

14 December 2012

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The Australian Securities Exchange Market Discussion Document on Derivatives Account Segregation and Portability

The International Swaps and Derivatives Association, Inc. (“**ISDA**”)¹ welcomes the opportunity to provide comments on the Australian Securities Exchange (“**ASX**”) *Market Discussion Document on Derivatives Account Segregation and Portability* (“**Discussion Paper**”) released on 25 October 2012.

ISDA is actively engaged with providing input on regulatory proposals in the United States (“**US**”), Canada, the European Union (“**EU**”) and in Asia. Our response to the Discussion Paper is derived from these efforts and from consultation with ISDA members operating in Australia and Asia. Our response is drawn from this experience and dialogue. Individual members will have their own views on different aspects of the Discussion Paper, and may provide their comments to the ASX independently.

ISDA commends ASX for its careful consideration in setting up its Over-the-Counter (“**OTC**”) derivatives clearing in-line with the Committee on Payments and Settlement Systems (“**CPSS**”) and the Technical Committee of the International Organization of Securities Commission’s (“**IOSCO**”) *Principles for Financial Market Infrastructures* (“**FMI**s and **PFMI**”, respectively)². We support the PFMI in promoting effective risk management, reducing counterparty risk and improving overall transparency of operational standards for central counterparties (“**CCPs**”) in the OTC derivatives market.

¹ ISDA’s mission is to foster safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products. ISDA has more than 800 members from 58 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. For more information, visit www.isda.org.

² Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, *Principles for Financial Market Infrastructures*, April 2012.

General observations

Before we address the questions posed in the Discussion Paper, we would like to make a few general observations.

One of the key points we would like to address is the need for choice and flexibility for Clearing Participants and their clients in selecting an account structure. Clearing Participants should not be mandated by rules, laws or regulations to only provide individual segregated account structure to their clients. A client should be given the choice of the type of account structure that best suits their needs and any additional costs they may incur. A Clearing Participant should also be given the flexibility to decide the account structure that best suit their needs.

Regulatory and Financial Impact

We cannot over-state the importance to Clearing Participants and their clients for ASX to meet the standards set by the Australian regulators and the PFMI. We strongly agree with the standards as set out in the PFMI which are due to be enshrined in Australia's revised Financial Stability Standards. We believe a harmonized and single international standard would provide greater consistency in oversight and regulation of CCPs worldwide.

In addition, as highlighted in the Consultation Paper, it is essential that ASX meets the PFMI standards to enable it to attain the status of a "Qualifying" CCP ("**QCCP**")³ as under the Basel Committee on Banking Supervision's ("**BCBS**") framework on '*Capital Requirements for Bank Exposures to Central Counterparties*, July 2012' ("**Basel Bank Exposures to a CCP**") and any equivalent local Basel III standards. This would enable Clearing Participants clearing through ASX to attain a lower risk weight for trade exposures, collateral and default fund obligations which would aid in reducing the cost of clearing via ASX. Some Clearing Participants may not be able to continue clearing through a CCP which does not achieve QCCP status due to the punitive regulatory capital treatment under the Basel Bank Exposures to a CCP.

In addition to the Basel Bank Exposure to a CCP, many jurisdictions, including some of the non-G20 jurisdictions have begun to consult and implement the G20 commitment for clearing. Consequently, Clearing Participants and clients may be obligated by law and regulation to clear many of their OTC transactions. As such, it is imperative ASX takes into

³ <http://www.bis.org/publ/bcbs227.pdf>, Basel Committee on Banking Supervision, *Capital Requirements for Bank Exposures to Central Counterparties*, July 2012, page 1, Annex 4, Section I, A. General Terms, "A qualifying central counterparty (QCCP) is an entity that is licensed to operate as a CCP (including a license granted by way of confirming an exemption), and is permitted by the appropriate regulator/ overseer to operate as such with respect to the products offered. This is subject to the provision that the CCP is based and prudentially supervised in a jurisdiction where the relevant regulator/overseer has established, and publicly indicated that it applies to the CCP on an ongoing basis, domestic rules and regulations that are consistent with the CPSS-IOSCO Principles for Financial Market Infrastructures...In addition, for a CCP to be considered a QCCP, the terms defined in paragraphs 122 and 123 of this Annex for the purposes of calculating the capital requirements for default und exposures must be made available or calculated in accordance with paragraph 124 of this Annex."

account other regulatory requirements regarding derivatives clearing, such as the Dodd-Frank Act (“**DFA**”) and the corresponding European Markets Infrastructure Regulation (“**EMIR**”). These may restrict certain Clearing Participants and/ or their clients using ASX where ASX does not meet the requirements set out for CCPs and the relevant clearing arrangements in those regulations. For example, under EMIR, transactions that are subject to the clearing mandate must be cleared at an authorized or recognized CCP and the process of third country CCPs like ASX is likely to involve an assessment of ASX’s compliance with regulations and laws that are “equivalent” to EMIR. For example, Article 25(1) of EMIR states that “a CCP established in a third country may provide clearing services to clearing members or trading venues established in the Union only where that CCP is recognized by ESMA”⁴. Hence, ASX can only continue to accept European based Clearing Participants and/ or their foreign branches if ASX is recognized by the European Securities and Markets Authority (“**ESMA**”).

Similar issues arise under the DFA, section 5(b) of the Commodity Exchange Act (“**CEA**”) as amended by the DFA, which makes it unlawful for a derivatives clearing organization (“**DCO**”) to directly or indirectly perform the functions of a derivatives clearing organization for a swap unless it is registered with the CFTC. Under Section 2(h)(1)(A), “it shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a DCO that is registered under the [CEA] or a [DCO] that is exempt from registration under [the CEA] if the swap is required to be cleared”⁵. As you may know, in the US, the model for clearing is based on an agency model. The agency model works well in the US because it is heavily supported by layers of regulation and legislation which provides regulatory and legislative protection for a Participating Member’s clients. ISDA has commissioned King & Wood Mallesons to provide an analysis of the legislative and regulatory support required to support an agency model for client clearing in Australia. We have attached this memorandum for your reference in Appendix 1.

Disclosures

As part of the G20 commitment for clearing, an increasing number of OTC derivatives transactions will be cleared through CCPs. Both the buy-side and sell-side participants in the market will increasingly face CCPs as counterparties instead of each other. Clearing Participants and clients will be obligated by law and regulation, in many jurisdictions, to clear their OTC derivatives transactions via a CCP. Consequently, it is important for Clearing Participants and clients that have a clearing mandate to be able to assess the risks of their clearing arrangements, including the impact this may have on their regulatory capital requirements. It is extremely important that Clearing Participants be able to obtain sufficient information from CCPs to enable them to make appropriate risk assessments.

⁴ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF>, *Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC Derivatives, Central Counterparties and Trade repositories*, page L201/29.

⁵ <http://www.gpo.gov/fdsys/pkg/FR-2012-12-13/pdf/2012-29211.pdf>, Federal Register, Vol. 77, No. 240, Part II, Commodity Futures Trading Commission, 17 CFR Parts 39 and 50, Clearing Requirement Determination Under Section 2(h) of the CEA; Final Rule, page 74286.

With regards to segregation and portability, the PFMI, section 3.14.17, states the following:

A CCP should state its segregation and portability arrangements, including the method for determining the value at which customer positions will be transferred, in its rules, policies, and procedures. A CCP's disclosure should be adequate such that customers can understand how much customer protection is provided, how segregation and portability are achieved, and any risks or uncertainties associated with such arrangements. Disclosure helps customers to assess the related risks and conduct due diligence when entering into transactions that are cleared or settled through a direct participant in the CCP. Customers should have sufficient information about which of its positions and collateral held at or through a CCP are segregated from positions and collateral of the participant and the CCP. Disclosure regarding segregation, should include (a) whether the segregated assets are reflected on the books and records at the CCP or unaffiliated third-party custodians that hold assets for the CCP; (b) who holds the customer collateral (for example: CCP or third-party custodian); and (c) under what circumstances customer collateral may be used by the CCP. In particular, the CCP should disclose whether customer collateral is protected on an individual or omnibus basis⁶.

In addition to the disclosures for segregation and portability, ASX should comply with the PFMI Principle 23 for Disclosure of rules, key procedures, and market data⁷. The transparency will ensure Clearing Participants and clients will have the sufficient information to identify clearly and fully understand the risks and responsibilities of participating in ASX as well as to foster confidence and enable sound decision making in the market.

Response to specific questions

The remainder of this letter sets out our comments in relation to the specific questions posed in the Discussion Paper. Our response is set out underneath each question relating to OTC derivatives clearing. The headings used below correspond to the headings used in the Discussion Paper.

QUESTIONS

Question 1: Are there any additional high-level drivers or aspects of the drivers cited above that ASX should consider when examining the optimization of portability and segregation arrangement?

ASX should work closely with Australian Treasury on designing changes to the legislative framework to facilitate portability, and also on ensuring any changes the Australian Treasury proposes on the handling and use of client money in relation to OTC derivatives transactions

⁶ Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, *Principles for Financial Market Infrastructures*, April 2012, page 87.

⁷ Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, *Principles for Financial Market Infrastructures*, April 2012, page 121-123.

in the Corporations Act will interact most effectively with ASX's changes and avoid any potential conflicts for porting or segregation.

In addition to the US, EU and Australian regulations on OTC derivatives reforms, there is a need to consider global initiatives such as the BCBS “Basel III: International framework for liquidity risk measurement, standard and monitoring” (“**Basel III liquidity requirements**”) and the recently released BCBS and IOSCO consultative document “Margin requirements for non-centrally-cleared derivatives”. The assets required to meet the Basel III liquidity requirements and for the proposed margin requirements for non-centrally-cleared derivatives will be the same high quality liquid assets used to meet the margin requirements of a CCP. Consequently, the pool of eligible collateral will decrease, resulting in, Clearing Participants and clients being forced to decrease or optimize the margin that is posted. It is important against this backdrop that ASX strives to provide Clearing Participants and clients a solution that will optimize their usage of collateral.

A more detailed risk and cost study for each account structure type should be performed to determine the increased costs and risks for each model. To highlight the potential increase in cost for the various account structures, ISDA has performed an estimation of the industry-wide incremental costs for various client account structures for a DCO. Although this industry-wide estimate is based on the DCO model and differs from ASX’s Principle model, the industry-wide estimates serves as an illustration for the additional costs that may be incurred when choosing different client account structures. For reference, please find some industry cost estimates in Appendix 2.

Question 2: Please provide your views on the proposed core objectives, identifying any additional major objectives if necessary?

ASX should develop account structures which will enhance the stability of the clearing house by reducing the need to close out end users' positions when a participant defaults in a volatile market. This is a key consideration in Principle 14 of the PFMI which states “a CCP should structure its portability arrangements in a way that makes it highly likely that the positions and collateral of a defaulting participant’s customers will be transferred to one or more other participants”⁸.

