ISDA® Safe, Efficient Markets

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Chairman Roberts, Ranking Member Stabenow and Members of the Committee, ISDA is grateful for the opportunity to submit a written statement on the reauthorization of the Commodity Exchange Act (CEA)[1].

The reauthorization process provides an important opportunity for Congress to review the Dodd-Frank regulatory framework established after the financial crisis. It also enables Congress to assess progress that has been made by the Commodity Futures Trading Commission (CFTC) and other US regulatory agencies in implementing that framework, measure improvements in the safety and robustness of the financial system, and potentially recalibrate regulations to ensure they support their original objectives and have been implemented in a cost-effective manner.

We commend the Committee's leadership in monitoring the progress of the reforms and ensuring the CFTC operates on a sound footing when performing its important oversight functions.

As outlined in this statement, further work is required to ensure the regulatory framework achieves its objectives. There are numerous examples of where the rules have led to inefficiencies and higher costs for derivatives users, and have resulted in fragmentation of markets and liquidity. The statement will highlight areas where further action is required and propose recommendations. The statement also describes how these regulatory changes have led to the development of transformational industry solutions designed to ensure consistent and efficient implementation of certain requirements.

Background

The Dodd-Frank Act was enacted in 2010 to reduce systemic risk and ensure markets function safely and efficiently. The Act expanded the CFTC's authority to include the regulation and oversight of swaps, in addition to its existing authority over futures and options[2]. It also expanded the CFTC's longstanding broad anti-fraud and anti-manipulation authority to swaps[3].

Since then, substantial progress has been made by the CFTC and other US regulatory agencies to implement derivatives regulations related to clearing, margining, trade execution, trade reporting and capital, in line with the provisions of the legislation. US derivatives

[1] Public Law 93-463, Section 12(d) (Oct. 23, 1974); Public Law 104-9, 109 Stat. 154, Section 1-2 (Apr. 21, 1995)
[2] Commodity Exchange Act (CEA) § 2(a), 7 U.S.C. § 2(a)
[3] CEA § 9(a)(2)-(3), 7 U.S.C. 13(a)(2)-(3); CEA § 4c, 7 U.S.C. § 6c

markets are now more transparent and more resilient than ever before, and the market is functioning more safely and more efficiently.

In clearing, 88.9% of interest rate derivatives notional traded in the first quarter of 2019 and reported to US trade repositories was cleared. Approximately 81% of credit derivatives traded notional was cleared[4]. In fact, ISDA analysis shows that market participants are clearing more than what is required under the CFTC's clearing mandate, highlighting the intrinsic benefits of clearing[5].

In reporting, regulatory standards have been implemented in the US and 20 of the other 24 Financial Stability Board (FSB) jurisdictions, and regulators now have more data at their disposal to understand the derivatives market and identify systemic risk than ever before[6].

With regards to trading, 60% of interest rate derivatives and 77.5% of credit derivatives notional traded in the first quarter and reported to US repositories was traded on a swap execution facility (SEF).

New margin rules for non-cleared derivatives are being phased in, contributing to a reduction in counterparty credit risk. Variation margin (VM) requirements were introduced in 2017, and the largest 20 market participants had collected $858.6 billion in VM for their non-cleared trades at the end of 2018, according to ISDA analysis[7]. Initial margin (IM) rules have been phased-in since September 2016, and approximately $157.9 billion in IM had been collected by the 20 biggest firms at the end of 2018 – a 47% increase versus a similar survey conducted in March 2017.

On capital, the large internationally active banks have added over $2 trillion of Tier 1 capital to their balance sheets since 2011, making them much more resilient to market stress. US banks are today stronger and better capitalized than ever.

A lot of work has gone into developing, implementing and complying with these rules. Without doubt, the financial system is more robust, more resilient and more transparent as a result.

ISDA and its members are proud of this progress, and we recognize that it has been achieved through unprecedented levels of cooperation, both at the legislative and regulatory level and at the industry level.

It is important to state clearly that we are not advocating turning the clock back on regulatory reform, nor do we believe there would be any support in the industry for such a move.

