

February 15, 2013

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

Re: Notice of Proposal Rulemaking – Enhancing Protections Afforded
Customers and Customer Funds Held by Futures Commission
Merchants and Derivatives Clearing Organizations (RIN3038-AD88)

ISDA is grateful for the opportunity to comment on the Commission’s proposed rulemaking referenced above.

Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 60 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

Our particular focus is the proposed amendment to 17 C.F.R. § 22.2(d) to the effect that a futures commission merchant which operationally commingles cleared swap customer funds must ensure that “at all times” its residual interest in its cleared swaps customer accounts exceeds the aggregate margin deficits of its relevant customers (the “Residual Interest Proposal”). ISDA understands the varied and important concerns for customer protection that underlie the Commission’s rulemaking generally. While these concerns have been amplified by the MF Global and Peregrine Financial failures,¹ *neither of these failures would have been avoided or mitigated by the Residual Interest Proposal.*

The Residual Interest Proposal is aimed at “fellow-customer risk” in a double-default situation.² ISDA was a proponent of the “legally segregated, operationally commingled” (“LSOC”) customer collateral holding methodology that is intended to diminish “fellow customer risk” and that has been given effect in Part 22 since November 2012. The Residual Interest Proposal, however, does not add substantive fellow-customer risk customer protection to

¹ 77 F.R. at 67868-69.

² Id. at 67895.

that already afforded by LSOC. The Residual Interest Proposal was not included in LSOC³ and its cost was not included in industry assessment of the additional costs imposed on FCMs by LSOC. ISDA believes the cost of the Residual Interest Proposal to be dramatically high. A close analysis by the Commission of the protection already afforded by LSOC, and an equally close analysis of any additional benefits and the substantial costs of the Residual Interest Proposal, neither of which are contained in the Proposing Release, should be a prerequisite to any further action with respect to the Residual Interest Proposal.

We believe that these analyses should convince the Commission that the cost of the Residual Interest Proposal is unaffordably high and unjustified by incremental benefit. We ask the Commission to abandon the Residual Interest Proposal.

I. The Benefits of the Residual Interest Proposal Are Largely Illusory and Unneeded

A. LSOC Offers Practical Protection Against Fellow-Customer Risk.

LSOC, given effect in existing Part 22, was intended to provide cleared swap customers with protection against “fellow-customer risk”⁴ in a “double default” situation. The Residual Interest Proposal is aimed at the same risk, but as a “mechanism for demonstrating FCM compliance”⁵ with the prohibition on using the collateral of one customer to support the obligation of another. We suggest that this demonstration is both unneeded and damagingly costly to the market.

LSOC, fundamentally, requires enhanced bookkeeping and communication between FCMs and DCOs so that DCOs may allocate to each cleared swaps customer of a clearing FCM a portion of the value of collateral that has been deposited by the FCM at the DCO for its customer account.⁶ DCOs are obligated to respect each customer’s collateral value “required and collected” from the FCMs as that customer’s alone. Any excess collateral “collected” from a customer is within the DCO obligation to allocate to the providing customer.⁷

Each clearing member FCM is required under LSOC to report each customer’s “portfolio of rights and obligations” to the relevant DCO at least once each business day. Additionally, each DCO and FCM must calculate and record its collateral requirements for each cleared swaps customer at least once each business day. Finally, a failing FCM unable to meet a margin call is obligated to take steps, including notifying the DCO of the customer failures underlying the FCM’s inability.⁸

B. Limits of Both LSOC and the Residual Interest Proposal: What Problem Does the Residual Interest Proposal Solve?

³ 77 F.R. 6336, Feb. 7, 2012.

⁴ *Id.* at 6338.

⁵ *See* 77 F.R. 67866, 67895.

⁶ *See* 77 F.R. at 6363.

⁷ Commodity Futures Trading Commission Staff Interpretation, Question 2.2, Nov. 1, 2013. Under Rule 22.13(c), excess collateral may be deposited at a DCO, assuming DCO rules permit and require the FCM to identify daily the excess amount for each customer. DCOs are moving to provide this capacity. *See* CME Implementation of LSOC: Day-to-Day Procedures, available at www.cmegroup.com/clearing/files/lsoc-and-cme-groups-vision.

⁸ Rule 22.19 (c)(2)

In sum, LSOC should provide the means for a DCO, upon a double default, to properly allocate collateral value to non-defaulting customers. This is not to say that LSOC accounting will be wholly accurate at every moment or, in particular, that a failing FCM will properly complete its day of default reporting obligations.⁹ By the same token, however, there is no assurance that the Residual Interest Proposal's requirements would be met by a faltering FCM, or that a given customer's excess collateral, if misrecorded or misreported, would end up back in the hands of the proper customer, regardless of the presence of ample FCM residual interest. In other words, proper allocation of any excess will remain dependent on LSOC accounting and will not be enhanced by the Residual Interest Proposal. It is not clear, then, what the Residual Interest Proposal will achieve.