However, there are practical issues in implementing porting agreements. In the event of a Clearing Participant member defaulting, the CCP may elect to force allocate positions to the remaining non-defaulting Clearing Participants. There exists a risk that the non-defaulting Clearing Participant may not be able to finance the additional margin required to support these new positions, particularly in a time of market stress, given that the defaulting Clearing Participant’s position will not be known to the non-defaulting Clearing Participant. Additionally, depending on how much time it takes to port a defaulting Clearing Participant’s position, their clients may become “interim Clearing Participant” and may be required to make intraday margin calls and contribute to the default fund. Consequently, it is

⁸ Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, *Principles for Financial Market Infrastructures*, April 2012, page 82.

fundamentally important for ASX to have legal certainty with respect to its default management arrangements for porting.

We encourage ASX to perform further analysis around the risk issues relating to cross margining between the OTC derivatives segment and the futures segment. As the OTC derivatives and futures are different products with different risk profiles, using the same default management processes, default waterfalls and funds may not be the most desirable solution for either regime. We commend ASX for seeking to promote collateral efficiencies and we support increasing collateral efficiencies under the right circumstances.

Question 3: Do you believe that ASX's CCPs will need to undertake any other activities to facilitate client portability in the derivatives markets? Please consider any domestic or overseas regulatory requirements, if appropriate. ASX is keen to establish whether any additional complexities arise under prime brokerage arrangements.

The effectiveness of porting arrangements set out in the rules of a CCP need to be assessed in light of an event of a default of any Clearing Participant. There may be a need for legislative reform in Australia to lend support to porting arrangements particularly where the relevant defaulting Clearing Participant is not an Australian entity and cross-border conflicts of law issues may therefore arise. The PFMI highlights this potential for conflict of laws and require that the CCP's rules and procedures for segregation and portability arrangements should avoid any potential conflict with applicable legal and regulatory requirements⁹. In a time of market stress, a Clearing Participant may not be willing to port-in a defaulting Clearing Participant's portfolio without having the time to review, understand the risk and to take on those positions in that portfolio. It may be useful to Clearing Participant to have a tool that would enable them to review the defaulting Clearing Participant's portfolio quickly and to assess the risk of taking on those positions.

We do not believe it is appropriate for ASX to impose a requirement for a client to have a clearing agreement in place with an alternative Clearing Participant at all times. This is because there are costs and risks for an alternative Clearing Participant to enter into a back-up clearing agreement with a client that merit further detailed considerations. One concern for the alternate Clearing Participant is the increased cost of the alternate Clearing Participant's contribution to the default fund. It is unlikely upfront guaranteed porting arrangements will be widely available without significant conditionality as a Clearing Participant would need to take into account a broad range of time sensitive factors before agreeing to accept a ported position, such as the size of the portfolio and the types of trades in the portfolio.

⁹ CPSS-IOSCO's *Principles for Financial Market Infrastructures*, page 83, 3.14.5: "...The legal framework will influence how the segregation and portability arrangements designed and what benefits can be achieved. The relevant legal framework will vary depending upon many factors, including the participant's legal form of organization, the manner in which collateral is provided (for example, security interest, title transfer, or full ownership right), and the types of assets (for example, cash or securities) provided as collateral...a CCP should also consider potential conflict of laws when designing its arrangements. In particular, the CCP's rules and procedures that set out its segregation and portability arrangements should avoid any potential conflict with applicable legal and regulatory requirements".

Question 4: Do you agree with the suggested approach? Please explain your rationale for the answer and whether the proposal meets any overseas regulatory requirements you may have.

We have only commented on those questions relating to OTC derivatives clearing. We believe careful consideration should be given before implementing the same regime for both the OTC derivatives segment and the futures segment due to the differing nature of the products, risk profiles and business models.

Question 5: What would be the impact on Clearing Participants and/or their clients of the introduction of ISCA's by ASX Clear (Futures)? Please provide feedback on your likely implementation timelines and costs.

We have only commented on those questions relating to OTC derivatives clearing.

Question 6: Do you foresee any issues with the implementation of this approach? If so, how do you recommend that ASX should address them?

We have only commented on those questions relating to OTC derivatives clearing.

Question 7: Do you believe that the choice of account type – ISCA or omnibus – should be available to all market users or even be mandatory in some cases? Please consider categories such as market-makers, retail clients and overseas users when answering.

We have only commented on those questions relating to OTC derivatives clearing.

Question 8: Should it be compulsory for ISCA holders to have concurrent clearing agreements with at least two Clearing Participants? If so, should this apply to all or just a particular category of clients?

We have only commented on those questions relating to OTC derivatives clearing.

Question 9: Do you believe that the introduction of individual segregated client accounts for ASX's listed CFDs would add value to the ASX product offering? In your answer please note your view of the advantages or disadvantages with such an approach.

We have only commented on those questions relating to OTC derivatives clearing.

Question 10: Should the ISCA approach be compulsory for all ASX listed CFD users or should an omnibus client account be retained for margin purposes on an optional basis?

We have only commented on those questions relating to OTC derivatives clearing.

Question 11: Do you believe that any other changes should be made to the account structures facilitating the clearing exchange traded options by ASX Clear? In answering, please consider the large number of individual client accounts and the potential impact on the CCP's operations in a Clearing Participant default.

We have only commented on those questions relating to OTC derivatives clearing.

Question 12: Should ASX Clear also introduce a client omnibus account on ASX Clear akin to that on ASX Clear (Futures)? If so, should the type of client permitted to use this account be limited in any way?

We have only commented on those questions relating to OTC derivatives clearing.

Question 13: Do Clearing Participants foresee any factors that would prevent their maintenance of up-to-date client account information in ASX Clear's DCS system?

We have only commented on those questions relating to OTC derivatives clearing.

Question 14: Do OTC market participants (either as potential clients or Clearing Participants of the ASX Clear (Futures) OTC clearing service) have any specific preferences or requirements for client account structures in OTC clearing? In answering, please consider any overseas regulatory obligations that may be placed upon your organization and/or those of your clients.

We would have a strong preference that a range of options be given to clearing members and their clients in relation to the account structures for the clearing of OTC derivatives. Different account structures carry different costs and it should be a question for each client having regard to their risk tolerance as to which option they prefer. We would strongly support transparency at a CCP level, both of the cost and of the associated risk, with the choice being left to clients. This is reflected in the CPSS-IOSCO Principles' 3.14.17, which states:

...a CCP's disclosure should be adequate such that customers can understand how much customer protection is provided, how segregation and portability are achieved, and any risks or uncertainties associated with such arrangements. Disclosure helps customers to

assess the related risks and conduct due diligence when entering into transactions that are cleared or settled through a direct participant in the CCP¹⁰.

Clients should be allowed to choose between individually segregated client accounts (“ISCA”) and omnibus account structures, and between margining on a gross or net basis. We do not agree with the premise in the Discussion Paper that gross margining is a prerequisite of effective porting. It may be possible, for example, to port positions without porting the collateral or to port collateral on a net basis, with clients making up any collateral shortfall with the Backup Clearing Participant.

In this regard it is worth noting that in Europe, under Article 39(5) of EMIR¹¹, both CCPs and clients are required to offer (at least, in the case of Clearing Member) both omnibus and individually segregated accounts. This requirement might be pertinent for the ASX, in particular if it is planning on offering clearing services to clearing participants based in the EU, given the requirement for CCPs to apply for recognition under Art 25 of EMIR in these circumstances and the equivalence test that will be applied by ESMA.

Question 15: Where a Clearing Participant calls margin from an individually segregated client account in excess of that called from the Client Participant by the CCP, should the Clearing Participant be required to pass the additional margin to the CCP? If not, what alternative approaches would provide the client with the protection in circumstances of a Clearing Participant default?

Where a client selects an omnibus account structure and provides margin to the Clearing Participant in excess of that which is required to be provided by the Clearing Participant to the CCP, the Clearing Participant should be entitled to retain and to rehypotecate the collateral. A client may choose to select an omnibus account structure because of the enhanced credit protection received by the Clearing Participant by holding excess collateral, together with the liquidity benefit, which will be priced into the OTC derivative transaction with the client, resulting in the client being compensated for this risk. This is not a new market practice as seen in the PFMI footnote 129 which states that “collateral exceeding the amount required by the CCP to cover the net positions is often maintained by the participant”¹².

Where a client selects an individually segregated client account, then the margin provided to the Clearing Participant in excess of that which is required to be provided by the Clearing Participant to the CCP should be placed with the CCP. Under Article 39(6) of EMIR provides that “when a client opts for individual client segregation, any margin in excess should be

¹⁰ Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, *Principles for Financial Market Infrastructures*, April 2012, page 87.

¹¹ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF>, *Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC Derivatives, Central Counterparties and Trade repositories*, page L201/36.

¹² Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, *Principles for Financial Market Infrastructures*, April 2012, page 85.

posted to the CCP and distinguished from the margins of other clients or clearing members and shall not be exposed to losses connected to positions recorded in another account”¹³.

The client and Clearing Participant should be allowed to decide which account structure suits them best after assessing the risks and costs of opting for such an account.

Question 16: Where an institution stands as an intermediary between the ultimate client and the Clearing Participant, and those positions are held in an individually segregated client account, should the Clearing Participant be required to allocate each underlying client’s positions to a specific individual account? If not, are additional or alternative measures required to ensure the appropriate level of client protection?

Again, a variety of different options (with associated pricings) should be available to the ultimate client, who can choose depending on its attitude towards the credit risk of the intermediary and the Clearing Participant. We believe further work is needed for ASX to achieve the optimum segregation and portability outcome that deals with the complexities inherent in global net margining arrangements.

As clients may potentially act through multiple brokers in multiple jurisdictions across multiple exchanges, currencies and types of collateral, ASX may wish to consider building in some flexibility in its clearing model to enable a client to receive one margin call across all exchanges from a global broker.

Question 17: Do you agree with ASX’s interpretation of the interim Basel Committee rules? Please outline any difference of views.

We agree that a 2% risk weight will apply for trade exposures to for banks acting as a Clearing Participant to a CCP for its own purposes and a corresponding risk weight of 2% will apply to the collateral posted to the CCP and held in a bankruptcy remote manner. A 0% risk weight will be applied for collateral posted to a bankruptcy remote custodian. If a Clearing Participant offers clearing services to a client, a 2% risk weight applies to the Clearing Participant’s trade exposure to the CCP if the Clearing Participant is obligated to reimburse the client for any losses suffered in value changes of the client’s transactions in the event of the CCP default. If a bank is a client of a Clearing Participant, a 2% risk weight for trade exposures will also apply. However, this is subject to the offsetting transactions being identified by the CCP as client transactions and collateral is held by the CCP and/or the Clearing Participant and is protected from “(i) default or insolvency of the clearing member, (ii) the default or insolvency of the clearing member’s other clients, and (iii) the joint default or insolvency of the clearing member and any of its other clients”¹⁴. Additionally, the client

¹³ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDE>, *Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC Derivatives, Central Counterparties and Trade repositories*, page L201/36.

