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Re: Canadian Securities Administrators (CSA) Consultation Paper 91-401 on Over-the-Counter (OTC) Derivatives Regulation in Canada (the Consultation Paper)

The International Swaps and Derivatives Association, Inc. (**ISDA**) welcomes the opportunity to respond to the Consultation Paper published by the CSA on November 2, 2010 setting forth the CSA Derivatives Committee proposals regarding the regulation of over-the-counter (**OTC**) derivatives.

ISDA was chartered in 1985 and has over 800 member institutions from 54 countries on six continents. Our members include most of the world's major 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 derivatives to manage efficiently the 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.

As the CSA is likely aware, ISDA is actively engaged with providing input on regulatory proposals in the United States, the United Kingdom, Europe and Asia. Our responses to the questions posed in the Consultation Paper are derived in part from these efforts and from consultation with ISDA members operating in Canada. It is out of this rich experience that ISDA respectfully submits the following comments regarding the Consultation Paper.

Before we answer the specific questions, we would like to make a few general observations.

Global Markets and Regulatory Coordination

The CSA recognizes in the Consultation Paper that derivatives are traded on global markets and many of the regulatory initiatives require global coordination. We ask that the regulators consider the global nature of the markets when drafting derivatives rules so that they do not restrict the ability of Canadian entities from continuing to participate and be competitive in the global derivatives markets. To this end, it is vital that regulators seek to avoid mandating duplicative, overlapping requirements and/or infrastructure where sufficient alternatives exist. For example, regulators should consider whether it is appropriate to establish a Canadian central counterparty clearing house (**CCP**) solution if an already existing or soon-to-be existing CCP based abroad can adequately service Canadian market participants, whether a single global trade repository for each asset class of derivatives accessible by all regulators is superior to multiple, regionally based trade repositories and whether foreign exchange forward and swap transactions warrant separate consideration and different treatment than other OTC derivative asset classes[1].

The CSA should also coordinate with the other regulatory authorities in Canada to ensure there is consistent regulation across Canada. As noted in the Consultation Paper, derivatives are overseen differently in various Canadian jurisdictions and regulatory

[1] With respect to the last point, the Dodd Frank Act recognizes the potentially different treatment that is warranted for foreign exchange forward and swap transactions. ISDA comment letter to the US Treasury's invitation to comment is available on ISDA's website at www.isda.org.

authority is derived through a variety of legislative regimes. The different regulatory regimes operate on federal and provincial levels and rulemaking with respect to derivatives should be allocated appropriately amongst the various regulators. While market conduct concerns are clearly in the jurisdiction of securities regulators, certain concerns outlined in the paper such as capital and collateral with respect to certain market participants fall under the jurisdiction of, and should be left to, the prudential regulators outlined in the Consultation Paper in Section 6.2. Management and reduction of system risk through central counterparty clearing and post-trade transparency needs to be carried out at the federal level to be truly effective. The Bank of Canada is playing an important role on these issues and the CSA should not impose rules that conflict with or diminish the Bank of Canada initiatives. ISDA also recommends that the CSA work closely with and be guided by the Office of the Superintendent of Financial Institutions and the Investment Industry Regulatory Organization of Canada with respect to capital related issues and the Canadian Market Infrastructure Committee (**CMIC**)[2] with respect to clearing and reporting requirements.

Definitions and Scope

It is not clear from the Consultation Paper what exactly the CSA means by "OTC derivatives" and what they intend to regulate. In defining OTC derivatives, the CSA needs to be consistent across Canada in order to avoid regulatory arbitrage and it needs to be careful not to inadvertently include traditional banking products such as loans and foreign exchange that are already adequately regulated and do not pose the systemic risks outlined in the Consultation Paper.

It is also not clear what would be a "Canadian" derivative or market. We assume the CSA is trying to regulate derivatives with Canadian counterparties but will the regulations only cover trades where both parties are Canadian or is it sufficient for one party to be Canadian in order to come under the regulatory regime? If the CSA is regulating cross border trades, how does it intend to coordinate with foreign regulators to ensure consistency of regulations? If non-Canadian entities are referencing a Canadian asset in their derivative trade, is that trade intended to be covered by the CSA regulations?

The CSA will need to clearly define the scope of the transactions, entities, trades and markets that are intended to be covered by the regulations in order for the industry to give meaningful comments on proposed rules. The CSA will also have to work with the other regulators in Canada to outline which regulator has jurisdiction and rule-making authority over the various issues outlined in the Consultation Paper.

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[2] CMIC is composed of major dealers and buy-side participants that are active in Canadian derivatives markets. It is a group with roots in the Industry Advisory Group comprising six of the largest Canadian banks which was created in January 2010 for the purposes of assessing international developments, collecting data on Canadian OTC derivatives markets and developing policy recommendations related to the implementation of G-20 commitments. Its area of focus includes standardization, clearing and trade reporting.

We look forward to being able to provide further comments once these issues are clarified.

Section 3. Clearing

1. Do you agree with the recommendations on the approach to implementing mandatory central clearing? What factors should be taken into consideration by regulators in identifying OTC derivatives appropriate for clearing and which are capable of being cleared?

We strongly agree with the approach to implementing mandatory clearing of derivatives trades that are appropriate for clearing (second option), which is also consistent with Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (**Dodd-Frank Act**).

As noted on page 26 of the Consultation Paper, there are numerous problems with general option 1, including that it presupposes products can be cleared centrally, offers regulators less flexibility and doesn't provide sufficient clarity in relation to products that must be cleared. Moreover, focusing primarily on reducing counterparty credit risk in a drive toward standardized contracts for the purpose of central clearing could:

- actually increase risk, as market participants seeking to mitigate specific commercial risks may find it uneconomic to enter into the kind of tailor-made OTC transactions capable of mitigating such specific commercial risks;
- provoke a risk-enhancing trade-off between reducing credit risk in certain standardized contracts and increasing basis risk by encouraging the use of those standardized contracts to cover non-standard underlying risks, on a mismatched basis;
- discourage dealers from offering customized contracts and/or increase their cost where available thereby restricting affordable access to OTC derivatives for end-users that rely on OTC derivatives to manage the risks inherent in their core economic activities;
- require end-users to allocate increased amounts of money and margin at clearing houses and so increase the cost of managing risk; and
- increase intra-group transactions with no benefit in risk reduction where mandatory clearing is forced on affiliate (intra-group) transactions.

In summary, this option presents moral hazard, systemic risk concerns and frustrates international harmonization.

With respect to the second option, the review of swaps in order to determine whether to impose a mandatory clearing requirement is, of course, extremely consequential. If the relevant clearing solution fails to establish an operationally sound and robust risk

management framework, or captures an inappropriate category of swaps, the consequences for the derivative clearing organization (**DCO**) and for the market could be significant.