The purpose of LSOC was to protect nondefaulting customers from bearing the burden of defaulting customer payment failures left uncured by a failed FCM. This was accomplished by removing nondefaulting customers as potential contributors from the default waterfall and providing the DCO the means to monitor the nondefaulting customers' rights. The Residual Interest Proposal ignores the protection LSOC provides and purports to cover the same risk as LSOC does, but by requiring of the FCM (at least in the first instance) even greater payments than those at risk of FCM failure under present regulation.

Assuming, as suggested below, that FCMs choose to save themselves from this crushing payment burden by requiring additional pre-funded margin from customers, ironically, more customer funds will become vulnerable to the various other risks (e.g., investment risk) that LSOC does not protect against.¹⁰ This would be as inappropriate a result as placing this new burden on FCMs.

C. A Paradigm Shift in Clearing?

If the Residual Interest Proposal does not add appreciably to protection against fellow-customer risk, what does it do? Assuming that it requires the presence in the customer account of predicted amounts sufficient to offset any risk of customer margin deficit, the Residual Interest Proposal would remake the FCM's guarantee from a post-customer-failure resource to a pre-funded resource, at a cost that will inevitably be passed to customers. Assuming that FCMs choose to shift the burden of the Residual Interest Proposal directly to customers by requiring customers to prefund margin, the Residual Interest Proposal will make customers "self-guaranteeing" and diminish reliance on the FCM. This would clearly diminish the overall risk of FCM default (and hence double default), but at very significant cost to market participants and to market volumes and liquidity.¹¹

⁹ Misallocation was specifically considered by the Commission in its consideration of LSOC, with responsibility for rectification being the FCM's bankruptcy trustee. 77 F.R. at 6359.

¹⁰ See 77 F.R. at 6338, nn.13 and 17. A customer may of course require its pre-funded amounts to be held as excess at a DCO. This would diminish risks associated with FCM holding, but presents margin allocation issues, assuming the FCM is placing the customer's transactions on more than one DCO. Excess held at one DCO will not be readily available as pre-funded margin to serve another DCO's needs.

¹¹ Effectively doubling margins will damage futures and swaps markets by destroying the value proposition for many liquidity providers essential to the markets' efficiency. While some asset managers may be able to afford double margins, even they will suffer from the increased costs of finding the liquidity they need.

II. Quantifying the cost of the Residual Interest Proposal

The Residual Interest Proposal would require FCMs to fund margin deficits in customer accounts at all times, which means FCMs will fund customer variation margin (VM) losses on a gross basis as of the early morning call (and any intraday call), until customer's loss payments are received. Accordingly, FCMs will be required to reserve and fund a steady amount to cover these potential intraday funding drains, which will create a cost at least equal to FCMs' respective funding spreads for the funded reserves¹².

Because there is relatively little long-term cleared swaps data on which to base a preliminary estimate of the amount of funding needed to comply with the Residual Interest Proposal for swaps, we begin with the estimated costs of the proposal for futures.

We ignore here changes in initial margin ("IM") as they are minor (though additional) relative to variation margin ("VM") changes that would need to be covered gross under the Residual Interest Proposal. ISDA estimates the amount needed to fund futures customers' gross losses, on a volatile day, as being no less than 50% of IM. This estimate is based on the following. If all customers fund their potential one-day losses in advance, they would have to post twice their IM. If the FCM instead were to cover the losses, assuming all shorts and longs were perfectly balanced, the FCM would have to cover 50%. If either the longs or shorts predominated—which in practice they do—the FCM would have to cover potentially substantially more. For purposes of estimating the cost of the Residual Interest Proposal, ISDA assumes the one-day cover amount (IM for futures covers one day's losses) for futures is 60% of IM at any FCM. This is an amount which each FCM is going to have to reserve for, and to fund, and to pay for the cost of that funding.

- As of the CFTC's November 2012 FCM Data report, combined segregated and secured margin requirements totaled \$177B (i.e., \$147B for section 4d(a), \$30B for Rule 30.7)
- In order to estimate the potential future FCM funding requirement for futures arising from the Residual Interest Proposal, we subtract from the total the *existing* customer excess. There is a large amount of existing customer excess in futures¹³. We estimate futures excess is about \$40 – 70B. We use \$55B (mid point of this range) below.
- Applying the 60% rule (explained above), total FCM funding of customer gross deficits would be 60% of $177-55 = 60\%$ of $122 = \$73.2B$ ¹⁴

¹² Balance sheet and capital charges would be additional to the funding cost

¹³ Unlike futures we do not expect cleared swap customers to maintain significant excess funds. For instance, swap margins are called gross on both sides and there is no long option value margining. Swap customers are typically hedgers and retrieve their profits to pay losses on the assets and liability they are hedging.

