

September 9, 2011

The Honorable Scott D. O'Malia  
Commissioner  
Commodity Futures Trading Commission  
Three Lafayette Centre,  
1155 21<sup>st</sup> Street, NW.  
Washington, DC 20581

**Re: Review of Swaps for Mandatory Clearing under Section 723 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”)**

Dear Commissioner O'Malia:

The International Swaps and Derivatives Association, Inc. (“ISDA”)<sup>1</sup> is writing in response to your letter of July 28, 2011 regarding the review of swaps for mandatory clearing under Section 723 of the Act (the “Letter”), seeking comments on the manner in which the Commodity Futures Trading Commission (the “Commission”) will determine (i) which swaps would be subject to the clearing requirement and (ii) whether to issue a stay of a clearing requirement. Our comments also reflect the views and input of the industry group comprised of representatives of ISDA members (both buy-side and sell-side firms) and the Securities Industry Financial Markets Association and the Futures Industry Association that met with CFTC Chairman Gensler to discuss, among other things, a phased-in or transitional implementation of the new clearing requirements.

ISDA shares your concern that the final rulemaking may not provide sufficient substantive clarity on these extremely consequential areas and welcomes this opportunity to revisit these matters and share its comments with you. We hope this work assists the implementation of an appropriate framework for mandatory clearing, consistent with the

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<sup>1</sup> Since 1985, ISDA has worked to make the global over-the-counter (“OTC”) derivatives markets safer and more efficient. Today, ISDA is one of the world’s largest global financial trade associations, with over 800 member institutions from 56 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.

standards set forth in the Act, with a view to enhancing market liquidity, reducing risk and fostering financial stability.<sup>2</sup>

## **Introduction**

Section 723 of the Act<sup>3</sup> sets out five factors to be taken into account by the Commission in reviewing a swap or class of swaps for mandatory clearing. ISDA believes that the logical starting point for the mandatory clearing review process is the formulation of precisely defined swap product “types”. The definitional process is critical to avoid grouping together swaps that have meaningfully disparate characteristics. Once a product type has been appropriately defined, the five factors should then be applied with reference to such product type. ISDA believes that, in order to reach a mandatory clearing determination, the Commission must come to a substantially positive assessment of each factor and then weigh the factors’ combined adequacy, giving due weight to existing and prospective liquidity. ISDA believes that the connection between mandatory clearing and the DCM or SEF trading requirement under Section 2(h)(8) of the Commodity Exchange Act (“CEA”) has important implications for the mandatory clearing review process. As a mandatory clearing requirement will essentially “offer up” a swap type for mandatory trading, the five-factor test, if it yields a positive result for clearing, must also be applied to trading. We suggest that the Commission adopt a strategy of prioritizing only the most liquid and commonly-traded swap types for mandatory clearing review, thereby mobilizing the incentives provided by margining and operational efficiencies to encourage voluntary migration to clearing of related “suites” of swaps.

In respect of DCO requests for a review of a swap type for mandatory clearing, we suggest a series of “checkpoints” that may assist the Commission in its review. The checkpoints include consideration of (i) the DCO’s resources for clearing the product type, (ii) data connectivity, (iii) testing adequacy, (iv) pricing standards and margin calculations that have been agreed upon by the DCO’s risk committee, (v) resolution of market standardization issues and (vi) consistency of information provided by the DCO with that derived from other sources.

We suggest a simple standard for when a stay of clearing may be appropriate. The Commission should impose a stay when it has received information that, in the

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<sup>2</sup> Our initial comment letter, dated December 22, 2010, in response to the Commission’s Notice of Proposed Rulemaking: Process for Review of Swaps for Mandatory Clearing (available at <http://www2.isda.org/dodd-frank/>) contained a fuller discussion of substantive aspects of a mandatory clearing decision. We highlight in this letter matters that follow most immediately from the Commission’s final rule release, but refer the reader back to our earlier letter for what we trust remains helpful material.

<sup>3</sup> Section 2(h)(2)(D)(ii) of the Commodity Exchange Act

Commission's assessment, raises a credible, material question as to the correctness of a determination underlying the clearing requirement. We also suggest that the Commission adopt a minimum stay period to ensure stable markets and certainty for market participants. Finally, we suggest that the Commission make clear that the stay procedure will be available even after a clearing requirement has gone into effect. We believe the Commission should review its previous mandatory clearing determinations on an ongoing basis, both of its own accord and in response to submissions from market counterparties.