In terms of the factors that should be taken into consideration by regulators in identifying contracts appropriate for mandatory clearing in order to best achieve the goals of mandatory clearing and to mitigate adverse effects, we consider that the five factors outlined in Section 723 of the Dodd-Frank Act are a good starting point:

(I) *The existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data.*

Some types of swaps (for example CDS contracts in standard tenors and coupons referencing the on-the-run major traded indices) have a ready market of buyers and sellers, as evidenced by bids and offers that change throughout a trading day. By contrast, more complex products are frequently tailored to a counterparty's risk management needs and thus may be less liquid. A good example here would be a CDS on a bespoke portfolio of credits: it may be difficult to obtain daily market prices for this product. Further, the tailored nature of products like these means that reliable pricing data may not be available, and this can lead to significant model and parameter risks in a models-based valuation.

It is critical that a DCO has the capacity and expertise needed to manage all of the risks associated with the products that it clears. These risks include potential valuation error, which can in turn lead to errors in estimates of initial or variation margin requirements and/or guaranty fund obligations. Since margin must be calculated at least daily, and since daily (or more frequent) market prices form the best basis for valuation, the availability of daily market prices for cleared products must be assured in all market conditions, including stressed markets. This is key since, if the amount held as margin turns out to be inadequate to cover the liquidation of a portfolio, then the DCO itself may be endangered.

Based on the foregoing, it is clear that the size of the relevant swap market and its depth are crucial properties in the determination of the scope of mandatory clearing, and a conservative interpretation is required here. ISDA would be happy to provide expertise to assist in the definition of appropriate measures of the liquidity required for clearing, for mandatory clearing, and for contract market execution.

(II) *The availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded.*

This addresses two important and related points. First, it reinforces the importance of assessing the financial integrity and operational competence of a DCO. In this context, the determination must also take into account, in assessing the enumerated factors, whether these factors can be satisfied by the DCO given the potential volumes which it would clear under a mandatory clearing requirement.

Second, the evaluation should be premised on the determination that the terms and conditions of the cleared swaps and the terms and conditions on which they are cleared are consistent with the material terms and trading conventions on which the relevant swaps are then traded.

These determinations are essential to ensure that the imposition of a mandatory clearing obligation for swaps will, in practice, actually achieve the objectives of increasing market liquidity and reducing risk in the financial system rather than increasing it.

(III) *The effect on the mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the DCO available to clear the contract.*

Like the preceding factors, this factor is intended to examine whether a mandatory clearing requirement with respect to the relevant swap would decrease systemic risk. This, in turn, requires an assessment of the size of the market for the relevant swap, the risk attributes of the swap, the scope and risk profile of other products cleared by the DCO, and the aggregate amount (and terms of availability) of the DCO's financial and credit support resources. Other risks, such as settlement and operational risks that can contribute to a clearing failure must, of course, also be considered.

Finally, the current and likely future importance of a DCO to the market it serves must be considered together with the extent to which the failure of a DCO will itself contribute meaningfully to systemic risk.

(IV) *The effect on competition, including appropriate fees and charges applied to clearing.*

This issue is important as while competition is essential, it also exposes DCOs to new risks. Thus an assessment of a clearing application should address the potential conflict of interests between owners and management of DCOs and the wider financial system with particular sensitivity to risk management standards.

Here, regulation has an important role in correcting the effect whereby low margin and guarantee fund levels may win a DCO business in the short term at the expense of wider financial stability. Lower margin and guarantee fund requirements should

only be allowed where a DCO possesses sufficient alternative resources to support itself to a robust standard and where such a reduction does not materially increase systemic risk.

(V) *The existence of reasonable legal certainty in the event of the insolvency of the relevant derivatives clearing organization or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property.*

Financial stability requires legal certainty of outcome in insolvency. This is essential to ensuring, that, upon insolvency, the assumptions on which credit support levels and default management procedures were structured are well founded and reliable. It is also essential in order to mitigate concerns that may deter participation in the market or in available clearing solutions. In particular, confidence in the portability of customer accounts upon the insolvency of a clearing member is extremely important to market participants.

These five criteria, if taken together and conservatively applied, make it highly likely that a DCO will be able to value, call for margin on, and risk manage all cleared products. Therefore we encourage supervisors to interpret these criteria strictly, and only to mandate clearing for a particular product where they are clearly met at the time of the relevant application, and are highly likely to continue to be met in the future, including during future stressed periods. Such an approach will ensure adequate clarity and decrease the risk of inconsistent impositions of the clearing obligation.

Lastly, in terms of the implementation timing of any approach, ISDA notes that a transition period from 'clearable' to 'mandatory' sensibly reflects the work required and risks involved in moving a product to central clearing. Accordingly, we recommend an extended period between a CCP being given permission to clear a product and clearing becoming mandatory on that product. Further, ISDA would recommend transparency during any such period. This will provide important notice and information for affected parties on what the relevant margin and default fund calculations will be, what pricing requirements will be set by the CCP, and how default management will operate.

2. **What is your view on possible solutions for accessing CCPs and allowing for the most efficient use of capital? Considerations should account for risk models, collateral netting, membership criteria, etc. Possible iterations are, but are not limited to:**

a) Creation and Use of Canadian Multi-Asset CCP;

b) Accessing Global Single and/or Multi-Asset CCPs, with additional collateral requirements for non-cleared trades not available for clearing globally; or

c) Creation and Use of Canadian Single Asset or Multi-Asset CCPs used in combination with Global Single and Multi- Asset CCPs with collateral linkages between the CCPs.

ISDA currently does not have a view on which of the possible solutions is suitable for the Canadian market. We would reiterate our suggestion that the CSA work closely with the CMIC on this issue and also take into account whether Canadian market participants will be adequately serviced by already existing or soon-to-be existing CCPs based abroad.

Below we highlight a few of the key considerations that may inform the optimal solution for accessing CCPs and allowing for the most efficient use of capital.

Multiple CCPs:

The CCP industry typically exhibits network externalities, in that the value of the services offered depends on the number of participants and contracts cleared. In other words, an increase in the number of CMs will have benefits that accrue to existing CMs, as they will be able to clear with more counterparties. In addition, the CCP industry exhibits important economies of scale, which means that the average cost per transaction declines with an increase in the number of transactions. Staffing, premises, and information technology infrastructure, such as a database engine, the clearing platform, networks, and interfaces have high fixed costs. Also, CCP multilateral netting efficiencies diminish as the number of CCPs clearing the same product type increases[3]. In sum, a single CCP has potentially the lowest costs.

However, a single CCP would lead to the concentration of default and settlement risks in a single entity. If a single CCP fails due to inadequate risk management measures, there would be a tremendous impact on the market for the cleared product and potentially other linked markets simultaneously. Indeed, as stated previously, the OTC derivative market is global and the failure of a major CM would likely have a similarly material impact on more than one CCP, although the provision of emergency liquidity or other financial support to a distressed CCP may be easier to disperse in a multi-CCP world in which each CCP has its own liquidity and other financial support providers.

