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December 22, 2010

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

Re: RIN 3038-AD00 - Notice of Proposed Rulemaking: Process for Review of Swaps for Mandatory Clearing (75 Fed. Reg. 67277)

Dear Mr. Stawick:

This letter contains the response of the International Swaps and Derivatives Association, Inc. ("**ISDA**") to the Commodity Futures Trading Commission's (the "**Commission**") notice of proposed rulemaking ("**NPR**") regarding the process for the review of swaps for mandatory clearing, as required by Section 745 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank Act**").

ISDA is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 830 member institutions from 57 countries on six continents. These members include most of the world's 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 ("**OTC**") derivatives to manage efficiently the financial market 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.

At the outset, we wish to be clear that ISDA supports clearing for a wide range of liquid standardized[1] derivatives and wishes to work with the Commission to implement the mandatory clearing[2] of OTC derivatives required under the Dodd-Frank Act in a way which will enhance market liquidity and financial stability.

ISDA commends the Commission for its careful consideration in the NPR of the issues raised by the mandatory clearing provisions of the Dodd-Frank Act. ISDA has a number of comments on this important rule proposal and welcomes this opportunity to share these with the Commission. ISDA looks forward to assisting the Commission and its staff in implementing an appropriate framework for mandatory clearing, consistent with the standards set forth in the Dodd-Frank Act, with a view to enhancing market liquidity, reducing risk and fostering financial stability.

Background

The Dodd-Frank Act amended the Commodity Exchange Act ("**CEA**") to require the Commission to adopt rules for determining whether a swap, or group, category, type or class of swaps (collectively, "**swaps**") should be required to be cleared and to prescribe criteria, conditions, or rules under which the Commission will determine the initial and ongoing eligibility of a derivatives clearing organization ("**DCO**") to clear swaps.

Accordingly, this letter contains two parts. The first covers ISDA's comments in relation to the proposed rules governing the Commission's review of swaps in order to determine whether to impose a mandatory clearing requirement (whether the reviews are Commission-initiated or arise from a DCO submission or deemed submission). The second covers the rules for the review of initial and ongoing eligibility[3] of DCOs to clear swaps.

1. The Commission's review of swaps to determine whether to impose a mandatory clearing requirement

The Commission review contemplated by these provisions is, of course, extremely consequential. If the relevant clearing solution fails to establish an operationally sound and robust risk management framework, or captures an inappropriate category of swaps, the consequences for the DCO and for the market could be significant.

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[1] For the avoidance of doubt, we use "standardized" here in the sense detailed on page 4 of this letter. We do not consider that the degree of standardization necessary for exchange trading is necessary for clearing.

[2] We recognize that the NPR contemplates that the determination of whether a DCO is eligible to clear a swap is related to, but separate from, a determination as to whether such swap is subject to a mandatory clearing requirement. Our letter focuses primarily on the mandatory clearing requirement.

[3] We note that, understandably, the NPR focuses on determinations relating to the initiation of clearing (or mandatory clearing). We respectfully recommend that the Commission also address the rules and processes under which a DCO ceases to meet the relevant standards for clearing, or under which mandatory clearing is no longer appropriate. ISDA would be pleased to make representatives available to Commission staff to discuss appropriate measures for addressing scenarios such as these.

An ineffective DCO risk management framework could have systemic implications and could deter market participants from transacting in the relevant swap(s). The inappropriate imposition of mandatory clearing requirements could also adversely affect liquidity in the relevant swap(s) and similarly deter use of otherwise optimal risk management products. While sound, centralized clearing affords clear benefits, it should be noted that centralized clearing also entails increased operational and collateral costs. As a result, it is important that the Commission strike an appropriate balance in evaluating the relevant statutory standards applicable to a mandatory clearing determination, and weigh the relevant factors and market impacts with great care.