¹⁴ <http://www.bis.org/publ/bcbs227.pdf>, Basel Committee on Banking Supervision, *Capital Requirements for Bank Exposures to Central Counterparties*, July 2012, page 5.

would need to provide to the national regulator, if requested, an independent legal opinion that supports no client losses on account of the insolvency of an intermediary Clearing Participant or any of its other clients under the relevant law. In such a default situation, the client positions and collateral with the CCP will be transferred at market value unless the client requests to close out the position at market value. In the PFMI, this is provided for under 3.1.7 which states that “netting arrangements should be designed to be explicitly recognized and supported under the law and enforceable against an FMI and an FMI’s failed participants in bankruptcy”¹⁵.

If the client is not protected from losses, in the case of the Clearing Participant and another client jointly defaulting or become jointly insolvent, but the above conditions are met, a risk weight of 4% will apply to the client’s exposure to the Clearing Participant. A 0% risk weight will apply for a client’s collateral if it is held by a custodian and is bankruptcy remote from the CCP, clearing members and other clients. A 2% risk weight will apply to the collateral if it is held at the CCP on the client’s behalf and is not on a bankruptcy remote basis and certain conditions are met. Otherwise a 4% risk weight will apply to the client’s collateral if the client is not protected from losses of the Clearing Participant or another client of the Clearing Participant but other conditions are met¹⁶.

If a bank deals with a non-QCCP, the bank must apply a risk weight of 1250% to its default fund contributions, i.e., both the funded and the unfunded contributions. If there is a liability for unfunded contributions, i.e., unlimited binding commitments, under Pillar 2, the local regulator will determine the amount of unfunded commitments to which a 1250% risk weight will apply. Consequently, when dealing with a non-QCCP, a bank may face a higher capital charge than dealing with a bilateral counterparty.

In addition to the Basel committee’s rules, for EU banks and investment firms to benefit from the preferential 2% risk exposures to non-EU CCP, there is a possibility this preferential risk weighting may be restricted to exposures to CCPs authorised or recognised under EMIR. However, this is dependent on the final rules in the Capital Requirements Directives 4 (also known as “CRD4”).

Question 18: What steps should ASX take to minimize the regulatory capital weightings for banks centrally cleared transactions?

For Clearing Participants and banks that are clients of a Clearing Participant to calculate its trade exposures based on the net basis, certain conditions must be met. This would reduce the trade exposure to the CCP from a gross basis to a net basis and in turn a lower regulatory capital amount. ASX will need to ensure that it is a QCCP for the Basel Bank Exposures to a CCP purposes. It will also need to include in its client clearing offering, to the extent this is within ASX’s control, a structure which allows banks clearing as clients to obtain a legal

¹⁵ Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, *Principles for Financial Market Infrastructures*, April 2012, page 24.

¹⁶ <http://www.bis.org/publ/bcbs227.pdf>, Basel Committee on Banking Supervision, *Capital Requirements for Bank Exposures to Central Counterparties*, July 2012, page 6.

opinion to show that the transactions and the collateral held with the CCP are protected from the default of the Clearing Member and/or any of its other clients, and that client positions will be ported at market value unless the client chooses to close out the position at market value.

It is fundamentally important for ASX is able to ensure a netting contract or agreement creates a single legal obligation and is legally enforceable because if a bank cannot demonstrate that the netting agreements meet the conditions in as set out in paragraphs 96(ii) below, each single transaction will be regarded as a netting set of its own for calculation of trade exposures and would be calculated on a gross basis, thereby increasing the regulatory capital required.

Paragraphs 96(i) and 96(ii) of the BCBS framework on ‘*International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version*, June 2006’ (“**Basel II**”) states the following:

“Careful consideration has been given to the issue of bilateral netting, i.e., weighting the net rather than the gross claims with the same counterparties arising out of the full range of forwards, swaps, options and similar derivatives contracts. The Committee is concerned that if a liquidator of a failed counterparty has (or may have) the right to unbundle netted contracts, demanding performance on those contracts favorable to the failed counterparty and defaulting on unfavorable contracts, there is no reduction in counterparty risk.

Accordingly, it has been agreed for capital adequacy purposes that:

- (a) Banks may net transactions subject to novation under which any obligation between a bank and its counterparty to deliver a given currency on a given value date is automatically amalgamated with all other obligations for the same currency and value date, legally substituting one single amount got the previous gross obligations.
- (b) Banks may also net transactions subject to any legally valid form of bilateral netting not covered in (a), including other forms of novation.
- (c) In both cases (a) and (b), a bank will need to satisfy its national supervisory that is has:

- (i) A netting contract or agreement with the counterparty which creates a single legal obligation, covering all included transactions, such that the bank would have either a claim to receive or an obligation to pay only the net sum of the positive and negative mark-to-market values of included individual transactions in the event a counterparty fails to perform due to any of the following: default, bankruptcy, liquidation or similar circumstances

- (ii) Written and reasoned legal opinions that, in the event of a legal challenge, the relevant courts and administrative authorities would find the bank’s exposure to be such a net amount under:

- The law of the jurisdiction in which the counterparty is chartered and, if the foreign branch of a counterparty is involved, then also under the law of the jurisdiction in which the branch is located;
- The law that governs the individual transactions; and
- The law that governs any contract or agreement necessary to effect the netting.

The national supervisor, after consultation when necessary with other relevant supervisors, must be satisfied that the netting is enforceable under the laws of each of the relevant jurisdictions.”¹⁷

It is also fundamentally important for ASX to be deemed a QCCP that it be CPSS-IOSCO compliant and compliant with the Australian Financial Stability Standards (“FSS”). If ASX is not deemed a QCCP and CPSS-IOSCO compliant CCP, its Clearing Participants will be subject to punitive capital treatments under the Basel bank exposures to a CCP for both its trade exposures to ASX and to its default fund contributions. ASX should work with the relevant Australian authority to ensure it is CPSS-IOSCO compliant. Disclosure of such an endorsement will aid foreign Clearing Participants to achieve the lower risk weights in their home jurisdictions.

Question 19: Taking into consideration the likely additional custodian costs, do bank clients believe that ASX should seek to put in place arrangements that reduce the capital weighting on margins from 2% to 0%?

ASX should evaluate the cost of taking steps to place margin in bankruptcy remote structures to enable banks to benefit from a 0% risk weighting. This should be provided as one of the options offered by ASX. The Clearing Participant and client should be allowed to determine which arrangement would be more cost effective for them. As you may know, holding collateral through a bankruptcy remote custodian can be costly and may not be an economically attractive option for some Clearing Participants or clients.

Question 20: What, if any, changes do bank users of ASX’s CCPs, either as Clearing Participants or clients, believe ASX should make to its margin investment approach to ensure appropriate risk protections in the event of the default of the Clearing Participant and/or the CCP? Please note the benefits that you believe such a change would provide to the market and any additional risks to such a change. In answering, please consider client protection and, if you are a bank, any regulatory capital implications.

As CCPs are emerging as the most systemically important institutions in the financial system it is imperative that they are run based on a conservative lines with the aim to safeguard its own and its participants’ assets and minimize risk of loss¹⁸. Accordingly, the PFMI 3.16.4, states that a CCP’s

¹⁷ <http://www.bis.org/publ/bcbs128.htm>, Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards, A revised Framework Comprehensive Version*, June 2006, page 275-276.

¹⁸ Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, *Principles for Financial Market Infrastructures*, April 2012, page 92.

...strategy for investing its own and its participants' assets should be consistent with its overall risk-management strategy and fully disclosed to its participants. When making its investment choices, the FMI should not allow pursuit of profit to compromise its financial soundness and liquidity risk management.¹⁹

We would encourage ASX to explore ways of holding collateral in a manner which ensures the collateral is bankruptcy remote from ASX itself (for example through a trust and charge-back structure), not just because of the potential regulatory capital benefits for bank clients of a 0% risk weighting for collateral but also because of the systemically important role played by CCPs in today's financial system. In an ever increasing competitive clearing market, a CCP with a robust risk management and conservative investment strategy will be more attractive to potential clearing participants and clients.

Question 21: It may be possible for each individual client's margin to be lodged with a CCP and invested into a specific security or account according to a variety of investment risk thresholds to satisfy a range of user expectations on investment returns and risk appetites. Do you believe that there is demand for such a service? What would be the impact?

One of the key considerations in Principle 16 of the PFMI is that an FMI's investment strategy should "allow for quick liquidation with little, if any, adverse price effect"²⁰. Consequently a CCP may need to access the clients' margins promptly and liquidate those investments quickly. This may not be possible if those monies have been invested in an instrument that cannot be liquidated easily or promptly without a loss in value.

Yours sincerely,

For the International Swaps and Derivatives Association, Inc.



Keith Noyes
Regional Director, Asia Pacific



Cindy Leiw
Director of Policy

¹⁹ Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, *Principles for Financial Market Infrastructures*, April 2012, page 93.

²⁰ Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, *Principles for Financial Market Infrastructures*, April 2012, page 92.

Memorandum

Date 20 November 2012

From Scott Farrell, Partner, King & Wood Mallesons

To Keith Noyes, International Swaps and Derivatives Association, Inc.

Subject **Agency model of client clearing: legislative and regulatory support**

This is an analysis of selected issues related to client clearing and is intended for use only in policy considerations. This memorandum is not legal advice and in providing it we do not purport to be advising on the laws of the United States or any other jurisdiction. It should not be relied on in dealing with clearing members, clearing houses or any other person and legal advice should be sought before engaging in any such dealings.

1 Introduction

This memorandum responds to an issue which has arisen in the consideration of the protection of clients of a clearing member in that clearing member's default.

One of the fundamental protections for a clearing member's client is the segregation of that client's collateral from the clearing member's own property and the collateral held for other clients. Another is the ability of the client's positions and collateral to be transferred or "ported" to another clearing member in the case of the default of the client's clearing member.

Legislative protection of these rights is often needed in a jurisdiction, particularly to protect them against the normal operation of the jurisdiction's bankruptcy laws. This is desirable to facilitate the porting to be conducted quickly and efficiently.

In considering the need for such legislative protection, it might be thought that one model of client clearing, the "agency" model, requires less legislative support. This thinking might be founded on the assumption that the clearing member is merely an agent of its client and, as a result, the positions and collateral of the client are not involved in the clearing member's bankruptcy process. In other words, it might be considered that the common law will provide the necessary protections because of the agency relationship.