Further, some central banks such as the Eurosystem/European Central Bank have publicly stated that they do not favor a CCP for OTC derivatives traded in Europe that is located outside their jurisdiction. Such a statement is motivated, in part, by the consideration that the failure of a CCP that clears OTC derivatives denominated in a given currency may have an impact on the central bank's mandate to implement monetary policy and maintain financial stability in that currency. A single CCP would also raise significant challenges in terms of cross jurisdictional coordination in regulation and oversight, particularly during

[3] Darrell Duffie (2009) "Does a Central Clearing Counterparty Reduce Counterparty Risk?" available at http://derivativedribble.wordpress.com/2009/05/05/rethinking-central-cds-counterparties/

periods of financial stress. That said, as international regulatory cooperation in the supervision of the CLS Bank, DTCC, and LCH.Clearnet demonstrates, cross-border coordination is possible.

It is worth noting, in this context, that some of the benefits of a single CCP can be achieved by connecting several CCPs through links (where CCPs cooperate with each other) and cross-margining (where a CM uses its positions at both CCPs to lower collateral requirements overall). The regulatory, operational and legal demands of this interoperability are, however, substantial.

Interoperability:

At this time, we tend to the view that interoperability is a huge challenge for OTC derivatives. CCPs derivatives clearing is not fragmented along national lines but centralized and international, and the tailored nature of the product compared to more standardized cash asset classes makes it less suitable for interoperability. However, we would be supportive of proposals to give CCPs the right to interoperate and right of access to relevant data and systems – and believe this could help to bring clearing costs down for end-users – providing the additional risks arising from interoperability are properly managed.

Membership Criteria and Operational Standards:

Best practice CCP risk management starts with stringent requirements to become a clearing member (**CM**) in terms of sufficient financial resources, robust operational capacity, and business expertise. We suggest that any CCP solution adopt CM requirements that are clear, publicly disclosed, objectively determined, and commensurate with risks inherent in the cleared products and the obligations of CMs to the CCP.

CCPs typically seek to ensure that their CMs are creditworthy by establishing a set of financial requirements for membership. Usually CMs are required to meet, both initially and on an ongoing basis, minimum capital requirements, often stated as the larger of a fixed amount and a variable amount that depends on some measure of the scale and riskiness of the CM's positions with the CCP and in other financial markets. In most cases, membership is restricted to regulated entities that meet regulatory minimum capital requirements. CMs that carry client accounts are often required to meet capital standards that are more stringent than regulatory minimum requirements.

In addition to financial requirements, leading CCPs establish standards of operational reliability for CMs. CCPs typically impose tight deadlines for the submission of trade data and for completing various settlement obligations. The failure of a CM to meet these tight deadlines could significantly increase the CCP's risk exposures to that CM and possibly to other CMs as well. Compliance with operational deadlines is closely monitored on a day-to-day basis. Furthermore, in recent years many CCPs have been paying greater attention

to the backup systems that CMs would have available if their primary operating systems were disrupted.

3. **Is there sufficient liquidity in each of the individual Canadian derivatives markets (eg. equities, interest rate, commodities, foreign exchange, etc.) to support the creation of a Canadian CCP? Which derivatives markets may pose challenges to the operation of a Canadian CCP?**

As noted above, we consider that the "sufficient liquidity" requirement ought to be applied very conservatively. We repeat the importance of this, as a CCP must calculate net margin each day and price availability is required to do this. In addition, since this requirement applies for the whole life of the trade price availability must be guaranteed in all market conditions, including stressed markets.

Further study is necessary to determine if there is sufficient liquidity with respect to each derivative asset class. Certain parameters for liquidity for each product are a minimum number of market makers, frequency of trading (daily) and depth of market (daily trading must be in sizes that are not insignificant). Some products may meet these requirements, or not, depending on tenor. For example, 5 year fixed income swaps may be traded daily in significant sizes but the same swap with a 30 year term may not trade frequently enough to be considered liquid. In addition to having multiple market makers for each cleared product, it is important for a Canadian CCP to be able to manage the risk and collateral around those products in a way that accurately reflects the Canadian markets, that those market makers who are members of the CCP be required to provide daily valuations to the CCP.

If regulators chose to establish Canadian CCPs, a phased in approach to clearing along product lines will be required. For some products there may be sufficient liquidity now but forcing other products to be cleared where it is not appropriate or there is not sufficient liquidity may cause trading disruptions leading to a further reduction in liquidity leaving market participants unable to execute hedging transactions. A phased in approach would achieve a reduction in systemic risk for those products for which there is sufficient liquidity while allowing Canadian participants to continue trading in products where there is less liquidity in Canada.

As stated above, regulators should also consider the costs of establishing regionally-based CCPs, which may or may not be further bifurcated by asset class, as well as the availability of international CCPs to adequately meet the needs of Canadian market participants.

4. **Is there a willingness and an ability of Canadian market participants to use, create or participate in the creation of a Canadian CCP solution?**

ISDA believes that the CSA should be guided by CMIC's recommendations and findings.

5. **How should non-financial intermediary users of derivatives be able to clear their derivative trades? Should this occur through direct access and membership in a CCP**

or should this be done through an indirect clearing model with financial intermediary CCP members acting as agents for the non-member CCP derivative participants?

ISDA believes that indirect clearing should be available, though CCPs should support position and margin portability to ensure that a party's exposure is always to the CCP and not to the clearing member. That said, end-users should be aware of the trade off between highly segregated collateral and less segregation. Further clarity is required from regulators (internationally) on CCP collateral management, including mechanism for taking and holding collateral.

ISDA agrees with the CSA that not all participants in the Canadian OTC derivatives market should be subject to mandatory clearing. Market participants, and in particular end-users that rely on OTC derivatives to manage efficiently the risks inherent in their core economic activities, should maintain the ability to bilaterally transact tailored hedging and other risk-management products. Exceptions for certain classes of end-users should be publically disclosed and coordinated on an international basis to avoid regulatory arbitrage.

- ***Exemptions for commercial end-users:*** Such parties often have risk-management needs that are unique to their individual situations. For example, the location (basis), volume, timing and duration of derivatives required may vary from party to party, depending on individual hedging needs. Standardized offerings alone, therefore, are rarely adequate. Requiring such standardization could expose participants to additional market risk, while potentially limiting the speculative liquidity needed to help spread and absorb these risks. We expand further on this topic in response to the questions posed in Section 7: End-Users and Significant Market Participants.

