ISDA response to IOSCO Consultation on Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives
20 October 2014

Introduction

ISDA welcomes the opportunity to comment on the IOSCO consultation report on 'Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives.'

Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 64 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

ISDA supports IOSCO's intention to promote regulatory standards on risk mitigation techniques for non-cleared OTC derivatives that should be 'sufficiently compatible across jurisdictions to limit regulatory arbitrage, maintain a level playing field and avoid situations where where the same transactions are subject to conflicting rules.' This principle is of particular importance in OTC derivatives, the most 'global' of financial instruments.

All of our comments herein have at their core the wish to promote safety and efficiency in derivatives business, globally.

While ISDA welcomes this consultation paper from IOSCO, ISDA believes that it would be optimal for such a paper to be published and consulted upon by IOSCO prior to adoption of relevant regulation in any major jurisdiction. While the standards resulting from this consultation will promote a high level of consistency between regulation of OTC derivatives adopted by Japan, the EU and US authorities on the one hand, and other IOSCO jurisdictions on the other (where in many cases, such regulations may not have been adopted yet), adoption of granular standards prior to adoption of EU and US rules could help to ensure consistency between EU and US rules (where some material differences are apparent, albeit that outcomes are broadly equivalent) and between the rules of Europe and the US and other jurisdictions where regulation is not yet in place.

Nevertheless, we hope that these and other standards developed by IOSCO will facilitate equivalence, substituted compliance, and other concepts related to the ability of different IOSCO jurisdictions to defer to each others' regulatory frameworks for the purpose of cross-border trades.

ISDA recalls that in its 'Methodology for Regulatory Comparisons', published in August 2013, ISDA proposed a number of principles for regulators to follow to facilitate inter-jurisdictional recognition of derivatives regulation, including the following:

- For purposes of substitute compliance or equivalence, comparisons of one jurisdiction's requirements to another's may use a variety of analytical methods, all of which must start with identification of a set of common principles that elaborate on the G-20 regulatory goals'; and

- Regulators should consult and cooperate with each other before implementing their derivatives regulations.

It should be recalled that derivatives regulation resulting in territorial fragmentation ultimately results in higher costs for end users seeking to hedge commercial risks, with negative consequences for investment and economic growth.

In this context, we underline our support for the role that IOSCO can play in establishing consensus on regulatory standards applying to OTC derivatives among IOSCO members.

We further add that it is important that IOSCO encourage its members to consult further with industry when implementing these standards at jurisdiction level.

Response to IOSCO questions

a) Are the proposed risk mitigation standards generally appropriate in light of the objectives? Are there any particular standards you consider to be inappropriate for inclusion? Please provide rationale.

ISDA is generally supportive of the standards as published. However we have a number of specific comments on some of the standards.

- *Standard 1: Scope of Coverage: Financial entities and systemically important non-financial entities (hereinafter referred to as "covered entities") that engage in non-centrally cleared OTC derivatives should employ risk mitigation techniques consistent with the standards set out in this report.*

ISDA believes that the scope of risk mitigation standards in different IOSCO jurisdictions, as addressed in consultation by IOSCO, would best have been determined prior to adoption of regulation in those jurisdictions. We observe that there are already important differences in the scope of EU and US rules, for example, with trade confirmation and some other non-cleared derivatives risk mitigation rules applying to non-systemic non-financial counterparties in Europe, but not applying to similar end users in the US.

- *Standard 2: Trading Relationship Documentation Covered entities should establish and implement policies and procedures to execute written trading relationship documentation with their counterparties prior to or contemporaneously with executing a non-centrally cleared OTC derivatives transaction. Such documentation should include all material terms governing the trading relationship between the counterparties*

ISDA believes that this standard as addressed in consultation by IOSCO, would best have been determined prior to adoption of regulation in certain jurisdictions. Although ISDA agrees with the principle, we observe that although this has been implemented in the US rules (for trades among Swap Dealers and Major Swap participants), there is no explicit corresponding requirement in the EU rules for EU authorised investment firms dealing with professional/wholesale clients (or non-authorised firms). Any consideration of implementation of such a standard in other IOSCO jurisdictions should be undertaken with caution, and consideration of what should be a 'covered entity' in this context should take account of the costs and benefits of applying such a requirement to non-financial firms, for whom such a requirement would be somewhat burdensome.

- *Standard 3: Trade Confirmation: Covered entities should establish and implement procedures to ensure the material terms of of all non-centrally cleared OTC derivatives transactions are confirmed as soon as practicable after execution of the transaction.*

With reference to Annex 1 ('Possible Material Terms for Confirmation') we underline that, while the list of 'possible material terms for confirmation' is not exhaustive, neither should it be seen as a 'minimum' list for IOSCO members drafting their own jurisdictions' regulation (for example, some of the fields are not relevant for some transactions e.g. (e.g. 'grade' for some commodity transactions, and some derivatives transactions do not involve 'upfront payments')).