Definitional Considerations

The Dodd-Frank Act and proposed Commission rules refer variously to "swaps", "categories" of swaps, "classes" of swaps, "types" of swaps and "groups" of swaps. The meaning and scope of each of these references is critical to understanding the scope of a Commission determination that mandatory clearing applies (i.e., precisely which swaps are affected). It is equally critical to a complete and accurate evaluation of the statutory factors that are to be considered in connection with a mandatory clearing determination. This is reflected in the statutory factors requiring the Commission to consider: the availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded.

It is important that the determination that a product is 'clearable' includes the requirement that the terms and conditions of such clearing, and the terms and conditions of the cleared swap after novation to the DCO do not involve the introduction of terms or conditions that cause the cleared product to differ in material respects from the product that is commonly traded in the market. Otherwise the imposition of a mandatory clearing requirement will, among other consequences, introduce basis risk for clearing members. In addition, the attributes (including liquidity and current and historical price) of the cleared products may differ substantially from the traded product in ways that will also contribute to increased risk and adversely impact market liquidity.

As a corollary, when a swap, type, class, group or category of swap is identified as subject to a mandatory clearing requirement, the scope of that requirement must be defined by reference to the specific material terms that govern the clearing, and the terms and conditions, of the relevant swap(s) following novation to the DCO.

Accordingly, the Commission's definition of products subject to the mandatory clearing requirement must be as clear and specific as possible. By way of example, in the context of rate swaps, the product definition should include at least the following characteristics (to the extent applicable):

(i) instrument description (for example, vanilla interest rate swaps with constant notional principal);
(ii) acceptable currencies (and whether the contract is single currency);
(iii) acceptable indices;
(iv) types (for example, fixed vs. floating or floating vs. floating);
(v) maximum residual term;
(vi) notional amount (minimum to maximum of the relevant currency unit);
(vii) applicable day count fraction (for example, Actual/365 or Actual/Actual);
(viii) applicable business day convention;
(ix) minimum residual term of the trade (i.e., the period from the date of submission of the trade to the date of termination); and
(x) applicable calculation periods (for example, "stub periods").

For CDS, the reference entity and transaction type (including whether senior/subordinated, coupon, and the credit events covered would also be required).

This precision of definition is necessary because instrument liquidity can vary dramatically with tenors or if other changes are made to the contractual terms (even if these changes appear small). Thus in order to guarantee that only those instruments of sufficient liquidity to ensure DCO robustness are within the scope of mandatory clearing, the Commission should draw that scope precisely. To that end, key terms such as "category," "group," "class" or "type" of swap need further definition.

It should also be noted that the cost for DCOs and swap counterparties is increased where higher levels of uncertainty in relation to the applicability and risk of a clearing obligation exist. This would suggest an early and narrow definition of the mandatory clearing requirement and a reasonable transition period to allow market participants to comply with the new clearing requirements is appropriate. A further transition period between the implementation of the mandatory clearing requirement and the application of any swap execution facility/trading requirements is also suggested.

The Five Factors of the Dodd-Frank Act

We welcome the Commission's acknowledgement in its proposed rule that the following five factors outlined in Section 723 of the Dodd-Frank Act[4] should be the basis for the Commission's determination:

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

Some types of swaps (for example CDS contracts in standard tenors and coupons referencing the on-the-run major traded indices) have a ready market of buyers and sellers, as evidenced

[4] See Section 2(h)(2)(D)(ii) of the Commodity Exchange Act, 7 U.S.C 2(h)(2)(D)(ii).

by bids and offers that change throughout a trading day. By contrast, more complex products are frequently tailored to a counterparty's risk management needs and thus may be less liquid. A good example here would be a CDS on a bespoke portfolio of credits: it may be difficult to obtain daily market prices for this product. Further, the tailored nature of products like these means that reliable pricing data may not be available, and this can lead to significant model and parameter risks in a models-based valuation.

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

Liquidity is also an important consideration in applying the mandatory clearing requirement because of the statutory linkage between mandatory clearing and mandatory trade execution on designated contract markets and swap execution facilities. Clearly the levels of liquidity necessary to impose such a mandatory trade execution requirement are, of necessity, greater than the levels necessary for clearing.