- ***Limited, proportionate exemptions for non-systemic financials:*** We are concerned that requiring non-systemic end-users to use CCPs will have liquidity effects which are insufficiently understood at present, and, given the way that derivatives are used to manage overall portfolio risk, may artificially and inefficiently isolate derivatives components from the rest of these portfolios, requiring posting of high levels of margin on derivatives and not net exposures. This could, for example, have significant effects on savings and pensions.

- ***Exemptions for intra-group transactions:*** We would propose that there should be allowance for an exemption from the clearing obligation (and possibly the reporting obligation) in relation to transactions with affiliates. For example, this will be important as in many cases there may be legal requirements that affect which group companies can face counterparties through but the risks may be hedged or managed

in another group company, so that it will need to be possible to transfer risk intra-group.

Section 4. Trade Repositories

1. **Do you agree with a mandatory reporting requirement for all OTC derivatives trades? If not, should there be a threshold below which reporting would not be required?**

ISDA believes, in principle, that trade data on OTC derivatives trades should be made available to regulators, on a post-execution, non-real time basis, using open source data standards and that trade repositories are a suitable vehicle for provision of this data. Competent authorities should be able to receive relevant information by querying trade repositories. For example, the DTCC Trade Warehouse has proved to be a valuable source of information for international regulators in the case of CDS contracts in particular (as well as providing many other operational benefits for industry and regulators, including facilitation of central clearing and trade compressions), and has made this information available to all international regulators.

We caution, however, that it will be a vital precondition of the deployment of trade repositories to address confidentiality issues. While we would agree that it is important for a trade repository to take adequate measures to safeguard data, it is also important that both market participants and trade repositories have the legal right to disclose data where required to do so, and that clear regulations govern when a trade repository should disclose data and to whom. Regarding legal considerations with respect to confidentiality, in some jurisdictions, and depending on their standard terms of business, dealers may currently not be able to disclose client data, even if clients consent to such disclosure. Regulators should provide for consistency with foreign privacy laws, some of which carry criminal penalties for wrongful disclosure of information[4]. Any trade repository should provide a robust model to ensure any data subject to confidentiality requirements is only disclosed subject to a relevant permissions process.

Market participants will also wish to understand the circumstances in which a trade repository may be able to disclose their individual details to third parties, on an identifiable basis. It will be necessary to establish clear criteria as to how to determine which regulators around the world are able to obtain data from trade repositories (and whether there are any limits on the data they are allowed to request from the trade repository), as well as to establish the extent to which those regulators may be entitled or required to disclose that information to third parties and the extent of their ability to refuse third party requests for disclosed data. Similarly, it will be necessary to establish the extent to which, as private bodies, trade repositories may be liable to disclose information as a result of litigation

[4] As part of an on-going industry effort to provide as much transaction data on OTC derivatives by dealers to trade repositories, ISDA engaged outside counsel to survey the G20 jurisdictions with a view to establishing the current position in those jurisdictions and to highlight any legal obstacles to providing client data. The analysis was divided into categories according to the legal basis for the disclosure, such as disclosure without legal compulsion, disclosure required by the laws or regulations of the dealer's jurisdiction, and disclosure required by the laws or regulations of a foreign jurisdiction. It has become apparent that while there is more work for the industry to do, the industry also needs help from regulators.

between third parties or to law enforcement agencies (or in response to judicial assistance arrangements). Market participants will wish to see that there is a legal framework regulating the trade repository that provides adequate protection for their information.

Regulatory consistency is also of paramount importance. Many market participants will likely be subject to parallel reporting requirements imposed by various overseas regulators. To remove inefficiencies, simplify compliance obligations and enhance regulatory agency capabilities, regulators should adopt consistent reporting requirements, including, but not limited to, a common implementation effective date, rules defining when the timeline for reporting a transaction will commence, and rules defining a common set of information and data elements to be reported.

Lastly, any reporting convention that is adopted should not have the unintended consequence of disadvantaging market participants by disclosing their transactions, whether it be directly or indirectly, before the time that they have had an opportunity to manage their commercial risk. These considerations are equally important to market participants acting for their own account and for the account of customers

2. **With mandatory reporting of derivatives trades, should dealers have to report noncleared trades to a global trade repository or to a Canadian trade repository?**

The industry understands and fully supports the importance of trade repositories in providing supervisors with trade data to enable them to develop a more complete view of OTC derivatives market activity and thereby enhance their ability to oversee the market and its participants. As noted in the Consultation Paper, the industry has made significant strides in establishing and using trade repositories.

ISDA firmly believes that the location of a repository should not be an over-riding consideration. The CSA should seek to avoid the regulatory uncertainty and ambiguity (and potential room for regulatory arbitrage) and additional expense that will ensue if market participants are required to comply with inconsistent or redundant regulations. This is particularly true where, as in the case of trade reporting, complex, novel, and expensive information technology and operational systems must be developed over extended time periods. We understand that CMIC is reviewing trade reporting and that the views of Canadian participants are subject to the CMIC findings but, in light of the above considerations and given the global nature of the OTC derivative markets, at this time ISDA believes that market participants and regulators would be best served by establishing a single global trade repository for each asset class of derivatives that would be accessible by all regulators.

As the CSA correctly notes, establishing a single global trade repository for each asset class of derivatives "would avoid information being collected separately in multiple locations and would make it far more efficient for regulators to have a full understanding of the aggregate systemic risks being created by market participants." In particular, there would be no redundancy of platforms, no need for additional levels of data aggregation for

each asset class and reduced risk of errors and greater transparency (because a single trade repository per asset class would avoid the risk of errors associated with transmitting, aggregating and analyzing multiple sources of potentially incompatible and duplicative trade data). Multiple trade repositories for a single asset class, on the other hand, would fragment information, making access to aggregate information inefficient and more costly.

We recommend that global regulators work to devise systems that efficiently operate together to which such global regulators have access to data relevant to the performance of their responsibilities. Provided each regulator has access to the information, we do not think it is necessary to insist that a trade repository for each product or more than one product is located in Canada.

We agree with the CSA that one of the key risks to be managed by a single global trade repository is operational reliability. How data is reported is fundamental to ensuring operational robustness. We believe that swap transaction data should be recorded and reported pursuant to a single electronic data standard, to avoid having to deal with multiple proprietary standards from different trade repositories. This will enable transactions to be reported in an efficient and timely manner in a form readily accessible to all concerned parties.
We believe that compliance with reporting rules is likely to be more operationally sound and less costly if regulators adopt Financial Products Markup Language (**FpML**) [5] as the protocol for reporting swap transactions to trade repositories. FpML is an open standard, free of charge and, because it is independent of the software or hardware used by participating companies, ensures interoperability. FpML's descriptions of derivatives allow recipients to compute valuations for a wide variety of standard and complex derivative transaction types that represent an overwhelming share of the market activity. For infrequently traded transaction types, FpML provides a format for reporting key economic details of the transaction. We expect that FpML will eventually be used for all aspects of OTC transactions. In fact, most firms offering services related to OTC transactions are able to accept information in FpML format.