The remainder of this letter contains three substantive parts. The first sets out ISDA's responses to the questions regarding how the Commission should consider the five factors in section 723 of the Act. The second replies to the question regarding how the Commission should determine whether staying the clearing requirement is appropriate. The third addresses several additional matters related to the implementation of the final rule and continuing review of clearing mandates.

## **1. How should the Commission consider the five factors?**

- a. *What criteria should the Commission consider when evaluating whether the Derivatives Clearing Organization ("DCO") has properly categorized "group, category, type, or class of swaps"?*

Terminology used in rule. As a primary step, terms used in the existing rule such as "category," "group," "class" or "type" of swap should be defined to mean the same thing, namely, each instance of a product that meets all the definitional criteria for that category (referred to simply as a "type" in the remainder of this letter).

Precisely drawn criteria for product type. Precision of definition of each type of swap is necessary because instrument liquidity can vary dramatically with different tenors or other variables (even if these differences do not appear significant).<sup>4</sup> In order to guarantee that only those instruments of sufficient liquidity to ensure DCO robustness are within the scope of mandatory clearing, the Commission's definition of product types subject to the mandatory clearing requirement must be as clear and specific as possible.

Example – rate swaps. By way of example, in the context of rate swaps, each product type definition should include at least the following characteristics (to the extent applicable):

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<sup>4</sup> For example, on any trading day, the clear majority of newly initiated swaps in CDS indices are concentrated on the four current on-the-run indices covering investment grade and high yield names in North America and Europe. Data from DTCC indicated that in a recent week, these four indices accounted for 62% of newly initiated index trades.

- instrument description (for example, interest rate swaps with constant notional principal);
- acceptable currency (if the contract refers to a single currency or currency pair);<sup>5</sup>
- rate basis (for example, fixed vs. floating or floating vs. floating; duration and reset dates for floating rates);
- acceptable index or indices;<sup>6</sup>
- maximum term;
- notional amount (minimum to maximum of the relevant currency unit);
- applicable day count fraction (for example, Actual/365 or Actual/Actual);
- applicable business day convention;
- minimum residual term of the trade (i.e., the period from the date of submission of the trade to the earliest contractual date of termination); and
- applicable calculation periods (for example, “stub periods”, “compounding periods” etc.)

The foregoing are examples with respect to interest rate swaps. A similar list of potential variables must be compiled for swaps in other major groups. The process of choosing potential swap type variables is a fundamental element in the clearing regulatory effort and is in itself worthy of time and careful attention.

*b. Should the Commission accord more weight to one or more of the factors than others? If so, why?*

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<sup>5</sup> Only contracts that refer to the same currency or currency pair should be grouped together in the same “type.”

<sup>6</sup> Only contracts based on an identically defined index (e.g., USD LIBOR-BBA) or, in the case of a floating vs. floating swap, index pair should be grouped together in the same “type.” Variants of index definitions may specify different fallbacks if a primary rate source is not available. In general, such variants should be treated as giving rise to different product types, unless it can be established that trading markets view them as fungible.

We believe that each of the five factors is equally important. In consideration of different types of swaps, different factors will come to the fore as key. All factors must be considered in all cases, as the statute requires. Given the potential interrelationship of clearing and trade execution requirements (discussed in paragraph d. below), concern for liquidity must be given adequate weight in all cases.

- c. *Should the Commission consider the factors differently depending on asset class (e.g., interest rate swaps, credit default swaps, and physical commodities)? If so, how should the Commission consider the factors for each asset class (or instruments therein)?*

The nature of the factors dictates that the Commission must reach an affirmative determination with respect to each of the five factors in order to mandate a swap for clearing. As noted above, different types of swaps will produce different factor-by-factor results, so that the decision process will become a weighing of the combined adequacy of multiple positives, swap type by swap type. A fundamental principle of the determination process should be that *over-mandating clearing is worse than under-mandating*. The former has the potential to destroy markets, the latter risks only deferring the rewards of clearing.