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[4] SwapsInfo First Quarter of 2019 Review, April 2019, https://www.isda.org/a/RNUME/SwapsInfo-Q1-2019-Review.pdf

[5] ISDA Research Note, Actual Cleared Volumes vs. Mandated Cleared Volumes: Analyzing the US Derivatives Market, July 2018, https://www.isda.org/a/6yYEE/Actual-Cleared-Volumes-vs-Mandated-Cleared-Volumes.pdf

[6] Financial Stability Board, OTC Derivatives Market Reforms: Thirteenth Progress Report on Implementation, November 2018, https://www.fsb.org/2018/11/otc-derivatives-market-reforms-thirteenth-progress-report-on-implementation/

[7] ISDA Margin Survey Year-End 2018, https://www.isda.org/a/nIeME/ISDA-Margin-Survey-Year-End-2018.pdf

However, we do think it is appropriate for the regulatory framework to be continually assessed, and for specific, targeted changes to occur where necessary to ensure the rules do not impose unnecessary costs and burdens on derivatives users.

Outstanding Issues and Recommendations

ISDA commends this Committee, the Administration and the various regulators including the CFTC for reviewing the legislative and regulatory framework, and taking steps to identify and make modifications where necessary to ensure the derivatives markets continue to function efficiently.

In response to a series of executive orders, including Executive Order 13771[8], the US Department of the Treasury announced in April 2018 that it eliminated or proposed to eliminate or modify more than 300 regulations. More than 250 Treasury recommendations had been made to reform and reduce the burdens of financial regulation[9].

We agree it is vital that unnecessary costs and complexity do not hamper the use of derivatives by US corporates, pension plans, insurance companies and asset management firms that rely on these instruments to hedge the risks associated with their commercial operations. ISDA urges the Committee to continue playing an active role in monitoring progress on these recommendations going forward.

<u>Margin Requirements</u>

- Phase Five IM Implementation: Looming Operational Challenge

The upcoming application of IM requirements to a wider cross-section of market participants is a key area where action is needed to ensure the rules are applied consistently, without imposing unnecessary costs and burdens on smaller, non-systemically important institutions.

According to ISDA analysis, more than 1,100 entities will come into scope of IM requirements in September 2020, when the threshold for compliance falls from $750 billion to $8 billion in aggregate average notional amount of non-cleared derivatives. This represents over 9,500 trading relationships[10].

Under the rules, new documentation would need to be negotiated with every counterparty and two custodial accounts for each relationship would need to be set up. Despite this, ISDA analysis shows over 70% of newly in-scope counterparty relationships globally will not be required to post IM, because their exposures fall below a $50 million IM exchange threshold[11].

[8] Executive Order 13771, Reducing Regulation and Controlling Regulatory Costs, January 2017, https://www.federalregister.gov/documents/2017/02/03/2017-02451/reducing-regulation-and-controlling-regulatory-costs
[9] Regulatory Reform Accomplishments Under President Trump's Executive Orders, US Department of the Treasury, April 2018, https://home.treasury.gov/sites/default/files/2018-04/20180423%20Regulatory%20Reform%20Report_0.pdf
[10] Joint Trades Final Stages of Initial Margin Phase-In Comment Letter, September 2018, https://www.isda.org/2018/09/26/joint-trades-final-stages-of-initial-margin-phase-in-comment-letter/
[11] ISDA letter to US Regulators on $50 IM Threshold and Documentation Requirement, June 2019, https://www.isda.org/a/UO6ME/Letter-to-US-Regulators-BCBS_IOSCOstatement_20190603_FINAL.pdf

On March 5, the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) issued a statement noting that counterparty relationships with exposures below the IM exchange threshold are not required to meet documentation, custodial or operational requirements[12].

It is important national regulators provide certainty that documentation and custodial requirements will not initially apply for those relationships below the $50 million IM exchange threshold. By adopting a risk-based approach, it will enable the industry to focus its efforts on ensuring larger firms that are likely to post IM are ready to comply. It will also ensure smaller, non-systemically important entities that are not required to post IM are not burdened with unnecessary operational costs.