While FpML is widely used in the derivatives industry, it is important to note, however, that not all derivative transactions can fully be reduced to FpML or another standardized computer readable language. For highly customized products it is not practical to create a standardized parametric XML representation that is suitable for confirmation purposes. For these products ISDA recommends that where electronic reporting is required, a summary representation should be used, supplemented if necessary by valuation reports.

3. **What impediments currently stand in the way of implementing real-time reporting of data to trade repositories?**

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[5] FpML is the open source industry standard for the OTC derivatives industry, developed under the auspices of ISDA. FpML/ISDA is an active member of the ISO 20022 Registration Management Group, working with other standard bodies to harmonize financial industry standards under ISO. For more information on FpML, see ww.fpml.org.

ISDA recognizes the many benefits of increased post trade transparency and supports the objective of real time reporting, provided that such reporting is technologically feasible. There are many practical issues to be addressed in requiring mandatory real time reporting and we believe that virtually all existing systems would have to be significantly overhauled to facilitate real time reporting or even "near real time" reporting for bilaterally traded derivatives. The parameters of what is meant by "real time" or "near real time" and the data sought should be set following consultation with market participants and taking into consideration any such technological constraints as well as consistency with parallel international regulations. Through this consultative process, market participants can make the required technological adaptations, including the design of trade data capture processes, that might make these data points readily available in a "real time" or "near real time" manner.

However, transparency comes at a cost, especially with respect to real time reporting of post trade data. There is a relationship between transparency and liquidity[6]. It has been long recognized that the level of post trade transparency can adversely affect market liquidity as a market makers' willingness to commit capital is contingent on their ability to effectively manage the risks associated with the transactions executed and generate adequate returns. With full real time transparency it is easy to see that, in many circumstances, market makers may be less inclined to execute large trades on short notice.

This dynamic can be demonstrated with a simple example. If a corporate end-user plans to raise a significant amount of capital by issuing a large bond to investors, it is exposed to the risk that interest rates may rise by the time it is ready to issue the bond. It can hedge that risk by entering into an interest rate swap with a market maker that is willing to provide liquidity. The market maker would then typically hedge the risk it has just taken on by entering into one or more interest rate swap or other hedging transactions with other market participants, indeed the price of the interest rate swap will likely be related to the price at which the market maker believes it can hedge the risk. If however the interest rate swap with the corporate end-user is reported to the market, then other potential counterparties will know that a market maker has executed a large swap and will be looking to hedge that risk in the market, and will change their prices accordingly, causing a risk of loss to the market maker. A rational market maker might react to this increased risk by either refusing to enter into the large transaction with the corporate end-user (thereby reducing liquidity), or by increasing the price of the interest rate swap offered to the corporate end-user to provide a buffer against the increased risk. The end-user may react by choosing to break the trade into smaller pieces, thus exposing itself to the liquidation risk that previously the market maker was tasked with managing. Any of these results is clearly detrimental to the end-user interests, and will have a negative impact on that end-user's ability to raise capital, damaging investment in the relevant economy.

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[6] ISDA Research Notes, Number 1, 2009 "Transparency and over-the-counter derivatives: The role of transaction transparency" available at http://www.isda.org/researchnotes/pdf/ISDA-Research-Notes1.pdf.

From the example above, it can be seen that the risk of adopting block trading rules that are not appropriate to the OTC derivatives markets is that end-users' ability to hedge their risk will be damaged, through a reduction in the opportunities to hedge that risk or through an increased cost of that hedging activity.

ISDA considers the development of appropriate block trading exemptions from real time public dissemination of OTC derivative information to be of critical importance to the successful implementation of real time reporting of data. This is explicitly recognized in the Dodd-Frank Act, which requires the CFTC and the SEC to specify the criteria for determining what constitutes a large notional transaction (block trade) for particular markets and contracts and to take into account whether the public disclosure will materially reduce market liquidity.

In order to maximize liquidity and minimize costs for end-users while enhancing transparency, reporting requirements should provide full exceptions or allow for reasonable reporting delays for large trades. Smaller trades, for which risk can immediately be offset by market makers would be reported in real time. However, as the size of the trades (and the resulting residual risk) increases, market makers need longer periods of time to manage the exposure before the trade details are made public. Only in this way will market makers have the opportunity to lay off risk in an economic manner and obtain a reasonable return on the capital allocated to the trade.

However, determining appropriate block trading levels is difficult. The OTC derivatives market is fundamentally non-standardized and contracts are customized to specifications of size, maturity, underlying instrument, and other factors. Different instruments within an OTC asset class may have vastly different trading sizes, activity and volatility, rendering a one size fits all or one size fits most transparency regime ineffective. Transparency rules and large trade exemptions should take into account the risk and liquidity characteristics of these various instruments. Chief of all these characteristics is the amount of risk that may be reasonably offset in a given period of time, namely the proposed reporting delay, for each instrument.

Moreover, the OTC derivative market is a wholesale, often bespoke, market with limited "natural"—that is, instantly available—liquidity; instead, market makers provide liquidity to such markets by putting their own capital at risk. It will therefore rely upon market makers being prepared to commit capital to facilitate business. If market makers do not earn a return that covers the cost of the capital they bring to the market, they will exit. Mandating a higher level of transparency in such markets can reduce the return to operating there and thereby exacerbate the inherent illiquidity of such markets. Just as transparency measures appropriate for actively traded equities might not be appropriate for thinly traded bonds, so transparency measures designed for exchange traded instruments might not beneficial for OTC risk transfer instruments. Different markets can support different levels of transparency, and trying to impose burdensome requirements on a market can simply cause liquidity to reduce.

To develop appropriate and well-calibrated block trading exemption rules, ISDA believes that significant detailed research on these markets must be undertaken before the appropriate block size threshold and reporting delay for particular transactions can be determined. We suggest that research should be directed towards determining the size of a transaction that would likely "move the market". ISDA recommends that relevant considerations should include the average daily trading volume for the relevant product and the size of two-way markets typically made by market makers, and that further investigation is required to ascertain whether these are in fact determinative factors. The analysis should be performed separately for different asset classes and likely for different products within each asset class, as the appropriate test for one product may not be appropriate for another product, in fact it may be appropriate to use different tests to determine the appropriate block size threshold and/or reporting delay for different products.

ISDA recommends that independent academic research be undertaken to determine the appropriate methodology for determining block size thresholds and public dissemination delays. ISDA has previously helped to co-ordinate similar research that examined the status of transparency in interest rate and credit derivative markets. This research was first committed and then presented to an international group of supervisors[7].

Allowing for reasonable block exemptions and reporting delays will preserve liquidity while providing nearly all of the same benefits as complete transparency. Rules for block trade exemptions and reporting delays should be studied carefully and implemented cautiously in an effort to balance the desire for market transparency with the market need for liquidity.