We also underline that we believe it would make sense for IOSCO to consider a more granular approach to setting out what is appropriate timeliness of trade confirmations, to promote efficiency in global firms' confirmations practices, particularly as there is convergence in evidence on this point between EU and US rules.

- *Standard 4: Valuation with Counterparties: Covered entities should agree on and clearly document the process and/or methodology for determining the value of each non-centrally cleared OTC derivatives transaction at any time from the execution of the transaction to the termination, maturity, or expiration thereof, for the purpose of exchanging margins.*

We question any requirement to agree on valuation methodology, as requiring a one-time agreement, or a coordinated agreement with counterparts could undermine risk management and create unmanageable risk as the market changes.

For example, with the advent of the low rate environment, firms have had to find a way to treat low rates in their interest rate option models. Firms have developed their own means of doing so, without having to wait for a consensus to form on how to do this. Such a consensus would not have developed quickly enough for this purpose.

Requiring all firms to implement their counterparties' valuation methods would have been impractical in this context, and would have made risk management extremely complex. Allowing firms to apply their own models not only allows better modeling of market prices, it also enables dealer to maintain a book with limited model error risk and hence a more balanced and safe book. In this regard, we highlight that the proposed standard 4 goes much further than the recent CFTC Notice of Proposed Rulemaking (of 3 October 2014) on Margin Requirements for Uncleared Swaps in this regard, which does allow an environment for heterogenous models to evolve.[1]

While IOSCO acknowledges the confidentiality of proprietary modelling information in its footnote 10 (page 12 of the report), we believe that, should this standard be retained, it should be clarified – in the standard - that market participants are not required to share detailed information with their counterparties on their models where mark-to-model transactions are concerned, but that it is for each counterparty independently, in such an instance, to get comfort on how the transaction will be valued over the lifetime of the contract.

Such a clarification would be in line with regulatory interpretation of compliance requirements in Europe, at national and ESMA level.

Any standard on Valuation should apply to covered entities only, and hence entities that should reasonably be expected to have such a valuations capability.

- *Standard 5: Reconciliation: Covered entities should establish and implement policies and procedures to ensure that the material terms and valuations of all transactions in a non-centrally cleared OTC derivatives portfolio are reconciled with counterparties at regular intervals.*

We observe that there are already some significant divergences between Europe and the US on what constitute 'material terms' in this context, with CFTC rules referring to 'primary economic terms' reported to a Swap Data Repository (SDR) and ESMA standards applying to Key Economic Terms largely aligned with industry Minimum Market Data Standards (MMS). We understand that IOSCO may therefore deem it necessary to avoid inclusion of granular detail on what constitutes 'material terms.'

The precise meaning of terms such as 'all transactions', 'regular intervals' and (in the Key Considerations) 'timely manner' in IOSCO jurisdictions' implementation of these standards is also key.

- *Standard 6: Portfolio Compression: Covered entities should establish and implement policies and procedures to regularly assess and, to the extent appropriate, engage in portfolio compression.*

We fully support this standard, and highlight that ISDA has been a longstanding supporter of its members' use of portfolio compression services as a means of reduction of transaction count and operational risk.

We believe that IOSCO jurisdictions should ensure that other derivatives reforms implemented in their jurisdiction do not conflict with this standard. Such reforms should not impede the ability of firms to compress legacy trades priced and entered into before such obligations take effect. In order to maximise opportunities to design efficient methods to execute portfolio compressions, and ensure the widest possible participation, jurisdictions should seek to ensure that trades or lifecycle events (such as replacement trades, partial terminations or novations) that are generated purely as a function of participating in a risk reducing compression exercise should not be mandatorily subject to clearing or trading venue obligations (as appears to be the case under draft European mandatory clearing requirements).

b) Are the key considerations appropriate and consistent with the standards? Are there elements of the key considerations that should instead be included in the standards? Are there additional or alternative key considerations that should be considered for each standard? If so, please describe them and explain why they should be included.

[1] §23.155(b) Calculation of Variation Margin, Control mechanisms.
(1**) Each covered swap entity shall create and maintain documentation setting forth the variation methodology with sufficient specificity to allow the counterparty, the Commission, and any applicable prudential regulator to calculate a reasonable approximation of the margin requirement independently.**

The point referring to standard 4 in our answer to question a) should also be reflected in Key Considerations for that standard.

On Standard 3 (Trade Confirmation), the Key Considerations state that 'confirmation should be done via non-rewritable, non-erasable automated methods where it is reasonably practicable for the relevant counterparties' or in writing via manual means (such as fax) or otherwise non-rewritable, non-erasable electronic means (such as email). Our assumption is that an email would be used to deliver the confirmation rather than that the confirmation would come in the form of an email (which would be a lower standard than required under ESMA interpretations).