We agree with a recommendation made by CFTC Chairman J. Christopher Giancarlo in a letter to Federal Reserve Board Vice Chairman Randal K. Quarles for US regulators to issue guidance that unambiguously provides relief for counterparty relationships that do not exceed the $50 million IM exchange threshold under US requirements[13].

- Inter-affiliate Margin for Non-cleared Derivatives

Inter-affiliate trades enable firms to centralize their risk management activities. For example, a European entity might prefer to enter into a swap with a local, European-based subsidiary of a US financial institution. That US institution might choose to consolidate its exposure within a centralized, global risk management function. The subsidiary would therefore enter into an offsetting transaction with that risk management unit. That internal, offsetting trade is known as an inter-affiliate or internal risk management transaction.

Critically, inter-affiliate transactions do not raise systemic risk concerns because they do not create additional counterparty exposure outside of the corporate group and do not increase interconnectedness between third parties. Instead, inter-affiliate transactions allow firms to manage their risk in a centralized way that ultimately limits overall credit exposure to third parties.

Requiring the exchange and segregation of IM for inter-affiliate transactions diverts capital away from more efficient uses in the market, and makes it more difficult for firms to manage their risks. At year-end 2018, the top 20 derivatives dealers had posted approximately $39.4 billion in inter-affiliate IM – capital that cannot be deployed in more productive ways.

While the CFTC has provided an exemption for inter-affiliate swaps from IM requirements[14], the US prudential regulators have not. This disparate treatment creates a competitive disadvantage for those entities subject to inter-affiliate requirements under US prudential rules.

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[12] BCBS/IOSCO statement on the final implementation phases of the margin requirements for non-centrally cleared derivatives, March 2019, https://www.bis.org/press/p190305a.htm

[13] Letter from CFC Chairman J. Christopher Giancarlo to Federal Reserve Board Vice Chairman Randal K. Quarles, May 2019, https://www.cftc.gov/PressRoom/PressReleases/7922-19

[14] Regulators in other key jurisdictions such as the EU, Japan and Singapore have also provided an exemption for inter-affiliate trades. The exemption for intergroup trades in the European Union is currently scheduled to expire 2020

In both margin issues, we understand regulatory fixes are under consideration by prudential regulators, but we would urge the Committee to continue monitoring these important issues until they are resolved.

- Legacy Trades

It is also important that legacy swaps are not brought into the scope of margin, clearing and other regulatory requirements simply because of contractual changes resulting from benchmark reform or Brexit. Legacy trades are currently exempt from these requirements (if executed before the implementation date), but a contractual change – such as an adjustment to incorporate robust fallbacks based on risk-free rates – could change that.

On March 5, BCBS/IOSCO stated that amendments to legacy derivatives contracts pursued solely for the purpose of addressing interest rate benchmark reforms do not require the application of the margin requirements[15]. We urge US regulators to provide clarity on this point. The industry faces enough of a challenge to prepare for phase five of the initial margin requirements without bringing legacy swaps into scope too.

SA-CCR

In December 2018, the US banking agencies – the Federal Reserve Board, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation – proposed the new standardized approach for counterparty credit risk (SA-CCR). This will change the method by which banks are required to calculate their counterparty credit risk exposure for all derivatives transactions.

ISDA is concerned that the current proposal is more conservative than global standards set by the BCBS and, in particular, does not reflect the underlying risk in commodity derivatives. If implemented as currently proposed, it would create an unlevel playing field for US banks and commercial end users that rely on commodity derivatives for hedging purposes.

ISDA has conducted a comprehensive quantitative impact study (QIS) and found that the current proposed SA-CCR rules would lead to a 70% increase in risk-weighted assets (RWAs) for commodity derivatives when compared with the current approach[16]. This jump is largely due to the calibration of supervisory factors, which are meant to reflect the volatilities of the transaction type. The supervisory factors for oil and gas contracts under the US proposal exceed those set by the BCBS, which results in a 37% increase in RWAs for oil and gas when compared with the Basel standard.

In order to avoid penalizing US banks and imposing higher transaction costs on commercial end users, US banking agencies should adopt supervisory factors for commodities that address the actual risk of the contracts and, at a minimum, do not exceed the BCBS standards.