4. **What information, if any, should be made publicly available? Should this information be available on a real-time, same day or historical basis?**

Only aggregated, anonymised delayed information should be made available to the broader market/public. We support real-time reporting in line with the above comments, to regulators but public reporting should be delayed.

5. **Should a trade repository be able to publish its non-confidential data for fees?**

ISDA does not have a position on whether a trade repository should be able to charge a fee for its non-confidential data. We note, however, that since trade repositories will have a monopoly on the reported information, regulators will need to ensure that the trade repositories provide fair and equal access to the information. The regulators will need to

[7] For details of the commitment, please see the letter dated March 1, 2010, available on the website of the Federal Reserve Bank of New York:
http://www.newyorkfed.org/newsevents/news/markets/2010/100301_letter.pdf

determine if the fees charged are fair and reasonable and accessible to all market participants.

Section 5. Electronic Trading

1. **Should regulators choose to implement mandatory electronic trading, which of the frameworks discussed above should regulators use in respect of such implementation (i.e., mandatory trading of products subject to mandatory clearing; mandatory trading contingent on the availability of a trading platform; allowing participants to determine whether or not to trade on a platform)?**

ISDA supports allowing participants to determine whether or not to trade on an organized trading platform. While increased use of trading platforms will bring benefit for particular derivative product types that are suitable for such venues, we believe that mandatory or incentivized use of such platforms where such products are not suitable to their use will not reduce risk and will negatively affect market participants and markets in general.

As the G20 recognised, it is not always appropriate for derivatives trading to take place on organised trading platforms even if the transactions have been become relatively standardised. There are many differing models for negotiating and executing a derivatives transaction and market participants should retain a choice between these different models to reflect their particular needs.

If mandating electronic trading or, for that matter, any type of trading requirement that is inflexible in its design and/or promoted too aggressively for products currently traded OTC, then the following risks could materialize:

- **The inability to customize:** Overly-ambitious promotion of a particular venue would likely concentrate trading activity in a subset of existing contracts, weakening the ability of market participants to customize contracts. More importantly, concentrating the market into a more narrow range of products linked to particular venues could potentially increase systemic risk, as clients would not have the ability to hedge and appropriately manage their unique risks.

- **(Associated) basis risk and earnings volatility**: If counterparties who wish to hedge are prevented from being able to enter into contracts that are customized to hedge the specific risks they face, they will face basis risk (a mismatch between the risks they face and the contracts they have to use), and earnings volatility, as it will be more difficult to qualify for hedge accounting treatment.

- **Loss of the means to manage risk**: The public transparency criteria associated with organized venues could prove problematic for market participants, particularly hedging counterparties, who could find the market more likely to move against them when they trade. For example, for some commodity contracts, where the number of participants is very low, disclosing the transaction, even on an anonymous basis, would be sufficient to identify the participants in the transaction and would not result in useful market information due to the specificity of the price.

A further reason for maintaining alternative methods of negotiating or executing trades is to allow for the possibility of significant drops in liquidity (such as where there is a jump in volatility). In those circumstances, market participants will wish to be able to seek out and negotiate with the available sources of liquidity on a bilateral basis. Constraints on their ability to do so will exacerbate market disruptions by restricting alternative sources of liquidity. For example, during the financial crisis there was a significant drop in volumes in standardized, plain vanilla exchange traded contracts.

- **Loss of market efficiency:** The unit size of OTC trades are typically larger than those on-exchange, reflecting (a) the professional nature of the market (exchanges often have a significant retail level of participation – at least for some types of instrument) and (b) the customized nature of the product (it is easier for counterparties to agree one deal, than for a counterparty to have to purchase many units of smaller-denominated exchange-traded contract). These can be signs of an inefficient market, as they can be the result of the unwillingness of market participants to perform effective risk transfer functions.

At a minimum, regulators should make an independent assessment as to whether a swap should be executed on an organized trading platform separate from its clearing determination with respect to the same swap. The CSA notes that the "U.S., in the Dodd-Frank Act, considers that standard OTC derivatives should be traded on exchanges or swap execution facilities." The CSA also points out that, "According to the Dodd-Frank Act, swaps and security-based swaps that are subject to the mandatory clearing requirement must also be executed on a regulated exchange, including newly created categories of trading venues known as swap execution facilities and security-based swap execution facilities. The mandatory exchange-trading requirement will not apply to a swap/security-based swap if no exchange lists it for trading or if an end-user exemption applies." However, even under the Dodd-Frank Act, the fact that a swap is required to be cleared is not dispositive of whether such swap should be executed on a Swap Execution Facility (**SEF**).

The SEF execution requirement is subject to new Section 5h of the CEA, which states that "The Securities and Exchange Commission and the Commodity Futures Trading Commission may promulgate rules defining the universe of swaps that can be executed on a swap execution facility. These rules shall take into account the price and nonprice requirements of counterparties to a swap and the goal of this section as set forth in subsection (e)." As a result, the SEF requirement itself, by its terms, is not absolute and affords the applicable regulator significant discretion in determining the swaps required to be centrally executed.

This conclusion is further underscored by the fact that a swap will be exempt from the SEF execution requirement if no SEF "makes the swap available to trade." This language

differs from the requirement that a derivatives clearing organization "accept" a swap for clearing. While the applicable regulator must consider the liquidity of a market in evaluating whether it should be cleared, it is theoretically possible (although perhaps not economically viable) for a derivatives clearing organization to "accept" both sides of a single swap for clearing. In contrast, a single swap that does not generate any trading activity beyond the one transaction cannot be said to be "available to trade" on a SEF. The exemption from the execution requirement, in other words, is more expansive and is premised on Congress's expectation that not all cleared transactions will necessarily be traded on a SEF. Moreover, the exemption from SEF execution applies to swaps that are not made "available to trade," regardless of whether they are "listed" on a SEF. In our view, the phrase "available to trade" connotes a SEF that has created an actual trading market, with market liquidity that can accommodate the needs of market participants, and not merely listed a swap for which there is no liquidity and no trading activity. As a result, the listing of a swap, standing alone, is insufficient to bring it within the execution requirement, unless the applicable regulator has made a separate determination that liquidity is at a level that makes the swap "available to trade." The phrase available "to trade," in our view, can only be interpreted to mean that the SEF has taken steps to facilitate the development of an actual trading market with adequate liquidity to accommodate the needs of market participants.

These considerations suggest that the applicable regulator undertake an analysis of a particular swap separate from its analysis with respect to clearing to determine if the swap can and should be subject to a SEF execution requirement. The Dodd-Frank Act affords the applicable regulator considerable latitude with respect to such determination. Further, the Dodd-Frank Act allows the use of a flexible concept of SEFs intended to promote both the clearing and execution requirements.