- It is crucial to stable and sound markets that a DCO be able to carry and risk manage swap types that are required to be cleared. This may be accomplished only if the factors are taken together and conservatively applied when making mandatory clearing determinations. Quantitative and qualitative considerations within the five factors should be considered together in the determination process so that the appropriateness of the clearing mandate for a particular swap type is verified on as comprehensive a basis as possible. Appraisal techniques that may be useful range from static measures for identifying risks, to sophisticated dynamic/network models, to qualitative assessments, and may incorporate calibration to market data. The outcome of applying these techniques will vary by asset class.
- The Commission has articulated a strategy of initially focusing reviews for mandatory clearing on swaps already being cleared or that a DCO wants to clear.<sup>7</sup> The Commission may wish to further optimize this strategy by prioritizing only the most liquid and commonly-traded

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<sup>7</sup> 76 Fed. Reg. 44464, 44469 (July 26, 2011).

swap types for mandatory clearing review. As a critical mass of cleared transactions is achieved, the resulting margining, operational, and other economic efficiencies will encourage product “suites” to migrate more or less collectively to clearing. In other words, moving the most standardized and popular swap types to clearing will provide incentives for related swap types to follow in short order. The Commission also may wish to consider application of the five factor test to potential interdealer clearing, as opposed to customer and dealer clearing. This would be appropriate as an initial means to accelerate progress to clearing and to allow conversion measures to be completed, tested and refined before full market clearing becomes mandatory.<sup>8</sup> In summary, judicious, targeted mandating of clearing should produce more constructive results than a broader approach that risks over-mandating.

- d. *To what extent should the Commission take into account, in its consideration of the five factors, the connection between (i) mandatory clearing under Section 2(h)(1) through (4) of the CEA and (ii) the trade execution requirement under Section 2(h)(8) of the CEA?*

We believe it is essential that the Commission take into account the connection between mandatory clearing and the trade execution requirement. Once the Commission makes a determination that a particular type of swap is required to be cleared, transactions in that swap type will be subject to a trade execution requirement unless no SEF or board of trade makes the swap type available to trade. Under proposed CFTC Rule 37.10, the available-to-trade determination will be made by SEFs rather than the Commission. SEFs will face a competitive incentive to make such a determination as quickly as possible after the Commission’s mandatory clearing determination in order to capture a first-mover advantage and consolidate market share in trading in that swap type.

The Commission should recognize that its mandatory clearing determinations are likely to operate in practice as mandatory execution requirements, given that the available-to-trade determination<sup>9</sup> is a separate, distinct and weaker substantive standard.

Two consequences follow from the linkage between the clearing and the trade execution requirement.

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<sup>8</sup> See the FIA/Financial Services Forum/ISDA/SIFMA joint letter, dated May 4, 2011, regarding Phase-In Schedule for Requirements of Title VII of the Dodd-Frank Act (“Trade Association Letter”) (available at <http://www2.isda.org/dodd-frank/>).

<sup>9</sup> 76 Fed. Reg.1214, 1222 (Jan.7, 2011).

- First, as part of each clearing decision, the Commission should apply the five factors to the question of execution, as well as clearing, in an iterative manner. Applying the five factors to clearing alone requires both an assessment of facts pre-clearing and an assessment of anticipated facts post-clearing. For example, after determining that there is a well-functioning, liquid market in a type of swap, the Commission must consider in advance the effects of a mandatory clearing determination on (i) trading liquidity (Factor I) and (ii) competition and the range of customer choice (Factor IV). These same factors must then be assessed again, but differently, when considering trade execution. For example, more substantial liquidity is required for viable trade execution than may be required for clearing.<sup>10</sup> If trading liquidity is inadequate to support facility execution, or if a SEF's or DCM's particular market structure or trading rules discourage liquidity by being poorly suited for that swap type or its traditional trading clientele, the swap type could become unattractive to market participants. As a result, trading liquidity and price discovery could suffer, resulting in a decrease in competition and customer choice.
- Second, it is appropriate at the outset to seek to mandate clearing only for swap types that coincide with market segments where trading liquidity is sufficient to support an execution requirement. As suggested earlier, this approach is fully consistent with the goal of fostering widespread clearing, as related swap types can be expected to gravitate naturally to voluntary clearing due to margining and operational efficiencies and regulatory consistencies. As the most commonly-traded product types within an asset class typically represent a substantial portion of the outstanding notional amounts in the asset class, this approach would have the benefit of significantly advancing the Commission's objectives while avoiding the risk of an unintended and unnecessary reduction in market liquidity.

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.

- e. *Final regulation 39.5(b)(3) sets forth a list of documents that each DCO must submit in its request for a mandatory clearing determination. What, if any,*

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<sup>10</sup> It is instructive to consider differences in trading frequency between OTC swap markets and exchange-traded markets. By way of example, globally, there are more than 1,000,000 listed futures trades a day and fewer than 20,000 OTC derivatives trades. See Annex A (slides excerpted from Opening Remarks of Robert G. Pickel, ISDA Executive Vice Chairman, at the ISDA Annual General Meeting, April 14, 2011).