[15] BCBS/IOSCO statement on the final implementation phases of the margin requirements for non-centrally cleared derivatives, March 2019, https://www.bis.org/press/p190305a.htm

[16] Industry Response to the Standardized Approach for Counterparty Credit Risk (SA-CCR), March 2019, https://www.isda.org/2019/03/18/industry-response-to-standardized-approach-for-counterparty-credit-risk-sa-ccr/

ISDA is also concerned about the potential cost implications for commercial end users, which rely on commodity derivatives for hedging purposes. The QIS showed that RWAs would increase by 50% for transactions with commercial end users.

Any requirements that constrain the use of derivatives may affect the ability of commercial end users to hedge their funding, currency, commercial and day-to-day risks, which would weaken their balance sheets and make them less attractive from an investment perspective. ISDA has recommended removing application of the overly conservative alpha factor from transactions with commercial end users.

It is important these issues are addressed to prevent disrupting financing and hedging for users of commodity derivatives markets. Although bank capital rules do not necessarily fall under this Committee's jurisdiction, the rule may have a significant adverse impact on the market participants and financial products that do. As a result, it is appropriate for the Committee to continue to monitor these important rule-makings. We thank the Chairman for his letter to US banking agencies on SA-CCR and inter-affiliate margin.

SEF Rules

The SEF rules are another example of where certain regulatory modifications are appropriate. To this end, we commend CFTC Chairman Giancarlo for engaging with all market participants to review SEF practices, and proposing reforms intended to better align the rules with Dodd-Frank provisions and encourage more trading on SEFs.

The CFTC issued proposed changes to its SEF framework at the end of last year[17], which included flexibility in the method of execution and the potential elimination of the 'made available to trade' determination (a process for determining which products should be subject to mandatory SEF trading).

Irrespective of that proposal, we believe regulators should remain focused on addressing key issues raised by market participants over the years and codify the existing no-action relief to provide greater certainty. Current no-action relief exists for certain types of package transactions and block trade requirements, among other provisions. Providing a permanent solution for these issues would simplify compliance efforts.

With respect to specific regulatory reforms, the CFTC should prioritize allowing SEFs to use a range of execution methods and to provide a clear process for determining which contracts should be subject to mandatory trading on SEFs. Consultation on this process should consider views from all market participants.

CCP Best Practices

As the volume of cleared derivatives has grown, central counterparties (CCPs) have become increasingly systemically important. However, two CCPs have experienced member defaults over the past five years that have exceeded the defaulting member's contribution to default resources and required the use of mutualized resources in the default fund, spreading losses to

[17] Swap Execution Facilities and Trade Execution Requirement 83 FR 61946, November 2018, https://www.cftc.gov/sites/default/files/2018-11/federalregister110518b.pdf

other CCP participants. These defaults have highlighted weaknesses in some CCP risk management practices, and emphasized the importance of consistent best practices.

In response, ISDA has analyzed current practice and published a set of recommendations. These include:

- Risk controls and margin requirement that adapt to concentration, liquidity, member credit quality and wrong-way risk in a member's portfolio
- Effective and transparent default management processes; and
- Robust membership criteria and greater assurances of continued adherence to them.

Importantly, these practices will ensure that, outside of an extreme stress event, the default of a member will not propagate to other members or the wider financial system.

We believe this Committee should continue to remind regulatory bodies that there is no more important duty than the oversight of CCPs to ensure best practices are met.

Treatment of Margin under the SLR

The clearing of derivatives is a central objective of the Dodd-Frank Act, but the supplementary leverage ratio (SLR) in its current form acts to disincentivize clearing. This is because the current rules do not take the exposure-reducing effects of initial margin into account.

The failure of the SLR to recognize the risk-mitigating benefits of collateral significantly impacts the economics of client clearing. While the impact on capital is modest relative to overall bank capital, it significantly increases the amount needed to support client clearing activities. Some banks have opted to scale back or withdraw from the client clearing business as a result, which runs counter to the objectives of Dodd-Frank to encourage central clearing.

