affiliate group in a short time-frame. We believe this circumstance to be a significant possibility given the relatively small number of transactors in the OTC derivatives market and the high likelihood that most CMs will be members of multiple DCOs. The proposed regulations do not address this call risk. Left unmanaged it poses a serious threat to DCO risk management.

We think that prudent management of call risk requires:

(i) daily reporting from the CM of their capital cover for the potentially numerous DCO assessments that it could be subject to from each DCO at which the CM is a member;

(ii) the CM to conduct regular stress tests at an 'extreme but plausible' market level in relation to the potentially numerous DCO assessments that it could be subject to, and to provide the results to the DCOs it is a CM at; and

(iii) each DCO to monitor and assess, on a daily basis, the ability of a CM and its related affiliates to meet these potential assessment exposures and share this daily analysis with other DCOs and the relevant prudential regulator(s).

Unless regulators and DCOs are able and willing to monitor a CM's assessment liability across all the DCOs at which it is a member and to ensure that such total liability is not excessive, we think that a far larger minimum capital requirement (e.g., $1 billion) remains appropriate.[1] At this significantly larger minimum capital requirement size, there would be less of a need for this ongoing regulatory scrutiny to address call risk across DCOs as much larger CMs are able to absorb these potential assessment costs whereas small CMs are more leveraged entities in the sense that the sum of their potential DCO assessment liabilities will be a larger number relative to their capital base.

(b) Mandatory Participation in CM Default Management

We applaud the NPR's requirement that entities who become CMs must have the ability to participate in the DCO default management process including the ability to bid for the portfolios of other CMs of the DCO[2]. We agree that this is critically important and that prudent DCO risk management should begin with stringent requirements to become a CM in terms of default risk management capacity (in addition to other important entry criteria

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[1] For example, existing DCOs for interest rate products have generally set minimum capital requirements between $1 billion and $5 billion depending on the type of clearing member and other criteria.

[2] This applies even when CM portfolios include very complex and illiquid products.

such as, for example, financial resources). If a DCO admitted a CM (or a group of CMs) that was unable to participate fully in default management, there could be significant negative repercussions for the DCO and for the market. In particular, the unexpected failure of one or more CMs to participate in default management at a moment of severe stress for the DCO would reduce available resources and liquidity, place heightened burdens on other CMs, and reduce the likelihood that the DCO's risk management process would be effective.

As an additional and related point, default management is too critical for CMs to outsource to unaffiliated third parties. Such outsourcing arrangements may not be sufficiently reliable in times of stress and should not be depended on, particularly in light of the systemic risk issues that may arise if the default management obligations of multiple CMs across multiple DCOs are outsourced to a handful of entities. In addition, there could be conflict of interest issues, since the unaffiliated third party would not have "skin in the game." As a result, through the actions of the unaffiliated third party a CM could be assigned an unsuitable part of a defaulting CM's propriety portfolio and/or at a sub-optimal valuation and/or wrongly accept customer positions from the defaulting CM. This conflict of interest concern is exacerbated where the entity to whom the default management obligations are outsourced to is a "competing" CM in the same DCO.

(c) Minimum Standards of Risk Management Capability

A DCO's participation requirements must ensure that CMs have adequate risk management capability. An appropriate risk management framework for a CM may be broadly categorized into following main components:

(i) Board and senior management oversight;

(ii) Organizational structure: the structure should conform to the overall strategy and risk policy set by the Board of Directors. Individuals who are allowed to take risk on behalf of the CM must have a strong understanding of the organization's risk profile, the products that they are allowed to trade, and the approved limits. The risk management function should be independent, reporting directly to senior management or Board of Directors; and

(iii) Strong systems and procedures for controlling, monitoring and reporting risk, including transactions between an institution and its affiliates. Such systems will include segregation of client assets and a credit limit process.

(d) Prohibition on Unaffiliated Credit Facility Funding Arrangements for Financial Resources

We think that a credit facility funding arrangement from an unaffiliated entity should not be available to satisfy CM financial resource requirements. Although a CM may have a contractual right to access additional funds, it will still have to seek funds from a financial institution at a time of stress where a credit provider may be, despite the contract, unable or unwilling to provide funds. In addition, given the likely correlation between financial institutions, such funding resources are insufficiently reliable. Finally, a DCO has no rights to monitor and request information from the non-member financial institution providing the credit support to the CM.