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

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

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

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

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

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

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

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

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

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

Here regulation has an important role in correcting the effect whereby low margin and guaranty fund levels may win a DCO business in the short term at the expense of wider financial stability. Lower margin and guaranty fund requirements should only be allowed where the Commission is confident that a DCO possesses sufficient alternative resources to support itself to a robust standard and where such a reduction does not materially increase systemic risk.

Finally, prudence would suggest that the Commission take into account competitive implications of the timing of imposing a mandatory clearing requirement in the light of the manner in which the distribution of open interest significantly constrains effective competition between DCOs.

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

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

As a related point, it is imperative that a comprehensive structure to address possible clearing market stress which might, if not mitigated, lead to clearing member or DCO insolvency is promulgated by the Commission in consultation with other stake holders. There are a number of requirements here:

(i) a general supervisory framework for DCO resolution. This framework, in conjunction with the rules of the relevant DCOs, is a critical requirement as market clarity is required on their resolution/bankruptcy regime;

(ii) for each DCO, a specific plan to address possible future stress. Such a plan might include consideration of whether an alternative DCO is able to clear a particular product prior to a determination of a mandatory clearing obligation for that product. This is important given that a DCO may be the principal venue for clearing a product and, in the absence of adequate continuity planning, DCO stress might preclude the functioning of the market for that product;

(iii) as a related comment, we would request greater clarity from the Commission on the application of Part 190 of the CFTC regulations[5], which along with subchapter IV of chapter 7 of the U.S. Bankruptcy Code, establishes a framework for the orderly and timely liquidation of an insolvent Clearing Member ("**CM**");

(iv) finally, it is important to note that both CM insolvency and DCO stress resolution have potential cross border aspects so clarity is also required on these matters.

The five criteria of the Act, if taken together and conservatively applied, make it highly likely that a DCO will be able to value, call for margin on, and risk manage all cleared products. Therefore, we encourage the Commission to interpret these criteria strictly, and only to mandate clearing for a particular product where they are clearly met at the time of the relevant application, and are highly likely to continue to be met in the future, including during future stressed periods. Such an approach will ensure adequate clarity and decrease the risk of inconsistent impositions of the clearing obligation. The Dodd-Frank Act provides the Commission with ample discretion and thus allows it to carry out its responsibilities in an efficient and prudent manner without the need to interpret these criteria loosely.

Given the importance of these criteria, we would welcome clarification from the Commission that these criteria will form the basis of both Commission-initiated reviews and of those undertaken as a result of a DCO submission or deemed submission.

We now go on to note some further issues relating to the Commission's review.

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[5] The Commission is given the authority to prescribe these rules under Section 724 of the Dodd-Frank Act.

Mandatory clearing exemptions and stays

ISDA believes certain transactions, otherwise eligible for clearing, should not be subject to mandatory clearing. We encourage the Commission to document the scope of these exceptions so that firms have clarity on when they apply.

Counterparty risk reducing trades: The most obvious and prevalent concern involves trades where the derivative eligible for clearing would reduce counterparty risk if executed on a bilateral basis. Such trades often involve cases where the clearable trades ("**A Trades**") are hedges to unclearable trades ("**B Trades**"), and both trades are with the same counterparty. More specifically, we consider there to be two types of possible exceptions for A Trades:

(i) where the B Trades are likely to be clearable in the future
(ii) where the B Trades are unlikely to be clearable in the future.

The first type of exception would be necessary until the B Trades become clearable. For the second type of exception central clearing is never appropriate so the exception would last to the maturity of the trade.

More generally if clearing a clearable trade results in a material increase in counterparty risk, then this trade should be eligible for an exemption to mandatory clearing. This will often happen when a clearable trade hedges or partially offsets a particular non-clearable trade as discussed above, but there may be other instances of this phenomenon.

