ISDA® Safe, Efficient Markets

May 8, 2013

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

Re: Notice of Proposed 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 further 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.

In our February 15, 2013 comment letter to the Commodity Futures Trading Commission ("CFTC"), we raised a number of significant concerns regarding the proposed amendment to 17 C.F.R. § 22.2(d) to the effect that a futures commission merchant ("FCM") which operationally commingles cleared swaps 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").[1] We write further to our February 15 letter (the "Prior Letter").

The Commission, in proposing an "at all times" residual interest cover of individual client margin deficits, did not estimate the substantial additional funding requirements that would be needed. Our Prior Letter indicated the potential for great cost in the Residual Interest Proposal. Our estimates using the methodology described in the Section II of the Prior Letter (attached hereto) show that the proposal would impose additional FCM funding requirements of

[1] Letter from ISDA to Secretary of the CFTC regarding Notice of Proposed Rulemaking – Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations (RIN3038-AD88) (February 15, 2013).

approximately $73.2B for futures and $335B for cleared swaps. Alternatively, if clients were to prefund their potential one-day moves in advance, that would require an additional $120B from futures customers and $558B from cleared swaps customers.[2] These colossal amounts resulted primarily from the "at all times" aspect of the Residual Interest Proposal, which would require FCMs to fund individual client margin deficits. To do so, FCMs would have to set aside funding resources, available at all times, in an amount that will cover potential residual interest demands at a very high level of confidence. Since the cost of such additional funding resources would challenge the FCM's business model, FCMs may require their customers to prefund their potential losses one day in advance, resulting in effectively double margin requirements for futures and an increase of 45% (i.e., 1/sqrt(5), employing the square-root-of-time rule and assuming a five-day risk period) for cleared swaps.

The traditional business function of an FCM is both to guarantee the performance of its customers and to act as a "clearinghouse" for customer margin payments. At the start of the day, the FCM meets or collects from the DCO the net variation gain or loss across the customer account, thereby enabling the DCO to cover its risk to the FCM, and the FCM to start paying out gains to individual customers. Throughout the day, as customers with market losses meet their FCM calls, the FCM is able to continue to pay out gains to customers with gains. By the end of the day, typically, all customer calls have been met, and all customer gains have been paid out; all achieved without the FCM having recourse to its own funding resources.

Those customers that did not meet their calls by end of day, however, would require either the FCM to cover the corresponding customer gains with its own money, or use customer excess collateral. We agree with the Commission that the latter practice has no merit, and that an FCM should cover customers that did not pay by the end of the day with its own funds, so that all customers with gains receive them, and no other customer's collateral is used for such purpose. For an FCM with robust credit risk management systems, covering end-of-day customer deficits should not be a significant cost.

Requiring however, as the Proposal suggests, the FCM to cover its individual customer margin deficits at all times with its own monies would break the traditional role of the FCM as a clearinghouse for margin payments; an efficiency that the current model provides would be lost, resulting in very significant additional costs to client clearing.

It may be helpful to observe that in the course of a day, as the FCM's advances to meet customer variation margin calls (which advances represent FCM 'residual interest' (were it computed at that moment) in the pool of customer collateral) are reimbursed by cash receipts from customers, that 'residual interest' amount (subject to recomputation during the relevant interval) again becomes available for funding other customer's margin calls. Moreover, because customer losses that accrue during the trading day and are the cause of margin deficits also result in a corresponding diminution of the customer's net equity (so long as the customer account has positive net equity), other customers of the FCM are not prejudiced by the intra-day existence of margin deficits. Furthermore, clearinghouse initial margin levels by regulation are designed to

[2] In the Prior Letter, the FCM funding amounts for futures and cleared swaps were derived by estimating the total one-day customer prefunding requirement and multiplying by 60%. The total additional customer margins estimates, $102B and $558, are simply the additional FCM funding amounts divided by 60%.

make remote the likelihood that a customer account that was adequately margined at the start of the trading day could move into a negative net equity position during the trading day. Thus the traditional clearinghouse model does not run counter to the Act.

At the present time, many customers cannot assure payment of their morning FCM call before the end of the New York day. Part of the problem is current custodial practices, and many clients use custodians in other parts of the world. Reducing the time between the start of the day and the time when all FCM customers can reasonably be expected to have met their calls will require changes throughout the industry. If this is an imperative, we recommend a period of study to see what new practice is feasible. Accelerating the customer payment cycle is not practicable for vast classes of customers, as this would require operational capabilities that many customers do not possess and overlooks the practicalities associated with clearinghouses and customers located in multiple time zones, where differing business hours and closing times of payment and settlement systems must be taken into account.

The Residual Interest Proposal is inconsistent with the current and established FCM business model and would refashion the FCM's role from one of guarantor and post-customer-failure resource to a pre-funded resource, at a cost that will be passed on to customers. Assuming instead that FCMs choose to shift the burden of the Residual Interest Proposal directly to customers by requiring customers to prefund margin, the proposal would remake the cleared swaps and futures markets into one exclusively for "self-guaranteeing" customers. This result would be damaging to markets by destroying the incentives for continued participation by liquidity providers essential to the markets' efficiency. Although some asset managers may be able to fund a doubling of margins, the associated funding and opportunity costs are likely to cause them to re-evaluate their continued participation in these markets.

Protecting non-defaulting customers from fellow customer risk is accomplished by LSOC. Under LSOC, non-defaulting customers are not considered potential contributors to the default waterfall. As noted in the Prior Letter, LSOC requires each clearing member to report each customer's portfolio of rights and obligations to the relevant DCO at least once each business day. Each DCO and FCM must calculate and record its collateral requirements for each cleared swaps customer at least once daily. In light of LSOC protections, the need to impose the costs which will be precipitated by the "at all times" Residual Interest Proposal as a "mechanism for demonstrating FCM compliance with the prohibition on using collateral of one customer to support the obligation of another" is unjustified; and the costs, unsustainable.

We suggested in the Prior Letter that the costs of the Residual Interest Proposal could be mitigated if the proposal were modified to require compliance at a single specified time in the course of a business day. In furtherance of this suggestion, we respectfully request that the Residual Interest Proposal be modified so as to require compliance at 5:00PM EST. This change would allow the Residual Interest Proposal to operate consistently with the existing FCM business model as an aggregator of payments and would render the proposal's costs manageable for both FCMs and their customers. By removing the predictive element of FCM funding requirements and allowing markets to reap the efficiencies of end-of-day accounting, we expect that the modified version of the proposal would impose incremental funding requirements of only a small percentage of those for the originally proposed "at all times" Residual Interest Proposal. While for cleared swaps there is yet little reliable data to estimate future FCM funding

of end-of-day customer deficits, experience in futures suggests a customer failure rate of approximately two percent, although there is an additional five percent miss of call times due to foreign exchange two day settlement. In a more professional market such as cleared swaps, we would expect even smaller failure rates.

The requested modification will not detract from the regulatory objectives of the Residual Interest Proposal. We urge the Commission to take into account the enormous costs of the "at all times" element of the Residual Interest proposal (which were not analyzed by the Commission at the time of the proposal) and the lack of any concrete and quantifiable benefits beyond the protections against fellow customer risk already provided by LSOC.

Sincerely,

Robert Pickel

Chief Executive Officer

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