However, as this paper shows, the "agency" clearing model which is used in the United States of America (the only jurisdiction where the agency clearing model is used for OTC derivatives clearing) is heavily supported by layers of regulation and legislation, which provide the segregation and porting protection for clearing members' clients.

To introduce agency clearing without this regulatory and legislative protection, in sole reliance on the common law of agency, would potentially expose clients to greater risks than would be desirable. This should be taken into account in considering the costs of mandating that any particular model of client clearing be used.

2 Background

In this memorandum we do not provide general information on the role or process of clearing over-the-counter (“OTC”) derivatives. However, there are three relevant concepts which we briefly summarise below:

- client clearing;
- two models of client clearing: agency and principal; and
- two protections for clients in those models: segregation and portability.

2.1 Client clearing

Client clearing is the clearing, through a clearing house, of transactions which originate from dealings in which one party (at least) is not a clearing member of the clearing house. In simple terms, client clearing is the process through which OTC derivatives can be cleared by counterparties who are not able, or do not want, to join a clearing house as a member. In order to clear their transactions, non-member counterparties need to become a client of a clearing member of the clearing house.

2.2 Agency and principal models

The two structures of OTC derivatives client clearing relate to a description of the relationship between the clearing members and their clients.

In the *Principal* or *SCM* model, the clearing member is described as being the principal to the client’s transactions, and the clearing member enters into “back-to-back” transactions between it and the clearing house. The clearing house does not deal directly with the client and, for the most part, recognises only the clearing member in relation to the cleared transactions.

In the *Agency* or *FCM* model, the clearing member is described as being the agent of the client, so that the client deals with the clearing house through the agency of the clearing member. The two principals to these dealings are described to be the clearing house and the client. The clearing member is not described as being a principal counterparty to those dealings. However, to ensure the stability of the clearing system, the clearing member guarantees its client’s performance to the clearing house.

This memorandum considers the agency model. This model is described in more detail in paragraph 3 (“Agency clearing model”) of this memorandum below.

2.3 Segregation and portability

Segregation and portability are two related concepts which provide critical protection to clients from the default of their clearing member.

Segregation is the separation (legally and/or operationally) of the collateral provided by a client to its clearing member from the collateral provided by any other client of the clearing member, and from the property of the clearing member itself. Segregation is especially important in relation to the collateral which has been delivered to the clearing house by the clearing member.

Porting is the transfer of the client’s positions and collateral from the client’s clearing member to another clearing member.

3 Agency clearing model

The most prominent agency clearing model in the clearing of OTC derivatives is the model implemented by the CME Group through its CME Clearing system in

the United States. Under CME Clearing, a client deals with a clearing member who must be a “futures commission merchant” (or FCM). The relationship between the clearing house, clearing member and client, is subject to the rules of the clearing house, the content of which is mandated by the *Commodity Exchange Act* and the *Commodity Futures Trading Commission Regulations* of the United States.

In this section we provide a summary of:

- the clearing procedure under this model
- the manner in which it segregates client collateral
- the manner in which porting occurs under it
- whether the “agency” is a pure agency, as a matter of common law.

These provide the context for the legislative protection which is in place in the United States, which is described in paragraph 4 (“Agency legislative framework”) of this memorandum.

3.1 Clearing procedure

The following is involved in client clearing under the CME model:

- The client instructs their clearing member to enter into a position on its behalf with the clearing house. The clearing member requests collateral in return. The clearing member must segregate collateral it receives from the client from its own assets. Segregation is discussed below at paragraph 3.2 (“Segregation”) of this memorandum.
- The clearing member enters into a position with the clearing house on behalf of the client.¹ The clearing house requests collateral in return, which the clearing member provides (either from the collateral already provided by the client, or from its own assets, subsequently requiring reimbursement from the client).
- To mitigate the clearing house’s risk, the clearing member itself guarantees the position (including collateral required from the client).² The clearing member also provides a contribution to the clearing house’s “guaranty fund deposit”, which acts as a safety net against clearing member default.³
- When a derivative is cleared, the clearing member and clearing house must segregate the relevant collateral from their own assets, and in the clearing member’s case from client collateral relating to derivatives not yet cleared.
- As the derivative position continues, CME (through the clearing member) will require the client to transfer collateral as necessary.⁴

¹ CME Rules r 804.

² CME Rules r 8G05; see letter from S Donohue, Chief Executive Officer of CME Group, to D Stawick, Secretary of the CFTC, entitled “Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants”, dated 11 April 2011, available at <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=35514&SearchText>.

³ CME Rules r 816.

⁴ CME Rules r 814.

- At any time, if a set of conditions have been met, the client may request for their positions and collateral to be “ported” to a backup clearing member.⁵
- If the clearing member becomes insolvent, and the porting conditions have been met, the client’s portfolio will be ported to the backup clearing member.⁶ If the conditions have not been met, the client’s positions will be closed out and netted,⁷ and the collateral will be returned to a segregated account at the clearing member against which the clearing member’s clients can claim pro rata.

A diagram of this arrangement is included as an attachment to this memorandum.

3.2 Segregation

Under the rules of the CME, clearing members are required to segregate:

*“all money, securities, and property of any ... client received to margin, guarantee, or secure a swap cleared by or through a derivatives clearing organisation”.*⁸

While for operational purposes client funds may be stored in the same account as the clearing member’s funds,⁹ in the case of OTC derivatives clearing the client’s funds must be accounted for separately, and treated as the client’s own.¹⁰ Consequently, the clearing member’s ability to use the collateral is limited; it cannot impose a lien on the funds or use them to satisfy other clients’ obligations. These restrictions on dealing with client funds are known as the “legally segregated, operationally commingled” (“**LSOC**”) model.¹¹ This model requires that the clearing member provide information to the clearing house as to the identity of the clients, and the amount of collateral held for each of them. This information must be provided at the time the trade is cleared, and then updated at least once every business day.¹²

3.3 Porting

Under the rules of the CME and the Regulations of the Commodity Futures Trading Commission (“**CFTC**”), where all of the following conditions are satisfied:

- a client is not currently in default to their clearing member;
- the client instructs their clearing member to transfer their portfolio to another clearing member;
- the transferred positions would have sufficient margin at the recipient clearing member;

⁵ CME Rules r 853A.

⁶ CME Rules r 853A.

⁷ CME Rules r 818.A.

⁸ 7 USC 1 § 6d(f)(2)(A); CFTC Regulations § 1.20.

⁹ 7 USC 1 § 6d(f)(3)(A)(i).

¹⁰ CME Rules r 8F120.

¹¹ CFTC (2012) *Final Rule on the Protection of Cleared Swaps Customer Contracts and Collateral and Conforming Amendments to the Commodity Broker Bankruptcy Provisions*, available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/sb_factsheet_final.pdf.

¹² CFTC Regulation § 22.11 and CME Rules r 8F009. CME considers that the reports its clearing house generates satisfy this obligation; <http://www.cmegroup.com/clearing/files/lsc-and-cme-groups-vision-cleared-swaps-customer-protection.pdf>. However, clearing members must still submit a daily statement of the amount they hold in each segregated account to CME; CME Rules r 971.

- (d) any remaining positions would have sufficient margin at the original clearing member; and
- (e) the recipient clearing member consents to the transfer,

a client is able to transfer their portfolio from one clearing member to another without closing out and re-booking its positions.¹³

Porting may take place at the client's election while the clearing member is insolvent, or automatically after the clearing member defaults.¹⁴

3.4 Agency characterisation

An in-depth analysis of the rights and obligations between a client, clearing member and clearing house is beyond the scope of this memorandum. However, commentators have noted that the arrangements described above do not clearly correspond with a "pure" common law agency arrangement. Reasons for this which have been provided are that it is difficult to ascertain exactly how privity of contract exists between a particular client and the clearing house or the exact nature of contractual rights which the client has against the clearing house, absent the legislative and regulatory protections.

However, it is common to refer to the CME system as an "agency" system and the CME Rules relating to IRS Products (for example) do state that the clearing member:

*"shall be deemed a guarantor and agent of the IRS Contract when cleared by such IRS Clearing Member for the account of an affiliate or customer of such IRS Clearing Member"*¹⁵

Any difficulty in finding the clear nature of the agency relationship, and the fact that this is not critical to confidence in the structure demonstrates that it is the legislative and regulatory framework which supports it rather than a clear common law agency.

4 Agency legislative framework

The rules and regulations under which the agency clearing model described in paragraph 3 ("Agency clearing model") of this memorandum is operated are complicated and are the result of many years of variation and adaptation. It is these rules and regulations (rather than the common law of agency) that have defined the relationship between clients, clearing members and the clearing house. Accordingly, it is not surprising to note that it is the rules, regulations and legislation which define the response if the clearing member defaults.

Below is described how those rules, regulations and legislation support the effectiveness of porting and segregation. This description shows the extent of the regulatory and legislative framework which has been implemented for the agency model in the United States.

4.1 Porting

There is a significant level of legislative support in place in the United States to support the porting of positions and collateral from a defaulting clearing member. The CFTC Regulations require clearing house rules to:

¹³ CFTC Regulations § 39.15(d); CME Rules r 853.

¹⁴ CME Rules 802.G and 853.

¹⁵ CME Rules r 8G05.

- (a) provide that the clearing house will port a client's portfolio on the client's request if the conditions described in paragraph 3.3 ("Porting") of this memorandum above are satisfied;¹⁶ and
- (b) not prevent a clearing member from accepting a portfolio ported after bankruptcy.¹⁷

This porting in accordance with the default rules of a clearing house is *expressly* contemplated and protected under "Commodity Broker Liquidation" provisions of the United States Bankruptcy Code¹⁸. These provide that where:

- (a) any time before seven days after bankruptcy proceedings begin in respect of a clearing member (including the time before proceedings begin);
- (b) a "commodity contract"¹⁹ is transferred out of the clearing member's possession; and
- (c) the transfer is not disapproved by the CFTC (in its absolute discretion),

then the transfer may not be avoided by the bankruptcy trustee. The cumulative effect of these sections enables porting for derivatives cleared through a derivatives clearing organisation in the default of a clearing member. Without them, the result would appear to require a court order or some other formality under United States law.

The critical nature of this legislative protection of the porting process in bankruptcy can be seen from the action of CME as clearing house seeking confirmation from the CFTC that the CFTC did not disapprove of the porting of non-defaulting customers' portfolios to other clearing members. This confirmation was expressed to be sought under the United States *Bankruptcy Code*.²⁰

4.2 Segregation

There is a significant level of legislative and regulatory support in place in the United States for the segregation of client funds.

The *Commodity Exchange Act* requires a clearing member to:

¹⁶ CFTC Regulations § 39.15.

¹⁷ CFTC Regulations § 190.06(a)(3).

