ISDA Safe, Efficient Markets

September 16, 2013

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

Re: Notice of Proposed Rulemaking – Derivatives Clearing Organizations and International Standards (RIN 3038-AE06)

The International Swaps and Derivatives Association, Inc. ("**ISDA**") appreciates the opportunity to provide the Commodity Futures Trading Commission (the "**Commission**") with comments and recommendations regarding the proposed rulemaking[1] described 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.

Implementation of PFMI

ISDA supports the Commission's stated goal of implementing regulations for derivatives clearing organizations ("**DCOs**") that are consistent with the CPSS/IOSCO Principles for Financial Market Infrastructures ("**PFMI**") prior to the end of calendar year 2013.[2] However, in view of the compressed timeline for finalizing the proposed rulemaking, ISDA suggests that the Commission issue its rulemaking as an interim final rule, so that market participants will have an opportunity to provide additional substantive comments.

ISDA also generally supports Proposed Rule 39.40, which recites the Commission's intent to establish standards that, together with subparts A and B of Part 39, are consistent with DCO core principles and with the PFMI, and which further states that subpart C should be interpreted in that context. This statement as to intended interpretation allows the Commission to incorporate ongoing developments regarding the application of the PFMI into the Commission's supervisory practices. In addition, the statement is responsive to the prong of the Basel Interim Framework's definition of QCCP that stipulates that the CCP's domestic regulator "publicly indicat[e] that it

[1] 78 Fed. Reg. 50260 (August 15, 2013)
[2] See id. at 50284.

applies to the CCP on an ongoing basis, domestic rules and regulations that are consistent with the [PFMI]."[3]

However, ISDA believes that the statement in Proposed Rule 39.40 regarding the interpretive context for new subpart C should be qualified by adding the phrase "except to the extent inconsistent with other regulations of the Commission." This additional language would make clear that the primacy of LSOC is not called into question by evolving international investigations of end-of-waterfall loss allocation. An illustration of the potential for inconsistency is provided by discussion of initial margin haircutting in the CPSS/IOSCO Consultative Report, "Recovery of Financial Market Infrastructures" (the "**Consultative Report**"). The Consultative Report states that it is not intended to create additional standards beyond the PFMI; rather it aims to supplement the PFMI and provide guidance on how financial market utilities can observe certain PFMI requirements with regard to effective recovery plans. Although the Consultative Report recognizes that legal and regulatory prohibitions on the mutualization of initial margin exist in many jurisdictions, it states that such restrictions "would not preclude, where legally permitted, either rules-based use of initial margin for liquidity purposes or to secure a participant's obligation to the FMI meet a cash call or other loss allocation …."[4] Although, in this instance, careful drafting and inclusion of the phrase "where legally permitted" avoids actual inconsistency with Commission Regulation 1.25 and, in the case of initial margin of Cleared Swaps Customers (as defined in Commission Regulation 22.1), LSOC, this example does illustrate the need for care in the incorporation of evolving standards.

Recovery and Resolution

ISDA notes that the issues surrounding recovery and resolution of central counterparties are novel and complex, and raise, among other considerations, questions regarding effects on incentives, disparate impact on various stakeholders, and intricate interplay with capital and accounting rules As a result, ISDA believes that new DCO rules addressing recovery and resolution (that go beyond existing assessment powers) would be appropriate subject matter for the Commission to invoke the extended review process[5] for rule changes that raise novel and complex issues and for a public comment period. In order to provide a meaningful basis for such review and comment, the Commission should articulate principles-based standards against which new DCO rules on recovery and resolution could be measured. ISDA suggests that such standards should include non-disruption of expectations regarding close-out netting sets and a requirement that loss allocation rules not place any non-defaulting clearing member or customer of a clearing member in a worse position than under a Bankruptcy Code liquidation of the DCO. We note that recovery tools such as forced allocation, initial margin haircutting of non-defaulting clearing members, invoicing back or partial non-voluntary tear-ups would not meet these standards and should be avoided. We believe that variation margin gains haircutting ("**VMGH**") should be considered as a loss allocation measure of last resort, i.e., only after all the resources in the waterfall have been exhausted. As a loss allocation method, VMGH is transparent and

[3] See Basel Committee of Banking Supervisors, "Capital Requirements for Bank Exposures to Central Counterparties'' (July 2012), page 1, available at www.bis.org/publ/bcbs227.pdf.
[4] Consultative Report, section 3.5.19, page 20.
[5] See Commission Regulations 40.5(d), 40.6(c) and 40.10(f).

predictable and creates incentives for surviving participants to actively engage in the default management process and to bid aggressively in the auction process.[6]

Proposed Rules 39.35(a)(3) and 39.35(b)(2)(iii) state that a SIDCO's or Subpart C DCO's rules should address how the DCO would replenish any financial/liquidity resources it may employ during a stress event, and Proposed Rule 39.39 (e) requires a SIDCO or Subpart C DCO to maintain viable plans for raising additional financial Resources. The Commission's rule should explicitly require the DCO to impose a limit on replenishing resources. This is critical as the rules of the U.S. prudential regulators require capped liability for clearing members in order for a clearinghouse to be designated as a QCCP.