The BCBS announced on June 20 that it had agreed a targeted and limited revision of the leverage ratio to allow margin received from a client to offset the exposure amounts of client-cleared derivatives[18]. We encourage the Committee to closely monitor how US regulators approach this issue. It is vital that derivatives users are able to access clearing services cost-effectively.

Reporting

The regulatory reporting framework is another example of where unnecessary complexities and duplications are creating excessive operational burdens and costs for derivatives users.

The CFTC has published amendments to the Part 49 rules governing swap data repositories and data reporting requirements. It is also expected to issue amendments to its Part 43 and Part 45 trade reporting rules, which provide important transparency on derivatives activity to the public and to the CFTC. We appreciate the CFTC's work to adopt the standard 'critical data elements' recommended by the Committee on Payments and Market Infrastructures (CPMI) and IOSCO and to address ambiguity that impairs the quality of the resulting data.

[18] Basel Committee discusses policy and supervisory initiatives and approves implementation reports, June 2019, https://www.bis.org/press/p190620.htm

However, ISDA remains concerned that the trade reporting requirements may still be overly complex, requiring data that is subjective and not easily accessible to firms, thereby reducing the quality and consistency of the information. A streamlined set of data fields that aligns with the information confirmed between the parties for the derivatives transaction will ultimately be more reliable and more useful.

Globally, the fact that 21 FSB jurisdictions have put reporting rules in place is a huge achievement. However, each requires similar data to be reported in a different way. Operational differences and, in some cases, privacy rules prevent unfettered sharing of data between regulators. Firms are required to meet idiosyncratic reporting formats and data fields in each jurisdiction.

This imposes a significant compliance burden on end users and is self-defeating – it makes it all but impossible for global regulators to quickly and accurately aggregate exposures across derivatives instruments. ISDA welcomes the work in this area by the CFTC, the CPMI and IOSCO, as multilateral coordination is critical. However, the pace of reform has been slow and incremental.

Regulatory Fragmentation

Another key challenge relates to cross-border trading and the fragmentation of liquidity. Derivatives markets are global, which gives companies the ability to efficiently and cost-effectively manage their exposures. For cross-border markets to function effectively, market participants need consistency in rule sets where possible and a robust cross-border framework that recognizes overseas rules that are comparable in outcomes.

This was understood by the Group-of-20 (G-20) back in 2009, when it agreed a set of commitments that paved the way for Dodd-Frank. In particular, it stressed that the reforms should be implemented in a way that ensures a level playing field and avoids fragmentation of markets, protectionism and regulatory arbitrage[19].

Unfortunately, the rules have often differed in scope, substance and timing when implemented across jurisdictions. Derivatives market participants are living with the huge cost and regulatory compliance challenges of complying with multiple rule sets.

ISDA has documented numerous examples of fragmentation in different parts of the regulatory framework, explaining how rules differ from jurisdiction to jurisdiction. As mentioned above, the most widely acknowledged example of regulatory fragmentation is in the regulatory reporting space, with 21 FSB jurisdictions requiring common data to be reported in different formats. ISDA has also documented the inconsistencies that exist in

[19] "We are committed to take action at the national and international level to raise standards together so that our national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage." G-20 Leaders Statement: The Pittsburgh Summit, September 2009, http://www.g20.utoronto.ca/2009/2009communique0925.html

margin requirements[20] and trading venues[21]. Both papers provide clear examples of regulatory driven market fragmentation.

Unfortunately, the CFTC took an extraterritorial approach in its 2013 cross-border guidance[22]. While section 2(i) of the CEA stipulates that the swaps provisions of Dodd-Frank should only apply to activities outside the US that have a "direct and significant connection" with US commerce, the CFTC took a much broader view and applied its rules to entities in other countries. The expansive extraterritorial reach of the CFTC and the rule-by-rule reviews mean the process by which market participants have be able to rely on deference or substituted compliance is limited and slow in coming.

These factors have resulted in an overlapping and duplicative regulatory structure that has led to inefficiencies, complexity and higher costs for derivatives users. Ultimately, it contributes to market fragmentation and increased risk.

- Cross-border Regulations

In order to resolve inconsistencies between global rule sets, it is imperative that the process for substituted compliance and equivalence determinations is robust and efficient. Regulatory tools already exist to provide for substituted compliance, but the decisions in practice have been slow to arrive and are often made on a granular, rule-by-rule basis.