¹⁸ Subchapter IV of 11 USC 7.

¹⁹ Under the Code, "commodity contracts" include: "*with respect to a clearing organization, [a] contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade that is cleared by such clearing organization, or commodity option traded on, or subject to the rules of, a contract market or board of trade that is cleared by such clearing organization*": 11 USC 7 § 761(4)(d).

Under that definition "clearing organization" is "*an organization that clears (i.e., matches purchases and sales) commodity futures contracts made on or subject to the rules of a contract market or commodity options transactions made on or subject to the rules of a commodity option exchange*" (being a "*derivatives clearing organization registered under the [Commodity Exchange] Act*"): 11 USC 7 § 761(2) and a commodity option is "*an agreement or transaction subject to regulation under section 4c(b) of the [Commodity Exchange] Act*", being "*any transaction involving any commodity regulated under this chapter which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty", contrary to any rule, regulation, or order of the Commission [the CFTC] prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe.*": 11 USC 7 § 761(5) and 7 USC 1 § 6c(b).

²⁰ Letter from A Radhakrishnan and G Barnett, Directors of the CFTC, to T Doar, Managing Director of the Chicago Mercantile Exchange, dated 2 November 2011, available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/mfglobalcmeletter110211.pdf>

- (a) deal with all property received from a client to secure derivatives (or accruing to the client as the result of those derivatives) as belonging to the client; and
- (b) account for that property separately, and not commingle it with the clearing member's funds, or use them for the purposes of any other client.

However, for operational purposes, client property and clearing member funds may be commingled and deposited in the same account.²¹

The *CFTC Regulations* impose stricter segregation, requiring that clearing members:

- (a) segregate any client funds which they hold, though they may be mixed with the clearing member's funds in its own account for convenience;²²
- (c) segregate any cleared swaps or cleared swap collateral held on behalf of clients, which may not be held in the same account as its own property, except to the extent that the clearing member "tops-up" the client's collateral;²³
- (d) not grant any security over the property constituted by (a) and (b) above;²⁴
- (e) determine daily the:
 - (i) total amount of funds held for all clients;
 - (ii) the amount of funds required to be held on deposit in segregated accounts (such as collateral for cleared derivatives); and
 - (iii) the amount of the clearing member's residual interest in the client funds;²⁵ and
- (f) once a day after first intermediating a derivative between a client and the DCO, provide the DCO with sufficient information to identify the portfolio of each client that is intermediated by the clearing member.²⁶

The *CFTC Regulations* also require that DCOs segregate all cleared swap collateral it receives from clearing members in the same manner the clearing member must segregate the collateral itself.²⁷

Further, the US *Bankruptcy Code* provides that the trustee of a clearing member in liquidation shall distribute client property (being property, or the proceeds of property, held on account of a clearing client of the sort considered above)²⁸;

- (a) rateably to its clients;
- (b) in priority to all other claims (with some limited exceptions).²⁹

²¹ 7 USC 2 § 6(d)(2).

²² CFTC Regulations § 1.20(a) and (c).

²³ CFTC Regulations § 22.2(b) and (f).

²⁴ CFTC Regulations § 1.20(a) and 22.2(b).

²⁵ CFTC Regulations § 1.32(a).

²⁶ CFTC Regulations § 22.11(c)(2).

²⁷ CFTC Regulations § 22.3.

²⁸ 11 USC 7 § 761(9) and (10).

The extent of the legislative and regulatory support provided for segregation can be seen from the “Brief of the Commodity Futures Trading Commission” to the United States Bankruptcy Court in respect of MF Global where it is said that:

“The CFTC’s regulations implement a “clear mandate” from Congress under the Commodity Exchange Act (CEA) and Bankruptcy Code to ensure “customer protection” in commodity broker liquidation. See In re Stotler & Co., 144 B.R. 385, 392 (N.D. Ill. 1992) (describing the statutes). These laws are designed to “ensure that the property entrusted by customers to their brokers will not be subject to the risks of the broker’s business and will be available for disbursement to customers if the broker becomes bankrupt.” See id. at 387 (quoting S. Rep. No. 989, 95th Cong. 2d Sess. (1977)). Accordingly, in the liquidation of a commodity broker under Title 11, “commodity customers are granted the highest priority against the bankrupt broker’s estate.” In re Bucyrus Grain Co., Inc., 127 B.R. 45, 48 (D. Kan. 1988). Section 766 of the Bankruptcy Code provides that the trustee in commodity broker liquidation proceedings “shall distribute customer property rateably to customers on the basis and to the extent of such customers’ allowed net equity claims, and in priority to all other claims,” except for certain administrative expenses. See 11 U.S.C. § 766(h). The CFTC, acting pursuant to its robust statutory mandate to protect commodity customers in commodity broker liquidations, see 7 U.S.C. § 24, has enacted a detailed set of procedures to guide trustees and assist courts in implementing the CEA and Subchapter IV of Title 11 of the Bankruptcy Code. See 17 C.F.R. § 190.01-.10 & appendices.”³⁰

5 Need for legislative/regulatory protection

Based on the description above, it is clear that the agency or FCM model used in the United States is based on considerable layers of regulatory and legislative support. In particular, this clearly supports the segregation of client property and porting of client positions and collateral which is critical to the operation of and confidence in client clearing under that model. Although the FCM model involves agency, it does not rely on the common law of agency to deliver protections fundamental to client clearing. If the agency model is to be mandated in other jurisdictions, this need for a legislative and regulatory overlay needs to be considered.

To take Australia as an example, its current legislative and regulatory regime has a number of differences with the United States framework which supports the FCM model. Australia does not have an equivalent to the detailed segregation requirements of the *United States Commodity Exchange Act*, although there are some client money and client property segregation provisions in the Australian *Corporations Act*. The Australian common law requirements on agents in dealing with property of their principal would not be sufficient to compensate for this difference. This does not mean that it is not possible to create clearing systems which have the effect of segregating property (indeed, it is possible). However, the steps needed to effect this go much further than simply establishing an agency relationship.

Similarly, there is no current Australian legislative equivalent to the post-insolvency “porting” provisions of the US *Bankruptcy Code*. US legislation supporting the agency model expressly provides that porting of a client portfolio away from a clearing member up to seven days after bankruptcy proceedings commence against that clearing member is permitted (so long as the CFTC approves) in spite of the automatic mandatory stay imposed on a bankrupt’s

²⁹ 11 USC 7 § 766(h).

³⁰ Brief of the Commodity Futures Trading Commission pursuant to the Court’s November 17, 2011 order, *In re MF GLOBAL Inc.*, available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cftcbrief121211.pdf>

assets under the US *Bankruptcy Code*.³¹ This exception from the ordinary bankruptcy rules allows for quick and effective porting on clearing member insolvency, with supervision provided by the CFTC. The Australian *Payment Systems and Netting Act* protects some transactions which occur under the rules of "market netting contracts" from Australia's insolvency laws. However, these primarily relate to the termination and valuation of obligations and they do not extend to the transfer of property. Consequently, the Australian legislative porting protection is not as extensive as that applicable in the United States. As with segregation, the common law is unlikely to offer the certainty and rapidity which prospective clients would need in the absence of this coverage. Because of this, porting is likely to need some legislative change in Australia to guarantee effectiveness in insolvency.

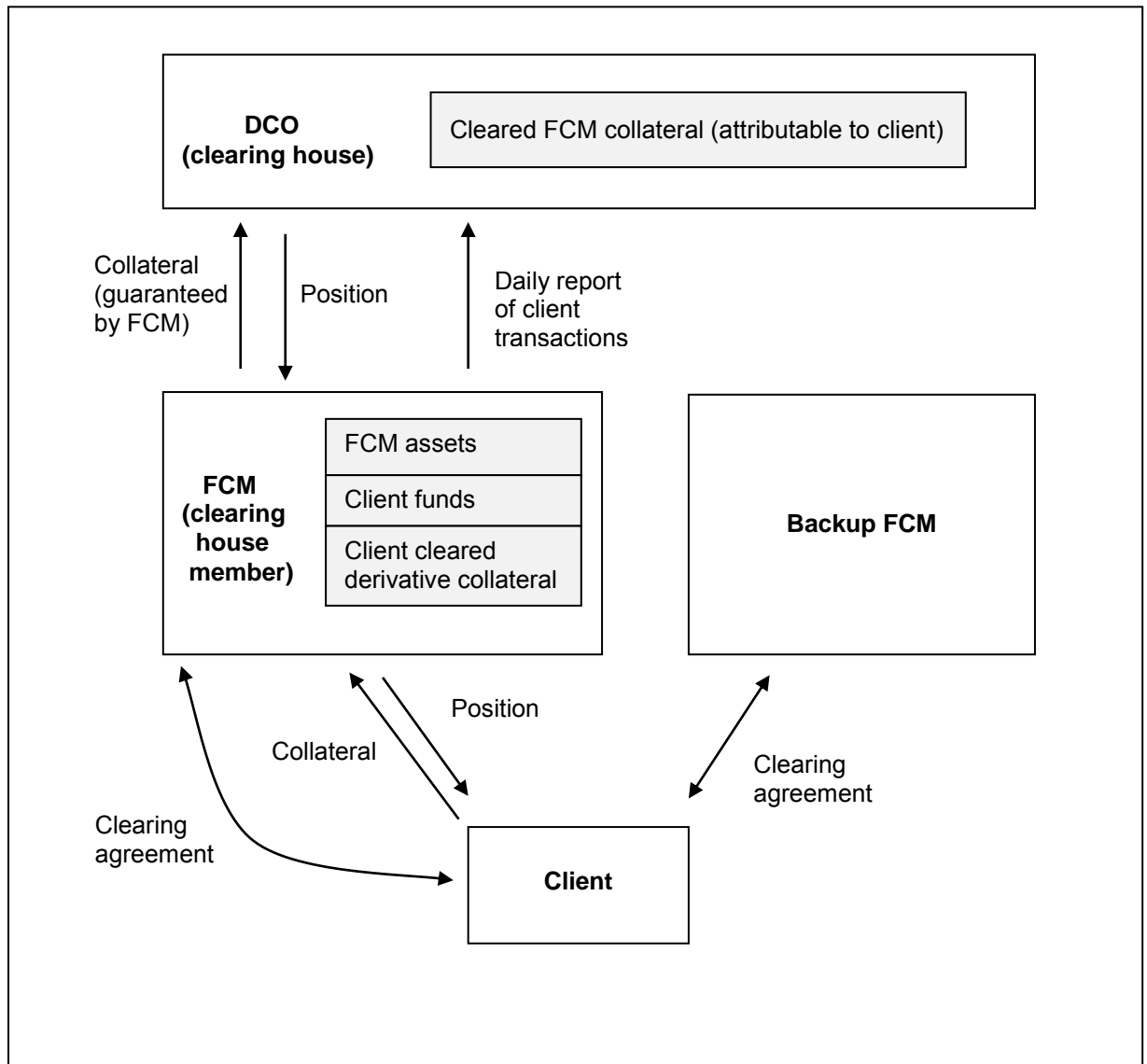
6 Conclusion

This memorandum has demonstrated that the agency clearing model (the FCM model) that has been implemented in the United States operates with the support of many layers of regulation and legislation and does not simply rely on common law principles of agency. This regulation and legislation is fundamental to the confidence which is placed in the FCM model and its effectiveness in protecting the client in the case of a clearing member default. Before mandating that an agency model is required in other jurisdictions, care must be taken to consider whether the requisite regulation and legislation is already present in that jurisdiction and, if not, the ease or difficulty in creating it. Without it, an agency model may not provide the legal certainty in regard to client protection that is needed.