*additional information should the Commission routinely obtain to aid in its consideration of the five factors? Please indicate the specific factor (and element therein) that such information would help the Commission evaluate.*

We understand that the Commission has chosen not to require that a DCO submit a completely dispositive set of information in support of a mandatory clearing determination. We understand, as well, that the Commission acknowledges its own responsibility ultimately to completely review the material submitted to it by a DCO and such supplemental material as the Commission may deem appropriate. We suggest, however, that the Commission require that any DCO application contain sufficient information upon its filing with the Commission to support a preliminary positive assessment by the Commission. Of course, the Commission's own complete review would test and, possibly, reverse that assessment. Any DCO submission that upon its filing fails to support a preliminary positive assessment should be rejected simply as a matter of economy, both for the Commission and for market participants.

- Each DCO submission will necessarily provoke specific questions and follow-up by the Commission as it performs its five factor review. We suggest the following additional discrete threshold questions that the Commission should ask in evaluating a DCO's submission:
  - Has the DCO proven through testing that it has the ability to clear the product (Factor II)?;
  - Does the DCO have sufficient operational and risk management resources and established data connectivity using standard protocols (in particular, to rapidly confirm trade clearing) (Factor II)?;
  - Have all market standardization issues defining the swap types, life events, etc. been resolved (Factors I-III)?;
  - Have pricing standards and margin calculations been agreed by the DCO's risk committee (Factors III and IV)?; and
  - Has the Commission received all the information it needs and (in respect of a DCO submission) has this information been verified as consistent with data from swap data repositories, swap dealers and major swap participants? In particular, is the Commission confident of accurate data on pricing, daily trade volume and number of market participants?
- In general, answering these key questions would ensure an objective assessment of a DCO's swap submission and mitigate the inherent conflict that exists as a



result of DCOs having an economic interest in a determination by the Commission that clearing is required.

**2. What criteria should the Commission employ to determine whether staying the clearing requirement would be appropriate?**

- The stay allows the Commission to reconsider its decision that a type of swap is required to be cleared. While we appreciate the Commission’s concern that enumerating stay criteria, may limit its ability to respond in unforeseen circumstances,<sup>11</sup> we believe a simple stay criterion would be helpful to the Commission as well as to market participants. As such, we propose that the Commission should stay the clearing requirement upon any request that raises a credible, material question as to the correctness of the determination underlying the clearing requirement.<sup>12</sup>
- The Commission may suggest in guidance that stay requests be formatted in terms of aspects of the five fundamental factors, or in terms of the checkpoints we have suggested above (or other similar criteria the Commission may find appropriate). We urge the Commission, however, not to be exclusionary in this regard. Imposition of a clearing requirement will have a profound effect on the market for the relevant type of swap. It is therefore crucial that the Commission retain the flexibility to correct a mistaken decision and to reevaluate a decision in light of new information. It is in the interests of all that the Commission err, if at all, on the side of stay and reconsideration, and so deliver clearing decisions with the certainty that the markets need in order to commit resources to clearing.
- We also suggest that the Commission establish a minimum stay period (e.g., 180 days) as a matter of market certainty. This minimum period should reflect not only the allotted 90 days for the Commission to complete its review but also a reasonable minimum period for the market to resume and complete, or restore, its preparations for mandatory clearing. If this minimum period is too short, market participants may be required to expend resources in their implementation efforts which ultimately may prove to have been wasted if the outcome of the Commission’s review is that mandatory clearing will not apply.

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<sup>11</sup> 76 Fed. Reg. at 44470.

<sup>12</sup> We recognize that the Commission will make its own assessment of materiality based on the context, including the likelihood and magnitude of any harm that would result if clearing is not stayed, as well as the costs that may attend a stay.