As an alternative, ISDA has proposed a risk-based framework for the evaluation and recognition of the comparability of derivatives regulatory regimes in foreign jurisdictions. This approach strikes an appropriate balance by focusing on risk and its cross-border implications. ISDA has further developed this concept in a paper that addresses regulatory driven market fragmentation[23].

A process should also be agreed internationally that would enable national regulators to implement equivalence and substituted compliance determinations in a predictable, consistent and timely manner.

Rather than attempting the impossible task of aligning each and every regulatory requirement across jurisdictions, this approach would allow substituted compliance determinations to be based on broad outcomes. It would reduce the chances of lengthy negotiations that could ultimately lead to reduced liquidity and fragmentation.

We welcome the CFTC's commitment to recalibrate its cross-border regulatory framework[24]. This is particularly timely given the significant progress other jurisdictions have made in

[20] Implementation of Margin Requirements and Market Fragmentation, June 2019, https://www.isda.org/a/XvkME/Implementation-of-Margin-Requirements-and-Market-Fragmentation.pdf

[21] A Practical Guide to Navigating Derivatives Trading on US/EU Recognized Trading Venues, April 2018, https://www.isda.org/a/COmEE/A-Practical-Guide-to-Navigating-Derivatives-Trading-on-US-EU-Recognized-Trading-Venues.pdf

[22] Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, July 2013, https://www.cftc.gov/sites/default/files/idc/groups/public/@lrfederalregister/documents/file/2013-17958a.pdf

[23] Regulatory Driven Market Fragmentation, January 2019, https://www.isda.org/a/wpgME/Regulatory-Driven-Market-Fragmentation-January-2019-1.pdf

[24] Cross-Border Swaps Regulation Version 2.0: A Risk-Based Approach with Deference to Comparable Non-US Regulation, October 2018, https://www.cftc.gov/sites/default/files/2018-10/Whitepaper_CBSR100118.pdf

implementing the G-20 reforms. The CFTC should assess the laws of foreign jurisdictions based on a common set of principles, with an understanding that each jurisdiction may have implemented the G-20 derivatives reforms from slightly different perspectives.

Not all regulatory outcomes have been inconsistent, however. The Principles for Financial Market Infrastructures (PFMIs), developed by CPMI and IOSCO, are a great example of principles that have resulted in relative regulatory consistency. We believe the PFMIs could be a model for improving consistency in the application of financial rules, setting a standard for a more transparent, timely, outcomes-based approach.

Regulators across the globe need a better process to resolve the rule differences and focus on meeting outcomes. We encourage the CFTC to undertake a reform of the extraterritorial application of its guidance to respect the work achieved in other jurisdictions and to focus more on substituted compliance.

- Brexit

Brexit could become another key source of market fragmentation.

The terms and timing of the UK's exit from the European Union remain uncertain, but ISDA will do its part to identify the issues and mitigate the impact on the derivatives market to the greatest extent possible.

A key concern is the risk of fragmentation and disruption should a 'hard Brexit' occur on October 31 – that is, the UK leaves the EU in a disorderly way, without an exit deal and without a transition period. In that instance, a top priority will be to ensure continuity of clearing and trading between cross-border counterparties.

To that end, ISDA welcomes the joint announcement by the CFTC and UK regulators in February to grant the necessary approvals and no-action relief once Brexit occurs to allow trading and clearing activity to continue[25].

This follows in the footsteps of a temporary equivalence determination for UK CCPs by the European Commission last December, in the run-up to the March 29 deadline[26].

These announcements will go some way to reducing market disruption and ensuring derivatives markets are able to function smoothly. A loss of recognition for UK CCPs would have created huge operational challenges, as thousands of contracts would have had to be relocated to alternative CCPs, giving rise to increased systemic risk, significant costs and distorted competition in global derivatives markets[27].