For instance, swap dealers manage their counterparty risk to each other, and to other counterparties, in part using active portfolio management techniques. Thus, if one or more unclearable trades exist between two parties, it may be decided to enter into a transaction which would reduce counterparty risk. This portfolio-risk-reducing trade may be clearable. However, requiring it to be cleared would evidently be counterproductive as it only reduces risk if executed on a bilateral basis. Therefore, mandatory clearing of such trades would deprive dealers of a valuable risk mitigation tool and would be contrary to the fundamental risk-reducing purpose of the Dodd-Frank Act.

Affiliate (intra-group) transactions: Another situation where an exemption for eligible trades to mandatory clearing may be appropriate concerns intra-group transactions. Transactions between affiliates allow entities within a corporate group to manage their overall risk more efficiently. Here central clearing would simply introduce further intra-group transactions (since it is likely that neither of the counterparties is the group CM) and thus forcing mandatory clearing in this situation would likely have no benefit in risk reduction, nor in decreasing the number of intra-groups trades. Moreover the associated initial margin requirements would result in an unnecessary consumption of group liquidity. Thus, we recommend an exemption from mandatory clearing requirements for all intra-group transactions.

Stay of clearing requirement: Section 723 of the Dodd-Frank Act provides the Commission the authority to stay the mandatory clearing requirement. We consider this to be an important provision as there are many circumstances under which the Commission should exercise this authority, some of which are discussed above. Further examples involve circumstances in which there is an absence of competition, or where there is an unresolved clearing member default at the only DCO then clearing the relevant product. Yet another, but important, example exists in circumstances where the Commission determines to impose a mandatory clearing requirement in a situation where a DCO has not elected to clear the product. As noted above, there are systemic risk implications where DCOs are allowed to clear products which they have not positively chosen to clear.

Finally, if a product subject to mandatory clearing becomes so illiquid as to threaten the DCO's ability to calculate margin or to manage a default, then a stay of the clearing requirement for that product may be necessary.

Additional Considerations

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

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

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

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

Wrong way risk: The Commission's determination in relation to the Swap Review and the DCO Eligibility Review must be sensitive to "wrong way risk", namely the risk that different risk factors be correlated in the most harmful direction.

Further and more specifically, clearing CDS whose reference name is either a CM or is highly correlated to the performance of a CM (for example, that of the sovereign in which the CM is incorporated) introduces a potentially systemic form of wrong way risk. We would urge the Commission to require DCOs to develop the appropriate risk management framework before any such systemically wrong way positions are mandated to be cleared.

Implementation timing: ISDA considers that two transitions periods, one from when a determination is made that a swap is subject to a "mandatory clearing requirement" to when such "mandatory clearing requirement" takes effect, the other from when a determination is made that a swap is subject to an "exchange or swap execution facility trading" requirement to when such requirement takes effect, are necessary to sensibly reflect the work required and risks involved in moving a product to central clearing and to trading venues. From a practical perspective, market participants will need sufficient time to conduct due diligence on any new DCOs/trading venues and put in place the necessary operational systems, processes and legal documentation in order to connect to such DCOs/trading venues. Accordingly, we recommend that the Commission consider an extended period between a determination being made that a swap is required to be cleared and clearing becoming mandatory on that product. This period would provide market participants the opportunity to make themselves appropriately ready to clear mandated transactions without risking either (i) disruption to their use of derivatives for hedging or (ii) noncompliance with the law. Similarly, we recommend a second transition period from when the "exchange/swap execution facility trading" requirement is determined to when such requirement takes effect in order to ensure that a stable and competitive market has time to develop. Further, ISDA would recommend full transparency of DCO requirements and performance during any such period(s). This will provide important notice and information for affected parties on what the relevant margin and guaranty fund calculations will be, what pricing requirements will be set by the DCO, how default management will operate, and to connect the relevant platforms and systems.

In addition and more specifically, the NPR states that the public review period will be 30 days and the total review time is 90 days. First, we suggest that the Commission extend the public review period to 45 days. Second, this public review period should only commence after:

(i) the DCO has proven the ability to clear the product through testing;
(ii) the DCO has sufficient operational resources and established connectivity to the market using standard protocols;

(iii) all market standardization issues defining the product, life events, etc. have been resolved;
(iv) pricing standards and margin calculations have been agreed by the DCO's risk committee; and
(v) the Commission has all the information it needs and (in respect of a DCO submission) this information has been verified as consistent with data from swap data repositories, swap dealers and major swap participants.