³¹ 11 USC 7 § 362

Attachment: diagram of FCM model





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January 18, 2011

David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW.
Washington, DC 20581

Re: RIN No. 3038-AD99 - Advanced Notice of Proposed Rulemaking — Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies (75 Fed. Reg. 75162)

Dear Mr. Stawick:

The International Swaps and Derivatives Association, Inc. (“ISDA”) is writing in response to the Advanced Notice of Proposed Rulemaking regarding the Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies (the “ANPR”) issued by the Commodity Futures Trading Commission (the “Commission”), seeking comment on possible models for implementing certain provisions of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).

ISDA, which represents participants in the privately negotiated derivatives industry, is among the world’s largest global financial trade associations as measured by number of member firms. ISDA was chartered in 1985 and today has over 800 member institutions from 54 countries on six continents. Its 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.

ISDA respectfully submits the following responses regarding the ANPR. These responses focus on the Commission’s requests for estimates of industry-wide costs that would be required to implement the various models described in the ANPR. This letter first describes different types of costs implicated by the various models and a suggested methodology for estimating those costs, and then applies that methodology to the individual models to provide industry-wide cost estimates

for each model. It concludes with some observations relating to offering customers the option to choose between different models.

As a general matter, ISDA notes that the estimates provided below have been produced on an expedited basis, and could be substantially improved with further study, including (a) obtaining data (i) from market participants, derivatives clearing organizations (“DCOs”), futures commission merchants (“FCMs”) and other experts as more data on cleared swaps becomes available and (ii) for other types of swaps beyond just interest rates which were the only swaps included in the estimates below and (b) expanding the analysis beyond the “hard dollar” costs to investigate potential systemic costs if moral hazard is introduced by the new models proposed by the Commission. We therefore suggest that the description of the types of cost implied by each of the models described below and the identification of methodologies for measuring those costs are as important as the final estimates produced.

I. Types of Cost

The ANPR requests feedback on the incremental cost that would be incurred in adopting each of three possible models for regulation of the treatment of customers’ collateral posted in respect of cleared swaps, compared with the Baseline Model. The Baseline Model would be based on the regulations that currently apply to collateral posted for futures contracts, and would provide that the money, securities and other property collateralizing the obligations arising out of the cleared swaps positions of all cleared swaps customers of a FCM that is a member of a DCO are held at the DCO on an omnibus basis. The DCO would have recourse to all such collateral (including any collateral representing the value of collateral posted by that FCM’s non-defaulting customers) in the event of any failure of the FCM member to meet a margin call with respect to the FCM’s cleared swaps customer account at that DCO.

The three other models are (1) Full Physical Segregation (the “Individual Segregation Model”), (2) Legal Segregation With Commingling (the “LSOC Model”) and (3) Moving Customers to the Back of the Waterfall (the “Waterfall Model”). We will refer to these models collectively as the “New Models”.

- Under the Individual Segregation Model, each customer’s cleared swaps account, and all property collateralizing that account, is kept separately for and on behalf of that cleared swaps customer, at the FCM, at the DCO, and at each depository. As a result, if the FCM defaults, collateral posted by the defaulting FCM’s non-defaulting customers would not be available to the DCO as a DCO default resource.
- Under the LSOC Model, the collateral of all cleared swaps customers of a FCM member of a DCO is kept on an omnibus basis, but is attributed to each customer based on the collateral requirements, as set by the clearinghouse, attributable to each customer’s swaps. If the FCM defaults, the DCO must treat each customer’s swaps positions, and related margin (based on the positions reported as of the day previous to the default) individually. In particular, the DCO may not use the collateral attributable to the defaulting FCM’s non-defaulting customers as a DCO default resource.

- Under the Waterfall Model, as under the LSOC Model, the collateral of all cleared swaps customers of an FCM member of a DCO is kept on an omnibus basis. Unlike the LSOC Model and the Individual Segregation Model, if the FCM defaults, the DCO may use the remaining collateral attributable to each of the defaulting FCM's customers (including that FCM's non-defaulting customers) as a DCO default resource, but only if the DCO has first applied both (a) the DCO's contribution to its default resources from its own capital and (b) the guarantee fund contributions of all members of the DCO. It is not clear from the ANPR whether "the guarantee fund contributions of all members of the DCO" would include only the funded portion of such guarantee fund contributions, or also any unfunded portion, i.e. further contributions that the DCO's clearing members are liable to make to the guarantee fund pursuant to an assessment authority of the DCO. It has not been necessary for purposes of the cost estimates below to make any assumption on this question, but this point should be clarified to allow end users, clearing members and DCOs to assess the impact of the Waterfall Model on the risk each end user and clearing member bears to the risk of a default by a FCM's customer. If unfunded assessments are required to be completed, clarity should be provided on how multiple sequential customer defaults would be treated.

There are three main types of additional cost that would be implicated in moving from the Baseline Model to one of the three New Models:

- Operational and compliance costs;
- Collateral requirements (increased IM or guarantee fund contributions); and
- Any systemic costs that may be implied by a New Model (including any potential moral hazard). Such potential costs are not addressed in this letter and would be very hard to quantify, therefore requiring further detailed study.

Operational and Compliance Costs

Operational costs will increase to the extent that more operational activity is required to comply with a model's requirements. Operational activity includes establishing and maintaining cash and securities accounts, making transfers to and from cash accounts (including messaging and wire transfer costs) and securities accounts (including receive and deliver fees), performing reconciliations, regulatory reporting, calculating funding requirements for cash and securities and on-boarding and client service activities. These costs are incurred in different ways. Some are likely to be up-front fixed costs, such as costs involved in opening new accounts and internal and external development of technologies to support the new systems, including vendors' ability to make changes to the industry operating systems in a timely manner to support any required implementation of the revised customer protection rules. Others are ongoing costs that may vary with the number of customers clearing through the FCM, such as account maintenance, cash and securities transfer fees, reconciliations, regulatory reporting, calculation of funding requirements, on-boarding of clients and client service, as well as the personnel costs associated with supporting these activities.

It is important to note that, for these purposes, the “customer” of the FCM is the individual legal entity that is the counterparty to swap transactions cleared through the FCM. In particular, in the case of an asset manager that acts on behalf of multiple underlying funds, each individual underlying fund is a customer which will require the set-up and maintenance of increased operational capabilities.

Compliance costs will also increase to the extent requirements applicable to FCM’s become more stringent or complex. Compliance costs are principally ongoing costs incurred in hiring additional staff to oversee and ensure compliance by the FCM with the new requirements.

One aspect of the Waterfall Model that was unclear was whether FCMs would have to report to the DCO, on a daily basis, the portfolio of rights and obligations attributable to each cleared swaps customer and perform necessary related reconciliations. The description of the Waterfall Model states that it is similar to the LSOC Model with two modifications, neither of which relates to the information that would be provided by FCMs obligation in this daily report. Whether this information will be required to be reported under the Waterfall Model may depend upon whether the intent is that the collateral of the defaulting customer should be immediately available as a DCO default resource, with only the collateral of non-defaulting customers being moved to the back of the waterfall. As these reporting and related compliance activities constitute the main additional source of operational and compliance cost for the LSOC Model over the Baseline Model, ISDA believes that clarification of whether these activities are required would result in more accurate cost estimates for the Waterfall Model.

Collateral Requirements

As noted above, under the Individual Segregation Model and the LSOC Model, the collateral of a defaulted FCM’s non-defaulting customers will not be available to the DCO as a DCO default resource. Under the Waterfall Model, the collateral of a defaulted FCM’s non-defaulting customers will only be available to the DCO after the DCO has first applied its own capital and the guarantee fund contributions of its clearing members, which would take some period of time. This stands in contrast to the Baseline Model, in which the collateral of a defaulted FCM’s non-defaulting customers will immediately be available to the DCO as a DCO default resource. This has different implications for the different New Models.

Under the Individual Segregation Model and the LSOC Model, the DCO’s default resources will be diminished compared to the Baseline Model. In order for the DCO to maintain its default resources at levels that are risk-appropriate and reflect applicable regulatory requirements, the DCO will require additional IM and/or additional guarantee fund contributions from the FCM (which costs would likely be passed onto its customers).

Under the Waterfall Model, the total default resources available to the DCO will be the same, but a proportion of those resources (the collateral held in a defaulting FCM’s customer account) will only be available to the DCO after a delay. The DCO, acting prudently, would need to take account of that delay in determining how much IM customers would need to post, because during that delay, the value of the defaulted FCM’s swaps positions and the value of the collateral posted by the customers could change, exposing the DCO to risk of further loss. For cleared OTC derivatives today, IM is typically calculated by DCOs to cover potential price movements during a five day

period to allow the DCO to run through its default procedures (the time necessary will likely vary depending on the applicable asset class). Under the Waterfall Model, the DCO would not be able to access that IM until it had completed its default procedures on the guarantee fund. The amount of additional risk implied by this waiting period may depend on the risk reflected in the customers' portfolio. If the customers' transactions are directional and the asset class is relatively liquid, then the DCO may anticipate being able to hedge the risk in the customers' portfolio during the period in which the default procedures are run in respect of the DCO's guarantee fund. If the portfolio is not directional but is exposed to other risks such as volatility, or if the asset class is less liquid, then the DCO might not be able to hedge the risk in that portfolio during the period in which those default procedures are completed. In this latter case, assuming that the DCO would need an additional time to run through a more complex set of default procedures to incorporate the Waterfall Model, the number of days' risk to be covered by customers' IM would increase. This increased risk would require an increase in IM provided by customers and/or the guarantee fund when compared to the Baseline Model.

II. Methodology for Estimation of Industry-wide Incremental Costs

In order to calculate an estimation of the industry-wide incremental costs of each of the three New Models, ISDA requested submissions of cost estimation from individual member firms that are or anticipate being FCMs to clear swaps for their customers. These estimations were performed in respect of three different possible sets of costs: (a) operational and compliance costs, (b) increases in IMs and (c) increases in guarantee fund contributions. The methodologies used for these three estimations are set out below.