[25] Joint Statement by UK and US Authorities on Continuity of Derivatives Trading and Clearing Post-Brexit, February 2019, https://www.cftc.gov/PressRoom/PressReleases/7876-19
[26] European Commission implements 'no-deal' Contingency Action Plan in specific sectors, December 2019, http://europa.eu/rapid/press-release_IP-18-6851_en.htm
[27] The Impact of Brexit on OTC Derivatives: Other 'Cliff Edge' Effects Under EU Law in a 'No Deal' Scenario, October 2018, https://www.isda.org/2018/10/09/cliff-edge-effects-under-eu-law-in-a-no-deal-brexit-scenario/

ISDA also welcomes the joint European Commission and CFTC statement on EMIR 2.2 in March[28]. We strongly encourage regulators to rely on enhanced supervisory cooperation and coordination when it comes to the supervision of third-country CCPs, and to defer to national authorities wherever possible.

- CFTC-SEC Rules

Global regulatory harmonization should be an objective of regulators everywhere to avoid duplications, inconsistencies and fragmentation. This is especially true in the US, where oversight of the market is bifurcated between the CFTC and SEC. ISDA appreciates the continued efforts of the agencies to harmonize their rule sets, and hopes they will continue to work together as the SEC finalizes its rules and the CFTC revises its existing framework.

Where inconsistencies and duplication continue to exist, we believe the issues could be addressed by adopting a 'safe harbor' approach that recognizes compliance with the other agency's rule sets. Such an approach should aim to streamline requirements and ensure customers can benefit from access to capital providers, both foreign and domestic.

The SEC's recent adoption of final rules on capital requirements for security based swap dealers and margin for non-cleared security based swap transactions is a good example of convergence between the two agencies[29]. Under the rules, dual registrants that deal predominantly in swaps and do not have significant amounts of security based swaps can choose to comply with the capital, margin, and segregation requirements of the CFTC rather than the SEC requirements.

Solutions

The implementation of Dodd-Frank and the G-20 commitments more broadly has been one of the most seismic transformations in the history of the derivatives market. ISDA has been at the forefront of this transformation, working to develop globally consistent solutions to common industry implementation challenges.

Industry Solutions for Margin

Where possible, ISDA has worked with members to develop global solutions for margin that ensure consistency in how firms apply the rules. To mitigate the potential for disputes over margin calculations, we released the ISDA Standard Initial Margin Model (ISDA SIMM) in 2016. Use of a single model helps with operational use, model approval, legal documentation, economical running costs, transparency and infrastructure development by users, regulators, vendors and middleware providers.

More recently, as the IM regulatory framework extends to smaller entities, we developed ISDA Create – IM[30], a powerful digital platform that allows the negotiation and execution of

[28] Joint European Commission and CFTC Statement on EMIR 2.2, March 2019, https://www.cftc.gov/PressRoom/SpeechesTestimony/jointeuropeanandcftcstatement031319
[29] SEC Adopts Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Amends the Capital and Segregation Requirements for Broker-Dealers, June 2019, https://www.sec.gov/news/press-release/2019-105
[30] ISDA and Linklaters Launch Full Version of ISDA Cerate – IM, January 2019, https://www.isda.org/2019/01/31/isda-and-linklaters-launch-full-version-of-isda-create-im/

IM documents with multiple parties simultaneously. This will help smaller, resource-constrained firms to comply with global margin requirements.

Digital Solutions

ISDA is playing its part in supporting financial institutions as they look to harness the potential of new technologies to drive efficiencies and reduce costs.

The derivatives market has developed over time in a bespoke and bilateral way, without standard conventions for how trade events and processes are represented. Each participant has developed its own unique representations. The lack of firm foundations has limited the ability to apply automated solutions across the industry in a scalable way.

In response, ISDA has developed the Common Domain Model (ISDA CDM), a digital blueprint for how derivatives are traded and managed across the trade lifecycle. We launched the full version of the ISDA CDM for interest rate and credit derivatives earlier this year[31], and are currently working to extend this to other asset classes.

Creating a standard representation for events and products that can be used by all participants, infrastructures, platforms and regulators will enable firms to develop automated solutions that can be interoperable and scalable in a way that has never been done before.