This process would address the risk that much of the information in the submission on which the Commission bases its determination of whether a swap is required to be cleared is provided by the DCO and the DCO has an economic interest in the particular swap being subject to mandatory clearing.

Rule 39.5(b) clarification: We wish to confirm that the Commission intends that a DCO Eligibility Review is to be separate from and precede a Swap Review and it is not intended that both reviews can commence simultaneously. As noted, the time for reviews is short and thus a specific focus and timeframe for each review is sensible.

Rule 39.5(c) clarification: We seek clarification that the authority granted to the Commission under Rule 39.5(c)(3)(iii), "Commission-Initiated Reviews", is restricted to requiring the retention of adequate margin or capital only for swap transactions that are not otherwise exempt from the clearing requirements.

Moral hazard concerns: In a circumstance where no DCO offers clearing services for a particular product, there are practical difficulties resulting from a Commission decision that mandatory clearing applies. Indeed, a determination of mandatory clearing in such a circumstance raises moral hazard concerns, as it may have the effect of requiring market participants to use a DCO despite their risk appetite.

2. Review of initial eligibility or the continuing qualification of DCOs to clear swaps

As clearing of certain swaps becomes compulsory under law, the DCOs that clear those swaps must be subject to rigorous organizational, conduct of business and prudential requirements. These requirements should reflect the new risks associated with clearing a swap and, if applicable, differing DCO membership. In addition, a DCO should have adequate internal systems, operational and administrative procedures, and should be subject to independent audits and disclosure requirements, including for example margin calculations. ISDA has separately commented on these and related issues, and we refer the Commission to our letters on governance and conflicts of interest for DCOs and on DCO financial resources[6].

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[6] These two ISDA comment letters can be found respectively at http://isda.org/speeches/pdf/CFTC-NPR-Comment-Letter-111610.pdf and http://www.isda.org//speeches/pdf/CFTC-Comment-CCP-Financial-Resources.pdf

As noted above, the Commission's review of DCOs should be proportional to the range of products the relevant DCOs clear, including the volume and risk characteristics of the products cleared. This also has implications for the determination of which DCOs are of systemic importance. That is to say, by virtue of its central role, a large DCO is likely to be a critical component of the market it serves. Consequently, the failure of such a DCO would probably result in a systemic event for the financial system.

As a related matter, the Commission's review of DCO eligibility should also take into account possible future market dominance and thus not 'crystalize' market standards or infrastructure which in the future may prove imprudent.

The Commission has proposed in Rule 39.5 that DCOs benefit from a presumption of eligibility to clear a swap that falls within a group, type, class, or category of swaps that the DCO is already authorized to clear. To some extent the issues raised by this proposal depend heavily on how broadly the Commission ultimately construes the terms such as "group" or "category". Even under a limited construction, however, this presumption may prove inappropriate. The best example of this would be a presumption that because a DCO clears liquid single name CDS (i.e. standard coupons and liquid tenors on names with good price visibility), then its risk metrics, pricing and historical data are adequate to support the clearing of a CDS of much longer tenors, or on different much less liquid underlyings. Such a presumption may lead to swaps being cleared that the DCO is unable to risk manage properly, the consequences of which would be to decrease the stability and soundness of such DCO.

Conclusion

The public policy rationale for the Dodd-Frank Act is to reduce risk, increase transparency and promote financial market stability by, inter alia, imposing a clearing requirement on swaps when the Commission determines that such requirement would be consistent with the five factors specified in the Dodd-Frank Act. ISDA believes that public policy is best served by the Commission interpreting these criteria strictly given the risks and alternatives tools available.

ISDA appreciates the opportunity to provide these comments. Should you require further information, please do not hesitate to contact the undersigned.

Sincerely,

Robert C. Pickel

Robert Pickel
Executive Vice Chairman