Operational and Compliance Costs Estimation Methodology

After identifying the different sources of additional operational and compliance costs set out under "Operational and Compliance Costs" in section I above, individual FCMs submitted their own estimations of the additional costs for that FCM that would be incurred in complying with the requirements of each New Model. These estimations were split into upfront and ongoing annual incremental costs.

As each FCM was making an estimation of incremental costs over the Baseline Model, each FCM was required to make certain assumptions about future activity, and ISDA recognized that different FCMs may make different assumptions depending on their assessment of the likely activity of their customers. However, in order to maximize the consistency of approach, ISDA proposed guidelines to be used by the FCMs in making their estimations. These guidelines were as follows:

- For one customer there would be a minimum of five accounts per currency in order to move cash and securities of such customer and subsequently the DCO for cleared swaps: (a) regular cash account (account into which customers pay monies at the FCM, a combination of variation margin and IM), (b) FCM settlement account (the FCM's representation of the client account sitting at the particular DCO), (c) investment account (client account at the FCM where excess funds are held for investment), (d) FED custody account (individual client account at the FCM for securities being held as either excess collateral or the pledged collateral for IM at the FED) and (e) DTC custody account (individual client account at the FCM for securities being held as either excess collateral or

the pledged collateral for IM at the DTC). For the Individual Segregation Model, five accounts per currency for each client will be required.

- On average, a customer will have requirements in two currencies.
- On average, a customer will clear through two different DCOs.
- There are 250 business days per year.

Under the Baseline Model there would be one payment made by the FCM to the DCO daily to cover the margin call for all the FCM's customers. In the Individual Segregation Model as it relates to the FCM and DCO relationship, as an example, assuming one FCM, two DCOs, one currency, and 1000 client accounts, a FCM would have to make 2000 wire transfers compared with the two wire transfers it would have to make under the Baseline Model. Under the Individual Segregation Model, it is easy to see how the number of wire transfers, accounts, and other activities would increase exponentially with multiple DCOs and currencies.

In conjunction with the wire transfers, there is the additional duty of reconciling the cash and security balances at each of these accounts for each client at each DCO against the equivalent at the FCM. The current CFTC regime requires regulatory balance reporting by noon EST daily for the existing omnibus accounts. The Individual Segregation Model would require confirmation and reporting of balances across the entire population of customer accounts as described above. The CFTC regulations require supervision of these activities by experienced and senior members of the FCM's organization, which therefore generally requires a senior individual to fulfill this role. Lastly FCM and DCO's infrastructure would need to be retooled in order to create the full segregation capability required by the Individual Segregation Model. The cost estimates set out for the Individual Segregation Model in section III below reflect these considerations.

As mentioned, the FCMs were free to modify these proposed guidelines if they felt that other assumptions were more appropriate and would more accurately reflect their customers' anticipated activity.

ISDA then calculated the average upfront and ongoing annual incremental costs for an individual FCM for each model.

Increases in IMs

The methodology used to estimate the industry-wide increase in IMs for the Individual Segregation Model and the LSOC Model adhered to the following steps: first, data from the interest rate OTC derivatives market was used to identify the current gross notional amount of customer transactions. Second, individual FCMs determined the gross notional of their own customer-facing transactions (the "FCM Customer Gross Notional"), and the gross notional of those transactions that are likely to be cleared, taking into account those customers whose activities are likely to be exempt from clearing (the "FCM Customer Cleared Gross Notional"), expressed as a percentage of the FCM Customer Gross Notional (the "FCM Customer Cleared Percentage"). Next, the required IM using the 99% confidence level was calculated by individual FCMs for the FCM Customer Cleared Gross Notional, expressed as a percentage of the FCM Customer Cleared Gross Notional (the "FCM Customer IM Percentage"). The FCM Customer IM Percentage was then recalculated using the

99.9% confidence level¹, and the increase in the FCM Customer IM Percentage between the 99% and the 99.9% confidence levels was expressed as a percentage increase (the “FCM Customer IM Percentage Increase”). Finally, the FCM Customer Cleared Percentage, FCM Customer IM Percentage at the 99% confidence level and the FCM Customer IM Percentage Increase were reported by the participating FCMs to ISDA.

From the submissions received, ISDA took a simple average of the FCM Customer Cleared Percentages and FCM Customer IM Percentage Increases reported, and applied them to the gross notional reported for all customer interest rate OTC derivatives transactions to produce an estimation of industry-wide increases in IM that would be required for the three New Models.

To estimate the industry-wide increase in IMs for the Waterfall Model, ISDA used the same figures for current gross notional amount of customer interest rate transactions, average FCM Customer Cleared Percentage, and average FCM Customer IM Percentage to determine the current anticipated IM required for interest rate swaps. To avoid overstating the increase in the IM required, and reflecting the uncertainty around how DCOs will assess the risk of delay in accessing customer collateral as a default resource, the increase in IM for the Waterfall Model was estimated at 45%.

Further details and observations on this process are set forth below.

ISDA believes that in order to estimate increases in IMs that would result from any of the three New Models, it is necessary first to estimate the likely gross notional amount of customer cleared transactions, because the IMs posted by clearing members for their house positions will continue to be a DCO default resource under any of the three New Models, as is currently the case for the Baseline Model. As a proxy for this trade population, ISDA used data from the Interest Rate Trade Repository Report published by TriOptima as of close of business on November 19, 2010², specifically the USD equivalent of the gross notional amount of interest rate OTC derivatives transactions with Non-G14 Dealer counterparties reported to TriOptima³. To ensure consistency, FCMs were asked to determine their individual FCM Customer Gross Notional figures using data reported to them by TriOptima as of the same date. The TriOptima figures for transactions with Non-G14 Dealer counterparties are considered to be a reasonable proxy for industry-wide interest rate OTC derivatives transactions with customers, given the level of participation in TriOptima’s Interest Rate Trade Repository Reports and the firms included in the G14 Dealers. The data used was limited to the interest rate asset class because the gross notional amount of interest rate OTC derivatives is by far the largest component of gross notional amount in the OTC derivatives market⁴, and because including other asset classes would introduce further complexity that likely could not properly be taken into account in the time available. ISDA stresses that because this excludes other asset classes, it will likely have resulted in an understatement of each FCM Customer IM Percentage and FCM Customer IM Percentage Increase and will therefore produce an understated estimate of industry-wide IM increase required.

¹ The ANPR makes reference to “99.99%”, but ISDA believes the number actually referred to was “99.9%”.

² Available at <http://www.trioptima.com/repository.html>

³ The total gross notional figure transactions with Non-G14 Dealer counterparties was USD 163,315 BN.

⁴ According to the Bank for International Settlements (“BIS”), at the end of 2009 the total notional amount of all derivatives outstanding was USD 614,674 BN, while the total notional of interest rate derivatives was USD 449,793 BN, or 73%.

The actual IM that is required to be posted by a clearing customer to a DCO will depend on the portfolio of derivatives that customer has facing that DCO, which of course varies by customer. In calculating the FCM Customer IM Percentage, FCMs were therefore asked to calculate, for transactions that are likely to be cleared, the current IM requirements for each customer individually at the 99% confidence level, and to aggregate those to produce the FCM Customer IM Percentage. Importantly, this calculation reflects an embedded assumption that each customer will clear through only one DCO, which maximizes the benefits of portfolio margining and therefore, as with the exclusion of other asset classes, potentially understates the FCM Customer IM Percentages and FCM Customer IM Percentage Increases.

In practice, not all interest rate swap transactions will be cleared, either because the underlying product is not cleared by any DCO, or because clearing of the particular interest rate product is not mandatory and not cleared or because the customer is relying on an exemption from the clearing requirement. That is why FCMs were asked to estimate the FCM Customer Cleared Percentage, to avoid potential overstatement of the FCM Customer IM Percentages and FCM Customer IM Percentage Increases.

For the Individual Segregation Model and the LSOC Model, following suggestions made at the Commission's Staff Roundtable on Individual Customer Collateral Protection (the "Roundtable") and reported in the ANPR, DCOs will require IMs to be calculated at the 99.9% confidence level, instead of the 99% level, if the collateral of non-defaulting customers is not available as a DCO default resource. ISDA's estimates use the same methodology, which is why each FCM Customer IM Percentage Increase was calculated as the change resulting from moving from the 99% confidence level to the 99.9% confidence level⁵.

For the Waterfall Model, substantial further study would be required to develop a margin methodology that recognized that some risk factors could be managed within a five day period and others, within ten days, and then to determine from a representative sample of client portfolios what the average or industry-wide effect would be given those factors. If the period of risk to be covered by IM were increased from five to ten days, then the required increase in IM was preliminarily estimated at 75% based on the interest rates asset class. However, to reflect the questions raised over whether such risks could be hedged during the default procedure period in respect of the guarantee fund, this was reduced to 45%. More precise estimates could be generated with further study, as recommended herein.

Increases in Guarantee Fund Contributions

The methodology used to estimate the industry-wide increase in guarantee fund contributions for the Individual Segregation Model and the LSOC Model was as follows: a ratio of total IM to total gross notional for OTC interest rate derivatives transactions was calculated by two FCMs by deriving a theoretical IM for each counterparty of that FCM (excluding cleared transactions and intra-group transactions, but not limited just to customer counterparties) at the 99% confidence level, assuming that all such transactions are cleared with the same DCO.

⁵ As noted above, the ANPR reports that a DCO estimated at the Roundtable that "it might need to increase collateral from a 99% confidence level to a 99.99% confidence level", but ISDA believes the increase described was in fact to a 99.9% confidence level. An increase to the 99.99% confidence level would imply a 200% increase in collateral required.

The percentage of transactions in the interest rates asset class that will be cleared was then estimated. In contrast with the FCM Customer Cleared Percentages estimated for the IM increases explained above, this estimate was based on all transactions, not just transactions with customers, since any increases to the required guarantee fund of a DCO will apply to FCM “house” as well as FCM customer positions.

The ratio of IM to total gross notional and the percentage of transactions that will be cleared were then applied to the outstanding gross notional amounts for the interest rate asset class obtained from the BIS report as of December 2009⁶ to estimate the industry-wide IM requirements for that asset class.

The IM requirement calculated for the interest rates asset class was then used to determine the guarantee fund that ISDA believes will be required by DCOs as a percentage of the total IM based on current market practice for clearing interest rate swaps. For this purpose, it was assumed that the largest two clearing members will account for 12.5% of the cleared notional each (25% together), and that the IM required at the 99.9% confidence level is 60% more than that required at the 99% confidence level. In futures, at the CME, ISDA understands that the two largest FCMs currently account for approximately 30% of the IM together, so the 25% assumption here is conservative. The 60% increase was estimated by fitting a fat-tailed distribution to interest rate OTC derivatives transactions.⁷ Based on information provided by DCOs, the guarantee fund would be required to approximately double⁸ if the collateral of a non-defaulting customer is not available as a DCO default resource, i.e. under the Individual Segregation Model and the LSOC Model. ISDA used this to estimate the increase in guarantee fund requirements that would be required.