The ISDA CDM is already being tested in a number of environments. Last month, ISDA announced the deployment of the model to support the UK Financial Conduct Authority, the Bank of England and participating financial institutions in testing phase two of the digital regulatory reporting pilot[32], a UK initiative to explore the use of technology to help firms meet their regulatory reporting requirements and to improve the quality of information reported.

Benchmarks

ISDA's work in supporting the industry through major changes extends beyond the G-20 commitments. When considering the global challenges facing the derivatives industry, there are none more global or more challenging than benchmark reform. With an estimated $370 trillion in notional exposure to key interbank offered rates (IBORs) across financial markets, this is an issue that affects all aspects of the economy, from Wall Street to Main Street.

ISDA has been working on this on multiple fronts, but has played a leading role in an industry effort to develop robust, consistent fallback language for derivatives contracts. The aim is to enable contracts referencing LIBOR and other IBORs to trade with the minimum possible disruption after a discontinuation of the underlying benchmark.

Last year, ISDA consulted on technical adjustments that would apply to the fallback rate in the event certain IBORs are permanently discontinued[33]. The aim of the adjustments is to

[31] ISDA Publishes CDM 2.0 for Deployment and Opens Access to Entire Market, March 2019, https://www.isda.org/2019/03/20/isda-publishes-cdm-2-0-for-deployment-and-opens-access-to-entire-market/
[32] ISDA CDM Deployed to Help Deliver UK Digital Regulatory Reporting Pilot, May 2019, https://www.isda.org/2019/05/21/isda-cdm-deployed-to-help-deliver-uk-digital-regulatory-reporting-pilot/
[33] Interbank Offered Rate Fallbacks for 2006 ISDA Definitions, July 2018, https://www.isda.org/2018/07/12/interbank-offered-rate-ibor-fallbacks-for-2006-isda-definitions/

ensure the contracts function as closely as possible to the counterparties' original intentions after a fallback kicks in, resulting in a rate that is predictable, transparent and fair.

The market reached a clear consensus on the preferred methodologies for those benchmarks covered by that consultation[34], and ISDA is currently running a further consultation on additional benchmarks, including US dollar LIBOR, CDOR and HIBOR[35].

Simultaneously, ISDA launched an additional consultation on pre-cessation issues. That consultation asks market participants for their views on the issues that would emerge following an announcement that LIBOR is no longer representative, and whether and how ISDA documentation should address it.

ISDA is also working to further flesh out the parameters and mechanics of the term and spread adjustments, and we plan to have new fallback language in place for certain IBORs at the start of 2020.

The ISDA SIMM, ISDA Create – IM, the ISDA CDM and the benchmark fallbacks are good examples of global solutions that enable changes in regulation and market structure to be implemented as consistently as possible.

As the industry continues to evolve, ISDA looks forward to developing further solutions and advancing existing ones to make sure market participants have the tools they need to deal with the challenges they face.

Conclusion

Significant progress has been made in implementing post-crisis derivatives reforms, and the financial system is much stronger and more transparent as a result. ISDA and its members have worked hard to implement the requirements, and have developed a number of industry solutions to help facilitate consistent compliance with the rules.

However, some parts of the regulatory framework could be further refined to improve efficiency and reduce unnecessary costs and duplication. In line with the G-20, we believe focus should be given to eliminating market fragmentation, which can "impair financial stability by reducing market liquidity and trapping scarce resources. It can drag efficiency and economic growth"[36]. That ultimately has an effect on US companies, retailers and households.

ISDA looks forward to working with this Committee, as well as US and foreign regulators, to develop solutions to address these important issues.

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[34] ISDA Publishes Final Results of Benchmark Fallbacks Consultation, December 2018, https://www.isda.org/2018/12/20/isda-publishes-final-results-of-benchmark-fallback-consultation/
[35] ISDA Benchmark Fallbacks Consultations, May 2019, https://www.isda.org/2019/05/16/may-2019-benchmark-fallbacks-consultations/
[36] Speech by Ryozo Himino, Vice minister for international affairs, Financial Services Agency, Japan, at the 2018 ISDA Annual Japan Conference, October 26, 2018, Tokyo, https://www.fsa.go.jp/common/conference/danwa/20181026.pdf