Proposed Rule 39.39 would require each SIDCO and electing Subpart C DCO to maintain viable plans for recovery or orderly wind-down necessitated by (i) uncovered credit losses or liquidity shortfalls and, as a separate plan, (ii) general business risk, operational risk or any other risk that threatens the DCO's viability as a going concern. The proposed rule lacks some of the detail provided in the Consultative Report. For example, the Consultative Report states that the FMI should assess the legal enforceability of its recovery plan (¶2.3.5), test and review the plan, for example by carrying out periodic simulation and scenario exercises (¶2.3.11) and define criteria (quantitative and qualitative) that will trigger the implementation of a plan (¶2.4.4). ISDA suggests that the Commission's rule include a comparable level of detail for the sake of clarity and providing substance to the requirement.

In ISDA's comment letter on the Commission's proposed mandatory clearing determination, ISDA recommended that the Commission commit itself to a study of DCO insolvency, with a goal of documenting uncertainties and proposing solutions. In the Commission's adopting release for its mandatory clearing determination, the Commission noted its participation in international efforts in this area and its regulatory coordination and cooperation, related to insolvencies under Title II, with U.S. authorities, including the FDIC.[7] ISDA encourages continuation of these efforts, and urges a public discussion of their results as a means to foster greater certainty regarding the consequences of DCO insolvency.

Other Aspects of the Proposed Rulemaking

1. Rescission of election to be regulated under subpart C

Under Proposed Rule 39.31(e), a DCO that has elected subpart C regulation would be permitted to rescind its election, subject to a 90-day notice period and to a prohibition, following notification of its intent to rescind, on holding itself out as a Subpart C DCO and a QCCP. As an additional condition on rescission of the election, ISDA recommends that the Commission require, as part of the enumerated items in Proposed Rule 39.31(e)(ii), the DCO to certify that it has obtained approval from clearing members (e.g., by member ballot) to rescind the election.

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[6] We note that a comparison of outcomes under VMGH and a Bankruptcy Code liquidation of a DCO may be analytically complex. Our recommendation that the Bankruptcy Code baseline be applied as a principle is not intended to preclude VMGH; rather the analysis of differences from the Bankruptcy Code outcome will result in a more informed choice of methodology.

[7] 77 Fed. Reg. 74284, 74290.

2. Commission Review of DCO Compliance

The rules should specify whether the Commission will evaluate a SIDCO's or Subpart C DCO's compliance with the Subpart C requirements as part of its general rule enforcement review (RER) program, or whether SIDCOs and Subpart C DCOs will be subject to a more rigorous and more frequent (e.g., annual) review process. Given the determination that SIDCOs are systemically important, and the importance to market participants from a capital perspective that SIDCOs and Subpart C DCOs continue to be considered QCCPs, we believe that frequent and rigorous review of SIDCOs and Subpart C DCOs is critical.

3. Governance

In addition to the requirements set out in Proposed Rule 39.32, governance arrangements should explicitly address decision-making during a crisis or emergency. Specifically, the Commission's rule should require the DCO to obtain the views and approval of member representatives (e.g., through the Risk Committee or otherwise) before taking any material action in response to an emergency.

4. Collateral/Liquidity Requirements

It is unclear how the proposed rules define and differentiate between the terms "credit exposure" (e.g., as used in Proposed Rule 39.33(a)(1)) and "financial obligation" (e.g., as used in Commission Rule 39.29). The Commission should define both terms and make its intended distinction clear.

ISDA agrees with the Commission's general approach of restricting qualifying liquidity resources to meet the liquidity resource requirement under Proposed Rule 39.33(c)(1), to the extent that such restrictions only apply to Proposed Rule 39.33(c)(1). We fully agree that the rules should permit the use of US Treasury securities (Proposed Rule 39.33(c)(3)(i)(E)) to satisfy the liquidity resource requirement under Proposed Rule 39.33(c)(1). While we agree that such instruments are readily available and convertible into cash, we do not believe the further condition under Proposed Rule 39.33(c)(3)(i)(E)(2), that the use of US Treasuries only be permitted if pursuant to prearranged and highly reliable funding arrangements, is necessary or appropriate. Such a requirement has the potential to exacerbate a liquidity crisis and pass on risk from the DCO to its liquidity providers.

The condition under Proposed Rule 39.33(c)(3)(ii) that a SIDCO or Subpart C DCO must take steps to "verify that such arrangements do not include material adverse change provisions" is problematic, and in any event is unnecessary because it is not a specific condition under the PFMIs. As a general matter, existing credit arrangements include such provisions in order to protect a financial institution and its shareholders, and to prevent the spread of risk from DCOs to other financial institutions.

Proposed Rule 39.33(c)(4) states that SIDCOs and Subpart C DCOs should "consider" maintaining collateral with low credit risk. Maintaining collateral of low credit risk should be mandatory, rather than simply a consideration. The proposed rule states that additional liquidity

resources must be likely to be saleable with proceeds available promptly. The words "with proceeds available promptly" should be deleted as this is not a requirement under the PFMIs, and in any case is not clearly defined.

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Thank you for your consideration of these comments. Please contact me or ISDA staff if you have any questions or concerns.

Sincerely,

Chief Executive Officer