ISDA did not estimate an increase in required guarantee fund contributions for the Waterfall Model, because the calculation would require more understanding of the make-up of OTC Cleared client omnibus accounts in terms of size distribution and diversity of client risk at the typical OTC clearing FCM.

III. Cost Estimate Results

The incremental additional costs on an industry-wide level for each of the three New Models over the Baseline Model obtained using the methodologies described above are presented below, followed by some observations on the results. For each New Model, the additional upfront and annual operational and compliance costs are presented, followed by the additional IM requirements and the additional guarantee fund requirements. ISDA does not express a view as to what might be an optimal balance between IM and guarantee fund requirements for each New Model, and so, with the exception of the Waterfall Model, the incremental IM requirement and the incremental guarantee fund requirements are presented as alternates. The incremental cost of a particular New Model over the Baseline Model is therefore the upfront and ongoing additional operational and compliance costs of that New Model plus either the additional IM requirement or the additional guarantee fund contribution requirement for that New Model.

⁶ BIS, OTC derivatives market activity in the second half of 2009, available at www.bis.org.

⁷ As a comparison, for futures, which are much more normally distributed (once the stochastic volatility component is removed by de-volatizing) the corresponding number is 33%.

⁸ See for example comments made by Ms. Taylor at the Commission’s Staff Roundtable on Individual Customer Collateral Protection at page 124 of the transcript:

http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission6_102210-transcrip.pdf

The results are summarized in the table below as additional costs over the Baseline Model:

	Individual Segregation Model	LSOC Model	Waterfall Model
Average upfront operational and compliance cost per FCM: ⁹	\$33.2 million	\$1.0 million	\$0.8 million
Average ongoing annual operational and compliance cost per FCM: ¹⁰	\$136.3 million	\$16.2 million	\$16.1 million
Industry-wide additional IM required: ¹¹	\$581 billion	\$581 billion	\$375 billion
Industry-wide additional guarantee fund contributions required: ¹²	\$128 billion	\$128 billion	N/A ¹³

Observations on Results

As noted above, the FCMs were required to make a number of assumptions about future activity, and given the time available for comment on the ANPR, it was not possible to develop stricter assumptions that could be applied across FCMs. In addition, the manner in which the cost information requested is accounted for in different FCMs may vary widely, presenting challenges in arriving at a consistent set of assumptions and categories for the various costs involved. These estimates could be substantially improved by a more detailed study of these issues than was possible in the time allowed for this letter. Thus, given the high potential costs shown in these estimates, ISDA strongly encourages the Commission to undertake a full and thorough study with input from a broad set of market participants to develop the most accurate assessment possible of the costs to the industry of implementing any of the three New Models and to delay issuance of proposed or final rules until such a study can be completed.¹⁴ Increased expense may make a

⁹ ISDA received submissions on upfront costs from 5 FCMs.

¹⁰ ISDA received submissions on ongoing annual costs from 6 FCMs.

¹¹ ISDA received submissions from 4 FCMs.

¹² It is important to note that the guarantee fund increase figure reported here reflects only the funded portion of the guarantee fund. It is likely that clearing members' liability to contribute to the unfunded portion of a DCO's guarantee fund would also be increased.

¹³ A figure for guarantee fund contribution increase has not been included for the Waterfall Model, as the calculation would require more understanding of the make-up of OTC Cleared client omnibus accounts in terms of size distribution and diversity of client risk at the typical OTC clearing FCM.

¹⁴ Potential assumptions about future states that would need to be made to estimate costs more accurately would include: balance sheet treatment of unmatured cleared and non cleared trades to each counterparty in the chain of trading; determination of counterparty population (if any) that will be exempt from mandatory clearing; behavior of end users in light of clearing fees and cost / benefit amongst available investment options; number of FCMs, size of those FCMs, and market share of each; determination of population of which cleared and uncleared trades and at what time (assuming a phased evolution toward clearing); the individual risk methodology of each DCO as well as rules which define membership criteria; number of CCPs centrally clearing in any given market; risk management factors in FCM and

number of investment strategies unworkable, reducing liquidity and further driving up costs for all market participants.

The ongoing annual operational and compliance costs for the Individual Segregation Model are significantly higher than for the other two New Models. This is driven in part by the volume of accounts that would need to be maintained for each customer, and the large number of customers. In particular, it should be noted that as the value of each customer's cleared swaps portfolio will likely change each day, a payment of variation margin will need to be made for each customer each day for each currency and for each DCO with which that customer clears. This stands in stark contrast to the position under the Baseline Model, the LSOC Model and the Waterfall Model, in which each FCM need make only one payment each day per currency to each DCO, representing the net variation margin required to be paid by that FCM across all of its customer cleared swap portfolios. Similarly, where IM is in the form of securities, a separate securities settlement will need to take place for each customer each time that customer's IM requirement changes, whereas under the other models, only the net change in IM across all the FCM's customers with the relevant CCP need be transferred. In addition, under the Individual Segregation Model, the actual security provided as IM by the customer will need to be transferred to the DCO, further reducing the netting benefit that can be obtained under the Baseline Model by converting IM provided by the customer into other eligible investments. The result of this very large increase in the number of payments and securities settlements is a very large increase in annual wire and securities settlement fees. If the FCM is required to post specific securities provided by its client, it would also need to consider the impact of substituting the client's securities for any pre-funded amounts provided by the FCM, i.e. the FCM would need initially to post collateral on behalf of the customer, then subsequently post the specific securities provided by the customer and receive back the pre-funded amount.

Although the ANPR is not explicit on this point, ISDA interprets the Individual Segregation Model as described in the ANPR to require that, if requested by the customer, the specific assets posted by a customer as collateral must be transferred to the DCO or a depository, provided that the assets posted by the customer are eligible to be posted as collateral to the DCO, i.e. those assets cannot be converted into other investments permitted by Commission Regulation 1.25. This interpretation is reflected in the estimates set out above. ISDA has based this interpretation on a negative inference, as in its description of the Individual Segregation Model, the ANPR does not state that customers bear the risk of loss on the value of collateral subject to the investment restrictions of Commission Regulation 1.25 (unlike the descriptions of the LSOC Model, the Waterfall Model and the Baseline Model). ISDA welcomes additional clarification from the Commission on this issue.

It should be further noted that the estimates above only reflect the costs at the FCM level. To the extent that multiple accounts must be maintained by FCMs to segregate individual customers' collateral, the same number of accounts would need to be reflected at the DCO level. These estimates also do not take account of costs that DCOs would incur as a result of the increased number of accounts to be maintained.

For each of the three New Models, there is an increase in operational and compliance costs compared to the Baseline Model. In addition to the costs noted above for the Individual

concentration and quality of clients at the FCM; the DCO's allocation between guarantee fund contributions and IM required; the allocation between the funded and unfunded portions of the guarantee fund at each DCO; and natural market evolution of where (asset class, tenor, global jurisdiction) investment managers determine the opportunities lie (i.e. portfolio construction).

Segregation Model, the increased costs under all three New Models are driven by the need to provide for additional staffing to comply with the information monitoring and reporting requirements that the three New Models imply. As noted above, the ANPR did not explicitly set out the operational and compliance obligations under the Waterfall Model. ISDA believes the small discrepancy between the numbers reported above between the LSOC Model and the Waterfall Model may represent different interpretations of that requirement. ISDA believes that if no additional reporting activities are required under the Waterfall Model compared with the Baseline Model, that there would not in fact be a significant increase in operational and compliance cost compared with the Baseline Model.

The additional IM and guarantee fund contributions required by the Individual Segregation Model and the LSOC Model are the same. This is because, as noted above, the risk impact of these two New Models on the DCO is the same. The additional IM required by the Waterfall Model would be roughly similar.

The interest rates asset class, while a very high percentage of derivatives, does not encompass all asset classes that likely will be cleared. The estimates of IM increase over the Baseline Model, reflecting only interest rate data, are therefore lower than they would have been had time and data been available to expand the analysis to other asset classes.

The results of the estimations used to calculate the additional IM required by each of the three New Models are set out below:

Additional IM required (compared with the Baseline Model):

	Individual Segregation and LSOC Models	Waterfall Model
Gross notional amount of transactions with Non-G14 Dealer counterparties:	\$163,315 billion	\$163,315 billion
Average of FCM Customer IM Percentages at 99% confidence level:	0.63%	0.63%
Average of FCM Customer Cleared Percentages:	81.00%	81.00%
Estimated industry-wide total IM required for customer cleared transactions at 99% confidence level:	\$833 billion	\$833 billion
Percentage increase in IM ¹⁵ :	69.75%	45.00%
Estimated industry-wide total increase in IM for customer cleared transactions:	\$581 billion	\$375 billion

¹⁵ Please see Section II above under “Increases in IMs” for details on how these percentages were estimated.

The estimates used to determine the additional guarantee fund contributions required (compared with the Baseline Model) for the Individual Segregation Model and the LSOC Model based on the interest rates asset class are as follows:

Gross notional amount of transactions (all counterparties):	\$449,793 billion
Clearable percentage:	90%
Ratio of IM to gross notional:	0.21%
IM requirement:	\$850 billion
Guarantee fund contribution as percentage of IM:	15%
Guarantee fund contribution:	\$128 billion

IV. Optional Models

As will be clear from the above, each New Model implies significant additional cost over the Baseline Model. The ANPR suggests the possibility of customers being offered a choice between different models.

If optionality is offered, certain costs could be incurred by FCMs and DCOs in providing any New Model. To give market participants appropriate incentives, the implementation of any requirement on FCMs or DCOs to offer optionality should be carefully considered so that those customers who do not select the option of increased collateral protection do not directly or indirectly bear the cost of offering that protection to other customers. One way in which this might occur is if highly credit worthy customers choose the more expensive, higher protection, option, so that the fellow customer risk is borne by the more risky customers, thereby reducing the effectiveness of the pooling from the point of view of the DCO, who must now also raise IM for those bearing fellow customer risk. This increase in IM not only results in an increased funding cost for those clients that did not need or want increased protection, but also increases the amount of collateral that those customers have at risk of loss mutualization.

* * *

ISDA appreciates the opportunity to provide comments on the Proposed Regulation and looks forward to working with the Commission as you continue the rulemaking process. Please feel free to contact me or my staff at your convenience.

Sincerely,



Robert Pickel
Executive Vice Chairman