We strongly believe that the CSA should allow participants to determine whether or not to trade on an organized trading platform. To the extent that the CSA pursues the regulatory authority to impose a mandatory trading requirement, we would strongly caution against any rule that would mandate trading of all OTC derivatives on an organized platform, and would suggest that, at a minimum, regulators make an independent assessment as to whether a swap should be executed on an organized trading platform separate from its clearing determination with respect to the same swap.

2. **Should regulators impose specific requirements on facilities where OTC derivatives trade? What specific elements should these requirements include (i.e. should these requirements be comparable to the requirements established in National Instrument 21-101 – *Marketplace Operation* and National Instrument 23-101 – *Trading Rules*?**

We believe that regulators should provide a suitable degree of flexibility in establishing requirements and criteria for facilities where OTC derivatives trade to ensure that the value that derives from the existing diversity of execution models is not lost. A diversity of execution facilities will promote innovation in the markets for both homogeneous and

idiosyncratic product as well as provide price transparency for participants which will become broadly available through the coexistence of multiple facilities reporting on either a pre-trade or real-time post-trade basis.

Specifically, ISDA believes that each swap trading platform needs to be appropriate for the product type it will execute, as the characteristics and corresponding trading needs vary. For example, a one-size-fits-all vision of an execution facility, modeled on a futures or stock exchange, will fail any market that has insufficient trading activity to regularly attract participants and offer prices. Permitting the broadest range of swap trading platforms would also benefit investors, promote market-based competition among providers, and enable greater transparency over time and across a variety of products.

3. **Do you agree with the criteria on assessing the degree of standardization necessary for mandating trading of OTC derivatives on an organized trading platform (namely, legal, process and product standardization)? Is there any other element that the CSA should take into account?**

ISDA agrees with G-20 Leaders' position expressed in Pittsburgh in September 2009 that many types of standardized products should be eligible for clearing. ISDA agrees that the three elements to be considered in relation to standardization are:

(i) *Legal uniformity*: this includes standard transaction documentation and definitions. A product's documentation will be sufficiently standardized if legal definitions exist, if participants have only a discrete number of documentation options to choose from, the swap is documented using market standard documents and definitions, if there is legal certainty of contract, and if the effects of default (and other life events) are well established and apply uniformly across the market.

(ii) *Process uniformity* (automation): this includes straight-through-processing facilitating the matching of confirmations, settlement and event handling. Electronic confirmation is the surest means of ensuring a contract exists and that a party is not subject to legal uncertainty because of delays in confirmation or lack of standardization in contractual terms.

(iii) *Product uniformity*: including standard valuation, payment structures, dates and determination of life cycle events. Conventions should be in place to govern how the product is traded, and existing industry practice should always be strongly preferred to novel arrangements. There should be a simple procedure for trading the product based on a "normal" transaction type. Industry practice here refers to events that might occur while the product is outstanding: rate resets, defaults, corporate actions, etc. All of these events should create effects that are well-known to and understood by market participants. In every case, product standardization should be driven by market needs, practices and priorities.

While standardization is a necessary condition for trading of OTC derivatives on an organized trading platform, it is not a sufficient condition. Standardized derivatives can be traded on an exchange only when a product has sufficient volume and liquidity to support reliable price discovery for the product. If sufficient volume and liquidity do not exist, it would be preferable to trade the products over the counter and then manage the risk in other ways, such as through a clearing house.

Exchange trading involves extensive standardization because it makes a product easier to trade, which leads to higher liquidity. But as a product becomes more standardized, it may attract a narrower range of traders, leading to lower liquidity. As a result of these conflicting effects, only products that inherently appeal to a large number of traders are likely to succeed on an exchange; more specialized products generally lack liquidity and consequently do not trade successfully on an exchange. Therefore, as a general rule, market forces determine whether or not a contract listed on an exchange will attract liquidity.

As well as the preconditions necessary for exchange trading, regulators should also consider whether such a mandate will have unintended consequences. In addition to considerations discussed in our response to Question 1 in this Section above, mandating electronic trading may cause liquidity to move from the jurisdiction mandating such a requirement, where such liquidity is most readily accessible to the bulk of the local end-users who use the OTC market for hedging, overseas. In his testimony to the House Agricultural committee in July of this year, Terry Duffy, Executive Chairman, CME Group stated:

> *"The efforts to drive OTC transactions onto electronic trading platforms and into regulated clearing houses may dampen OTC business in the U.S. in a manner that will deny U.S. exchanges and clearing houses the opportunity to serve that market. If the proposed legislation's constraints – including the scope of mandated trading and clearing and increased capital requirements – are unacceptable to the major OTC dealers and hedge funds, they may choose to shift their OTC business operations overseas, substantially reducing the size of the U.S. OTC market and jeopardizing U.S. futures markets that are complemented by OTC markets."*
>
> *"Derivative markets face global competition. Inappropriate levels of regulation in the U.S. invites major market participants to migrate business to their off shore offices and off shore markets."*

Significantly, exchange trading provides three general purposes, all of which the OTC derivatives industry is meeting in other ways. First and most important is central clearing, which the industry is now well along on and is committed to continued progress. Second is position and risk transparency, which we are achieving through centralized trade repositories as well as central clearing facilities. And the third is price transparency and

narrower spreads, which is also being achieved through a combination of increased cleared trading volume and electronic or other organized trading platforms.

It is important to note that arguing that narrower spreads is a benefit for investors ignores another crucial variable, market impact and/or liquidity, the ability to get business done. Regulator mandated exchange trading would entail a dangerous tradeoff between modestly reduced spreads and significantly reduced volume and liquidity resulting from forcing wholesale markets that trade infrequently and rely on market-making being forced to trade in an unnatural way. In the end, the limited benefits attributable to tighter spreads for OTC derivative products that can survive on an exchange is not worth the significant costs attributable to the absence of derivative products that corporate end-users rely on for their risk management needs.

The apparent lack of support from constituents that would arguably benefit from mandatory exchange trading, corporate end-users, is perhaps the greatest indication that regulator mandated exchange trading is imprudent.

4. **Is the availability of CCP clearing an essential pre-determining factor for a derivative contract to be traded on an organized trading platform?**

Policy discussions frequently confound exchange trading—which means that all trades must be negotiated and executed through a central venue—with clearing—which means that trades must be booked with a central counterparty that serves as the counterparty to all cleared transactions. Exchange trading is possible without clearing, although most exchanges involve clearing as well; and clearing is compatible with both exchange trading and over-the-counter trading.

Section 6. Capital and Collateral

ISDA believe that internationally agreed risk sensitive capital requirements make an important contribution to financial stability. Thus we urge the CSA to align itself with internationally agreed standards both for bank capital and for determining an appropriate level of financial resources for CCPs. Further details of our thinking here can be found in ISDA's letter on Derivative Clearing Organization financial resources, which can be found at http://www.isda.org//speeches/pdf/CFTC-Comment-CCP-Financial-Resources.pdf.