(e) Require DCOs to require CMs to hold capital proportional to risk

We strongly agree with the proposal that DCOs should "scale" a CM's participation depending on the CM's amount of capital. That is, under the NPR, a DCO should require each member to hold more capital in proportion to its level of risk exposure. Indeed, given the importance of this proposal, it is vital that CMs must be required (rather than permitted) to hold capital proportional to its risk exposure. §39.12(a)(2)(ii) reflects this by stating: "Capital requirements shall be scalable so that they are proportional to the risks posed by CMs." However, the commentary to this rule states: "§39.12(a)(2)(ii) and §39.12(a)(2)(iii), considered together, would require a DCO to admit any person…if the person had $50 million…but would **permit** a DCO to require each clearing member to hold capital proportional to its risk exposure.[emphasis added]" We urge the Commission to clarify its intention that the DCO must be *required* (rather than permitted) to mandate that each CM hold capital proportional to its risk exposure.

2. Risk Management Requirements

(a) Margin requirements

<u>Definition of normal market conditions:</u> The term "normal market conditions" should be defined. *Normal* market conditions certainly exist when there is no CM default. However, the absence of a CM default should not be the only criteria and we urge the Commission to provide more clarity.

<u>Appropriateness of 99% confidence level:</u> The appropriateness of the confidence level of 99% for the purposes of the initial margin calculation depends on the level of mutualization. Currently, there is mutualization for CMs in the DCO default fund and mutulization for clients in omnibus client accounts. Understood in this context, a 99% confidence level is appropriate. If the current levels of mutualization are removed, for example by a requirement to have individualized client accounts instead of an omnibus account, then an appropriate confidence level ought to be

higher than 99% %, since the funds available to a DCO to manage a client account default will be reduced.

Liquidation Time proposals: The current table conveys our understanding of the Commission's proposals:

	Executed on a designated contract market (DCM)	Executed on a swap execution facility (SEF)	Executed bilaterally
Proposed Liquidation Time (minimum number of days)	1	5	5

Rather than setting prescriptive time periods, the required Liquidation Time should be the actual time it takes a DCO to liquidate a portfolio of swaps. This will depend in part on the characteristics of the relevant swap and the market that it trades in (e.g., liquidity levels) and also the default procedures surrounding the liquidation of such swaps and how well-established they are (e.g., a DCO may have detailed default plans that have been put through several practical tests that demonstrate the relevant portfolio of swaps can be liquidated in a very short time). Using the execution platform of a swap as a proxy for such considerations and applying prescribed categorical liquidation times based on such proxies not only gives rise to inappropriate margin levels, but also disincentivizes DCOs from practicing the appropriate default management "drills" to reduce the liquidation time of portfolios of swaps. Instead of such platform-related prescribed periods, the rule should provide for the margin levels to reflect the actual liquidation time of the relevant portfolio of swaps and should further provide that in determining such time period, the DCOs should take into account such factors as the characteristics of the relevant swap and the market it trades in, and the liquidation times derived from the default management plan and practice testing run by the DCO. Regulators should have view of, and sign off on the default management plan.

DCOs should continually monitor the risk associated with concentration in participants' positions. If a DCO determines that a participant's cleared portfolio is so large that it could not be liquidated within the liquidation period assumed in the DCO's default management plan, then the DCO should have discretion to include an extra charge for concentration risk in the initial margin requirements of such participant.

Client positions: While requiring DCOs to maintain comprehensive, robust, and prudent risk frameworks, we urge the Commission to enact core principles which will require DCOs to adopt risk methodologies that minimize the size of the default fund contributions associated with client positions. We believe this change is highly desirable to enable DCOs to better guaranty the portability of client portfolios – if substantial default fund contributions are associated with client accounts, we believe it may be difficult to find a replacement CM willing to accept a large client's portfolio (and the responsibility for funding the default fund amounts associated with that portfolio), particularly when distressed market conditions may be otherwise incentivizing CMs to maximize their own liquidity. We note that by reducing the impact that the customer account risk has on the default fund size the risk to the CCP is increased. This increased risk can be addressed by increasing the risk margin of the customer account, which would require distinguishing between the initial/risk margin applicable to House and Client accounts.

(b) Spread margins

We think that permission for a DCO to reduce initial margin requirements for related positions should only be granted when the DCO can demonstrate a robust correlation in stressed market conditions and agrees to periodic public disclosure of its methodology and results.

(c) Customer margin

Given the significance of the "non-hedge positions" term used in §39.13(g)(8)(ii) of the proposed rules on customer margin, further clarity on its precise meaning is appropriate.