We observe that, while standard 3 refers to use of 'automated methods where it is reasonably practicable' for counterparties, use of such methods is dependent on both counterparties being willing or able to use necessary infrastructure. In the absence of a concrete mandate in this regard (which may not be appropriate for all types of counterparty), use of electronic confirmation platforms, for example, is not as widespread as it might (otherwise) be. IOSCO could consider whether the Key Considerations could refer to the need for regulators to encourage the use of electronic confirmation platforms.

On Standard 9 (Cross-Border Transactions), we welcome the Key Consideration that authorities should 'closely cooperate when introducing these standards and endeavour to reduce the risks of conflicts and inconsistencies between their regimes with respect to the cross-border application of risk mitigation requirements.' IOSCO members should take account of relevant risk mitigation requirements in place in other jurisdictions, as a means to ensuring global consistency and the ability of globally active firms to operate on a safe and efficient basis.

c) Are there standards or key considerations that should be further expounded on (e.g. specifying the deadlines for completion of trade confirmations under key consideration 3.2; the characteristics or parameters of what constitute "economically similar transactions" under key consideration 4.2; the frequency for conducting reconciliations under key consideration 5.1)?

Greater granularity in trade confirmation timelines as set out in these standards would promote greater convergence among IOSCO jurisdictions in terms of their approach to these timeframes, and efficiencies in compliance and back office functions for globally active firms. In this regard, IOSCO could consider addressing such granular detail in annex to these standards.

In Standard 6 (Portfolio Compression), and with reference to Paragraph 6.4, we emphasise that a key benefit of portfolio compression is to simplify market participants' positions, and that we believe this is as important to operational risk as reduction of overall market size. However we note that the benefits of portfolio compression are clearer for larger market participants than for less sophisticated counterparties that would find portfolio compression exercises more demanding. The caveat 'to the extent appropriate' is helpful in this regard, and in line with the approach taken in Europe, among other jurisdictions.

We believe that Standard 7 – on Dispute Resolution – is written suitably flexibly, as regards reporting of disputes to regulatory authorities, in particular. An overly prescriptive view of what would amount to a dispute (rather than a temporary discrepancy (as can happen in mark-to-model transactions in particular)) could have important capital consequences under Basel III. IOSCO member jurisdictions should allow a reasonable amount of flexibility and time for parties dealing with such valuation discrepancies (which rarely become full disputes). As such, we believe that the Key Considerations on this point should not be 'further expounded on'.

d) Are there additional or alternative relevant risk mitigation techniques that should be considered and implemented to reduce the risks arising from non-centrally cleared OTC derivatives transactions? If so, please describe them and explain why they should be considered.

No.

e) What are the practical challenges in implementing the standards? Please substantiate the issues identified and propose solutions to these challenges.

Major challenges for market participants, in relation to trade confirmations, specifically, include

- Transmission on 'T' (trade day)
  - The ability to transmit a confirmation on trade day allows a counterparty 24 hours to execute the confirmation. However this is problematic for more exotic or structured products in the absence of pre-trade agreements, even if generally feasible for vanilla / automated transactions. Hence we welcome IOSCO's proposal in the key considerations that deadlines should be allowed to vary for reasons that include taking account of the 'nature of the […] transaction.'
  - Further automation and expansion of confirmation platforms will facilitate transmission on trade day.

- Use of electronic platforms
  - As e-confirmation is not absolutely mandated in Europe and the US, client uptake is sporadic and not always utilised – in part due to lack of awareness but also due to the technical and cost barriers to entry.
  - Insufficient numbers of products and levels of functionality are available on existing platforms as yet.

- Clients not covered by regulation who are trading with our regulated entities
  - For example, clients located in jurisdictions outside Europe may not be covered by trade confirmation requirements in those jurisdictions, making it difficult to expedite trade confirmation with such counterparties on a timely basis.

- Client size
  - Certain very small clients cannot support the 24 hour turnaround required for timely confirmation as signatories are not available on the same day.

f) Are the proposed risk mitigation standards compatible with obligations arising under other international standards applicable to non-centrally cleared OTC derivatives, such as the margin requirements for non-centrally cleared OTC derivatives published by IOSCO and BCBS in September 2013? If not, please identify the relevant standards and explain any areas of incompatibility.

We believe that IOSCO jurisdictions should ensure that other derivatives reforms implemented in their jurisdiction do not conflict with this standard. Such reforms should not impede the ability of firms to compress legacy trades priced and entered into before such obligations take effect. In order to maximise opportunities to design efficient methods to execute portfolio compressions, and ensure the widest possible participation, it is hence important that trades or lifecycle events (such as replacement trades, partial terminations or novations) that are generated purely as a function of participating in a risk reducing compression exercise should not be mandatorily subject to clearing or trading venue obligations (as appears to be the case under draft European mandatory clearing requirements).