1. **What are the consequences that you foresee from higher capital requirements for financial institutions for derivative transactions not cleared through a CPP?**

ISDA supports capital requirements that are risk sensitive and defined to a precisely articulated soundness standard. Thus higher capital requirements are appropriate for uncleared exposures only where these have greater risk than cleared exposures. This may or may not be the case depending on various factors including but not limited to the financial resources of the CCP, CCP and bilateral margin requirements, segregation, CCP products cleared, and documentation, operational and other risks. If higher margin requirements are applied without regard to these factors they may provide an incentive to use central clearing even when clearing members are unconvinced as to the safety of the CCP. Further they may encourage some CCPs to clear products which are not sufficiently liquid or otherwise unsuitable for central clearing. Thus we encourage a proportionate use of capital requirements which is fully cognizant of the variety of risks in cleared and uncleared models.

2. **What are the consequences of mandatory collateral requirements for non-financial entities for non-cleared trades?**

Imposing mandatory collateral requirements for non-financial entities for non-cleared trades is inappropriate.

Increasing the costs associated with using OTC derivatives will hamper the ability of small and mid-sized companies to manage their business risks. Non-financial entities, which make use of customized derivatives, are not geared up to routinely post margin. The costs and demands of managing margin requirements on a daily basis are extremely prohibitive. Instead, they customarily collateralize as part of their overall banking relationship.

If margin were made a matter of law or regulation, the cost of funding collateral calls might be sufficient to lead non-financial entities to reduce their hedging activities and thereby increase their financial risk exposures. In essence, the proposal sets up a trade-off between arguably reducing the limited counterparty credit risk posed by non-financial entities use of OTC derivatives, which may be addressed via alternative credit risk mitigation arrangements, while increasing business risk for non-financial entities (i.e., currency, rate, price risks) by discouraging the use of OTC derivatives. Financial entities,

who are in the business of extending credit, should be able to manage their counterparty credit risk on an individual counterparty basis rather than by product or in accordance with mandatory collateral requirements.

On page 45 of the Consultation Paper, the CSA requests that regulators have the authority to mandate the use of two-way collateral agreements with zero threshold amounts for non-cleared trades. Imposing this requirement on non-financial end users is not appropriate for the reasons outlined above. Imposing a requirement that systemically significant financial entities deliver collateral to less creditworthy counterparties puts the financial entities' assets at risk in the event of a bankruptcy of the non-financial, non-systemic entity. This requirement is unnecessary and contrary to the regulator goals of reducing systemic risk. The parties to non-cleared trades should be allowed to negotiate their collateral terms in accordance with their own credit risk assessments.

We also recommend that Canadian regulators make clear that any collateral requirement (a) preserves the ability of counterparties to enter into contractual arrangements that net exposures across all outstanding transactions in a trading relationship, including transactions that are not derivatives, when calculating collateral requirements and (b) requires delivery of collateral only for net exposure.

3. **Do the differing capital standards currently imposed by Canadian regulators result in a level playing field for OTC derivatives market participants?**

As outlined above, we believe the prudential regulators are in the best position to ensure that capital standards imposed on Canadian entities are consistent with global standards and suitable to the risk management capabilities of each individual participant. The prudential regulators should coordinate with each other to ensure that the requirements result in a level playing field.

Section 7. End-Users and Significant Market Participants

1. **What are your views on the general approach of providing commercial hedging endusers of OTC derivatives with exemptions from the mandatory clearing, electronic trading, margin and/or collateral requirements? If such trades are exempt, what would the effect be on financial institutions on the other side of these trades?**

We believe that affordable access to appropriate methods of hedging, including the use of OTC derivatives, is vital to end-users as they seek to mitigate risks and maintain their economic viability. We caution against implementing regulation that would make access to these critical risk management tools either too difficult or too expensive to attain. We also understand that the construction of an end-user exemption is likely to be complex, given the need to ensure that there is no regulatory arbitrage but also provide that regulation is applied to non-systemically significant end-users in a proportionate manner.

We agree with the general approach that certain firms should be exempt from clearing and margin requirements, as the increased collateral and operational requirements would be too burdensome and the reduction in systemic risk is insufficient to justify the imposition of these costs on the economy as a whole. We are not aware of any study that has shown these firms to present risk to the financial system by virtue of their derivatives activities. Thus, any such requirements will result in increased costs to such commercial end users without any resulting benefit to derivatives markets. These requirements would also affect end-users' ability to use derivatives for risk management purposes as many of these firms, especially non-financial end-users, need their most liquid assets for working capital and investment purposes.

Such firms should also be permitted to choose the venue for execution that best suits their hedging needs – whether on exchange, electronic or bilateral.

Dealers facing end-users that do not pose a threat to financial stability should be permitted to evaluate and underwrite the credit risk of such end-users and negotiate bilateral collateral or credit support arrangements as they deem necessary.

End-users should be allowed to make representations in bilateral contracts which allow those end-users to avail themselves of the relevant exemptions. Rather than requiring regulatory certification, end-users should be presumed to be hedging and should only have to make an affirmative declaration as to the character of a transaction when or if they are entering into a speculative transaction.

2. **Should there be any other exemption from the mandatory clearing or from capital margin and/or collateral requirements for any category of end-users?**

We believe that the regulations should not focus on the form of legal entity or type of business in which a firm is engaged, but rather whether the firm's use of derivatives poses

a threat to financial stability. As such, we believe that any end-user that does not pose a threat to financial stability should be exempt from the mandatory clearing, electronic trading margin and/or collateral requirements.

Section 9. Segregation of Collateral

1. **What are your views regarding a regulatory rule requiring all collateral to be held in segregated accounts?**

ISDA provided its views on the issues raised in this section of the Consultation Paper to the CFTC in October of last year (**Comment Letter**). The Comment Letter incorporates by reference the white paper on Independent Amounts (**White Paper**), which ISDA, Managed Funds Association and the Securities Industry and Financial Markets Association jointly published in March 2010[8]. The White Paper describes various approaches that may be used to segregate independent amounts posted by a counterparty for the benefit of a dealer in respect of uncleared derivative transactions.

2. **Should end-users have the ability to elect segregation of collateral/margin?**

Please see above.

* * *

ISDA appreciates the ability to provide its comments on the Consultation Paper and looks forward to working with the CSA as it continues to consider the issues outlined in the Consultation Paper. Please feel free to contact me or ISDA's staff at your convenience.

Sincerely,

Katherine Darras
General Counsel, Americas

[8] The Comment Letter is available at www.isda.org and the White Paper is available at http://www.isda.org/c_and_a/pdf/Independent-Amount-WhitePaper-Final.pdf.