(d) Large trader reports

The NPR requires a DCO to monitor "large trader" positions across all CMs carrying an amount for that large trader and to conduct stress tests on the large trader. These proposals involve a DCO in monitoring and assessing client risk. While this expansion of oversight may provide benefits, many DCOs do not currently have the systems or infrastructure to monitor or assess non-CM risk. In addition, further clarity on how the Commission intends to apply the large trader definition to swaps is needed.

(e) Portfolio compression

Proposed §39.13(h)(4)(i) requires a DCO to offer multilateral portfolio compression exercises and proposed §39.13(h)(4)(ii) requires a DCO to require its CMs to to

participate in these exercises. We request clarification from the Commission on what is meant by "multilateral portfolio compression" in these proposals. If Commission is referring to position netting, then we agree that a DCO must offer such exercises. However, if the proposals mean that a DCO must provide multilateral portfolio compression services such as currently provided by, for example, TriOptima, then we do not understand the rationale for such a requirement in light of the fact that there already exist well-established service providers that the market has been using with respect to compression exercises and that the requirement that DCOs build out such duplicative services is likely to delay their roll-out of comprehensive clearing services (which should be their focus).

(f) Risk management policies and procedures

We strongly support the Commission's proposal to require CMs to have written risk management policies and procedures. In this context, we would also like to emphasize the importance of practical experience by CMs in risk management in addition to written policies and procedures.

3. Settlement Procedures

The proposals currently define payments and receipt of variation margin for futures, options and swap positions as settlements. However, posting of variation margin on swaps should not be viewed as "settling" the present value of the trade. Price alignment interest would still be paid on such variation margin. Similarly, deposit and withdrawal of initial margin are also defined as settlements in the NPR, whereas initial margin is not "paid" by the CM to the DCO but is posted often with a security interest granted by the CM.

Secondly, the "settlement finality" proposal states that all settlement fund transfers are irrevocable and unconditional when the DCO's accounts are credited or debited. While settlement finality is desirable in a bankruptcy context, we seek clarification from the Commission on how this will be compatible with the correction of errors and the fact that title transfer of initial margin may not occur when it is posted to a DCO.

4. Default Rules and Procedures

The proposals would require a DCO to conduct and document a test of its default management plan on at least an annual basis. However, given the importance of robust default management we think that default management tests should be undertaken more frequently and at least on a semi-annual basis.

In addition, a number of technical amendments to the proposed rules are necessary to reflect the appropriate risk management framework of DCOs. In this regard, Section 39.16(c)(2) provides that a DCO shall adopt rules that set forth default procedures, including the following: (v) a provision that customer margin posted by a defaulting CM

shall not be applied in the event of a proprietary default; and (vi) a provision that proprietary margins posted by a defaulting CM shall be applied in the event of a customer default, if the relevant customer margin is insufficient to cover the shortfall. In respect of clause (v), the words "in the event of" should be replaced with "to cover losses in respect of"; otherwise, customer margin would not be able to be applied even to cover customer losses, which clearly cannot have been the intention. With regards to clause (vi), the word "excess" should be inserted immediately before the words "proprietary margins" to make it clear that proprietary margin is to be applied first to cover proprietary losses, which is the basis on which such margin has been calculated and collected (and, correspondingly, the basis on which margin is calculated for customer positions). The use of proprietary margin to cover customer losses ahead of proprietary losses hastens the mutualization of losses among CMs (which would likely result in higher margin levels being imposed in respect of customer positions in order to avoid such outcome).

A plan for the mitigation of DCO stress and the procedure for resolving a failing DCO were not proposed in this NPR. However, as in its prior comments[3], ISDA wishes to emphasize that 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 forcing the unwind of large portfolios over the course of a relatively short period - a process which could result in further market dislocation. A credible DCO (or Systemically Important DCO ("SIDCO") as the case may be) resolution plan is vital for financial stability, particularly given that a DCO or SIDCO may be the principal venue for clearing a product. 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.

Conclusion

The public policy rationale for the Dodd-Frank Act is to reduce risk, increase transparency and promote financial market stability by, inter alia, imposing a DCO risk management regulations for DCOs. ISDA believes that the Commission's NPR provides a strong and thorough set of regulations that should, assuming the concerns set out above are addressed, facilitate DCO compliance with the DCO core principles and protect the integrity of the U.S. clearing system.

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[3] Please see ISDA response to RIN 3038-AC98, AD02 - Notice of Proposed Rulemaking Financial Resources Requirements for Derivatives Clearing Organizations (75 Fed. Reg. 63113) dated December 10, 2010

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

Sincerely,

Robert Pickel
Executive Vice Chairman