- Finally, the Commission should make clear that the stay procedure, both in response to counterparty applications and on the Commission’s own initiative, will continue to apply after a clearing requirement has taken effect. In such instances, swaps of the affected type entered into and cleared prior to effectiveness of the stay could, absent extraordinary factors, continue to be maintained on the books of the relevant DCOs, at least through the stay.
- 3. In responding to the Letter, we observed related matters to bring to the attention of the Commission:**
- The question of implementation timing inevitably attaches to discussion of clearing requirements and stay possibilities. It is of great importance that imposition of any clearing requirement be followed by an implementation period sufficient to allow the existing OTC market to “convert” to clearing without damage to the market or market participants. Implementation periods will need to be variable to reflect swap type-specific factors, such as the presence or absence of a range of competing DCO offerings at the time a clearing mandate becomes effective, and differing considerations as to risk management methodology and product standardization requirements. The experience of ISDA members in connection with existing voluntary clearing arrangements has been that it can take up to one year to build and test the required systems and governing policies and procedures for clearing. This implementation period would also be the opportune period for submission of stay requests, although we believe it imperative that stay requests not be limited to this period.
  - Implementation of any clearing requirement in the near term, of course, must be set in the context of completion and implementation of a variety of new rules, ranging from those establishing key definitions to those stipulating DCO requirements. The Commission should be clear that the earliest possible effective date for any mandatory clearing requirement will not occur until those DCOs responsible for mandatory clearing have implemented the governance, risk management and customer protection regimes mandated by final and effective Commission rules. In addition, all other materially related and prerequisite rulemakings should have been completed and published in order to permit an informed assessment of the complete regulatory structure and the full range of implementation factors as described in our prior comment letters.<sup>13</sup>

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<sup>13</sup> ISDA comment letter, dated June 2, 2011, regarding the Commission’s Reopening and Extension of Comment Periods for Rulemakings Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act; Trade Association Letter. Comment letters are available at <http://www2.isda.org/dodd-frank/>.

- We recommend that the Commission institute regular, periodic review of previous mandatory clearing determinations, and, if appropriate, impose a targeted stay of clearing until factors identified in its review have been resolved. Clearing determinations will necessarily be made on the basis of information available at the time. Each of the five factors may require reassessment to account for, among other things, liquidity changes, outstripping of operational resources, changes in market behavior that require adjustments to risk management models or challenges to legal certainty. Although some of these variances may be discovered in DCO examination processes, we suggest that a product-specific review of each required clearing determination be carried out by the Commission on an annual basis, or an ad hoc basis if market conditions require with respect to each swap type required to be cleared.

## **Conclusion**

The public policy rationale for the Act is to reduce risk, increase transparency and promote financial market stability by, among other things, imposing a clearing requirement on swaps when the Commission determines that such requirement would be consistent with the five factors specified in the Act. ISDA believes that the successful clearing of swaps will be best served by the Commission interpreting these criteria strictly given the risks and alternatives tools available. ISDA similarly believes that the Commission (a) should employ its stay authority liberally to assure the correctness of mandatory clearing determinations and (b) implement mandatory clearing with sufficient time for markets to flourish as a result.

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



Robert Pickel  
Executive Vice Chairman

## Annex A

Opening Remarks, 26<sup>th</sup> Annual General Meeting, April 12-14, 2011, Prague

Robert G. Pickel, Executive Vice Chairman, ISDA

A blue slide titled "OTC Derivatives Market Structure" with a yellow horizontal line. It contains a table comparing OTC Swaps and Listed Futures across various characteristics. The ISDA logo is in the bottom left corner.

<u>Characteristic</u>	<u>OTC Swaps</u>	<u>Listed Futures</u>
Trading Counterparties	< 1,000	>> 100,000
Retail Participation	None	Significant
Daily Trades	< 20,000	> 1,000,000
Tradable Instruments	>> 100,000	< 1,000
Trade Size	Very Large	Small
Market Structure	Bilateral (OTC)	Exchange

Sources:

The information on market structure of the exchange-traded and OTC derivatives businesses is derived from information referenced in a study entitled “Block trade reporting for over-the-counter derivatives markets” published by ISDA and SIFMA. This study was included as an annex to the comment letter dated February 7, 2011, filed by ISDA and SIFMA in response to the CFTC’s proposed rule on “Real Time Public Reporting of Swap Transaction Data”.

[www.isda.org/speeches/pdf/Block-Trade-Reporting.pdf](http://www.isda.org/speeches/pdf/Block-Trade-Reporting.pdf)

## OTC Derivatives Market Structure: IRS

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5500 Daily Trades

- 3600 swaps
- 1900 caps, floors, etc.

1200 USD and 830 EURO IRS are traded daily

Less than 50% of daily swaps trading is standardized

- Most liquid standardized swap (10y USD) trades 200x per day

ISDA

Source: [http://www.trioptima.com/uploading\\_images/pdf/FT\\_TriOptima.pdf](http://www.trioptima.com/uploading_images/pdf/FT_TriOptima.pdf)