¹⁴ We refer to the estimate provided by the Futures Industry Association in its letter of even date relating to this topic. We believe our estimates (which are, of course, preliminary) to be roughly consistent for purposes of this analysis.

Turning from futures to swaps, we apply the same 60% rule described above to derive our preliminary estimates for the long-term impact of the Residual Interest Proposal on funding requirements for cleared swaps as follows:

- As cited in ISDA's response to the LSOC ANPR,¹⁵ the total IM requirement for cleared IRS is estimated to be \$833B at the 99% confidence level. Assuming total IM requirements for CDS are equal to half this amount and noting ESMA is calling for a higher 99.5% confidence level in Europe, we estimated that the swaps IM requirement will total at least \$1,500B (assuming a 40% increase for the higher ESMA requirement¹⁶ on (the European¹⁷) half of the swaps).
- One day moves for swaps, relative to the IM required, are smaller than for futures, since swaps IM covers a longer 5 day period. Assuming the square root rule¹⁸, one day swap moves would be $\sqrt{1/5} = 45\%$, or \$670B total.
- Applying the 60% rule (explained above), the total FCM funding of customer gross deficits would be \$402B.
- Our analysis is further refined by considering only the DCOs likely to be subject to the CFTC's proposal. We would include:
 - CME and LCH IRS, which account for *at least* 80% of cleared IRS in the US.
 - ICE CC, ICE CE, CME US and LCH CDS, which account for *at least* 90% of cleared CDS in the US
- This reduces the amount of total FCM funding of customer gross deficits relating to cleared IRS and CDS to (80% of \$833B (IRS) + 90% of \$417B (CDS)) x 1.2 / $\sqrt{5}$ x 60% = \$1250B / $\sqrt{5}$ x 60% = \$335B

Procyclicality of the proposed LSOC impact

Swaps however are extremely risk sensitive, and BIS research suggests that IM requirements for cleared IRS can triple in times of stress, and IM requirements for cleared CDS can increase much more than that¹⁹. Consequently, while we have estimated the impact at \$335B

¹⁵ Re: RIN No. 3038-AD99 - Advanced Notice of Proposed Rulemaking —Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies (75 Fed. Reg. 75162) (ISDA ANPR), available at <http://www.isda.org/speeches/pdf/cftc-anpr-protection-for-cleared-011811.pdf>

¹⁶ LCH and ICE Clear Europe operate under European regulation, even though they are DCOs.

¹⁷ IRS and CDS have non-normal distributions, fat tailed and asymmetric. The ISDA response to the ANPR referenced above noted that the additional IM for 99.9% confidence was 581 for the 833 cleared IRS or an additional 70% IM, demonstrating how non-normal IRS is; CDS is more non-normal, of course.

¹⁸ If the time period associated with the IM calculation is reduced, assuming a normal distribution, the IM will fall by the square root of the ratio of the shorter time frame divided by the longer time frame.

¹⁹ BIS Working Papers, No 373, *Collateral requirements for mandatory central clearing of over-the-counter derivatives*, Daniel Heller and Nicholas Vause, Monetary and Economic Department, March 2012, page 30.

for swaps, in times of sudden stress, the extra funding requirements could create very severe additional funding demands from FCMs, at just the wrong moment.

III. Potential Mitigation – Not “At All Times”

The Residual Interest Proposal would require that an FCM “ensure that at all times” its residual interest exceeds the sum of margin deficits of all its cleared swap customers. This requirement will oblige the FCM to make a calculated, predictive funding of residual interest, engendering funding cost in excess of that needed to cover “real” margin deficits on any given day.

The real-time ebb and flow of customer business activity, including margin payments, does not as a practical matter lend itself to a constant FCM real-time residual interest funding program. Accordingly, the FCM charged with “ensuring” under the Residual Interest Proposal must deposit its residual interest based on a bad (if not worst) day margin deficit scenario. To mitigate this over-funding possibility, we suggest that the Commission study the effect of modifying the Residual Interest Proposal to require compliance at a single specified time in the course of a business day. For example, the Residual Interest Proposal might be recast as a requirement to cover deficits apparent at the end of a full day after positions are incurred or margin calls made. This would reduce the required amount to be funded by funds actually received from customers to settle calls. This proposal would also rationally reduce the effect of the additional CFTC proposal that margin deficits outstanding for more than one business day be deducted from the FCM’s adjusted net capital.²⁰ Although we disagree fundamentally with the appropriateness of the Residual Interest Proposal for the reasons stated in Section I above, easing the at-all-times aspect should diminish cost.

IV. Conclusion

For the foregoing reasons, we urge the Commission to either immediately abandon the Residual Interest Proposal or to undertake a thorough cost-benefit analysis intended to verify real costs of achieving well-explained goals.

Sincerely,



Robert Pickel
Chief Executive Officer

²⁰ See 77 F.R. at 67938 (proposed amendment to Rule 1.17).