ISDA® Safe, Efficient Markets

April 28, 2017

Hon. Steven Mnuchin
Secretary
Department of the Treasury
1500 Pennsylvania Ave, NW
Washington, DC 20220

Dear Secretary Mnuchin:

The International Swaps and Derivatives Association, Inc. ("**ISDA**") appreciates the opportunity to share its views regarding the President's Executive Order 13772 titled "Core Principles for Regulating the United States Financial System" (the "**Executive Order**").[1] As discussed in greater detail below, ISDA believes that the Administration can provide tremendous value by facilitating better inter-agency regulatory coordination domestically and abroad, ensuring that the U.S. implementation of international standards does not exceed those agreed-upon principles and providing targeted reform recommendations to the U.S. financial regulators.

We support the seven core principles established in the Executive Order, which are designed to encourage U.S. economic growth and mitigate risks to the U.S. financial system. Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 850 member institutions from 68 countries. These members comprise a broad range of 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, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers.[2]

We are encouraged by the Executive Order's directive ordering, among other things, the identification of, and reporting to the President on, "existing laws, treaties, regulations, guidance, reporting and recordkeeping requirements, and other government policies that

[1] Exec. Order 13772, Core Principles for Regulating the United States Financial System, 82 Fed. Reg. 9965 (Feb. 8, 2017), *available at* https://www.gpo.gov/fdsys/pkg/FR-2017-02-08/pdf/2017-02762.pdf [hereinafter Executive Order on Core Principles].

[2] More information about ISDA and its activities is available on the Association's website: www.isda.org.

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inhibit Federal regulation of the U.S. financial system in a manner consistent with those core principles."[3] To that end, we have identified laws, regulations and guidance implemented as part of either the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**")[4] or the Basel III Bank Accords ("**Basel III**"),[5] which we believe are inconsistent with certain core principles established in the Executive Order.

While the U.S. financial system is currently stronger, better capitalized and more resilient than ever, the implementation of certain aspects of Dodd-Frank and Basel III has revealed significant, adverse consequences that threaten the competitiveness and efficiency of U.S. financial markets and unnecessarily divert capital that could otherwise be deployed towards job creation and economic growth in the United States. ISDA believes better outcomes can be achieved through targeted reforms to existing laws, regulations and guidance under Dodd-Frank and Basel III, which are inconsistent with the core principles in the Executive Order. ISDA also believes that the Administration's support of regulatory reforms to Dodd-Frank and Basel III could play a crucial role in achieving these outcomes.

BACKGROUND

Over the past seven years, the industry has worked closely with U.S. financial regulators in implementing Title VII of Dodd-Frank, which establishes a new regulatory framework for the regulation and oversight of the over-the-counter ("**OTC**") derivatives markets. During that time, the OTC derivatives markets have progressed tremendously in terms of improving market transparency, enhancing prudential safeguards and reducing systemic risks stemming from the interconnectedness of firms. Over the same period, the industry has similarly worked with U.S. prudential regulators as part of the U.S. implementation of Basel III, which has been the most significant overhaul of U.S. bank capital and liquidity standards in over two decades. There are several notable developments that have resulted from these regulatory initiatives, including:

- There is more market transparency since all OTC derivatives are now required to be reported to swap data repositories;[6]

[3] *See* Executive Order on Core Principles, *supra* note 1, at 9965.

[4] Pub. L. 111-203, 124 Stat. 1376 (2010).

[5] Basel III is the third iteration of a comprehensive set of financial reform measures promulgated by the Basel Committee on Banking Supervision, a committee part of the Bank for International Settlements in a collaborative effort with the world's financial regulators, academics and stakeholders. Founded on "three pillars," Basel III was designed to improve banking institutions' resiliency, risk management and governance as well as increase transparency and accountability. *See* Bank for International Settlements, *Basel III: International Regulatory Framework for Banks*, BIS.ORG, http://www.bis.org/bcbs/basel3.htm (last visited Apr. 24, 2017).

[6] *See* Sections 727 & 729 of the Dodd-Frank Act, 7 U.S.C. § 2(a)(13), 7 U.S.C. § 6r (mandating the public reporting of both cleared and uncleared swaps).

- As of March 2017, 87.5% of interest rate derivative notional volume and 79.6% of trade count is cleared;[7]
- More than half of all interest rate derivatives, or 56.7% of notional volume and 58.7% of trade count, are transacted on electronic platforms;[8]
- The amount of bank capital held by U.S. banking entities has more than doubled since the 2008 financial crisis;[9] and
- New collateral rules have gone into effect for the largest OTC derivatives users, which are now required to post initial margin and variation margin on their non-cleared OTC derivatives.[10]

Notwithstanding these developments, the implementation of a new and comprehensive regulatory regime to oversee the $544 trillion OTC derivatives market[11] and the establishment of comprehensive reforms to U.S. bank capital and liquidity standards is not without its problems. For example, several of the Dodd-Frank and Basel III reforms resulted in domestic and international regulatory duplication without concomitant risk-reducing benefits, unnecessary complexity and undue and increasingly costly compliance burdens on U.S. businesses – some of which do not present a systemic threat to U.S. financial markets.

In addition to these problems, ISDA asserts that certain Dodd-Frank and Basel III requirements are expressly inconsistent with the following Executive Order core principles:

- Rationalizing and harmonizing the Federal financial regulatory framework;
- Furthering American interests by ensuring a level playing field; and

[7] These figures are available on ISDA's website at: www.swapsinfo.org. These figures are also available in the SwapsInfo First Quarter 2017 Review.

[8] *See id.*

[9] *See e.g.*, EXECUTIVE OFFICE OF THE PRESIDENT OF THE UNITED STATES, REPORT: THE FINANCIAL CRISIS, FIVE YEARS LATER, at 8 (2013), *available at* https://obamawhitehouse.archives.gov/sites/default/files/docs/20130915-financial-crisis-five-years-later.pdf (finding that bank capital has more than doubled since the crisis and that "[b]anks now hold sufficient capital so that, even under adverse stress test scenarios, they would hold more of it than their actual capital levels in 2008").

[10] This requirement will extend to other OTC derivatives users over time. *See* U.S. Commodity Futures Trading Commission, Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants: Final Rule, 81 Fed. Reg. 636 (Jan. 6, 2016) *available at* http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2015-32320a.pdf [hereinafter CFTC Final Margin Rule]; Prudential Regulators, Margin and Capital Requirements for Covered Swap Entities: Final Rule, 80 Fed. Reg. 74840, 74845 (November 30, 2015), *available at*: http://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28671.pdf [hereinafter Prudential Regulators Final Margin Rule].

[11] Bank for International Settlements, Global OTC Derivatives, BIS.ORG (2016), *available at* http://www.bis.org/statistics/d5_1.pdf.

- Making regulation efficient, effective and appropriately tailored.[12]

In the sections that follow, we identify a number of Dodd-Frank and Basel III regulatory requirements that are inconsistent with each of these three core principles. In general, as noted above, we believe that the Administration can help the industry address these inconsistencies by facilitating better inter-agency regulatory coordination, ensuring that the U.S. implementation of international standards do not go beyond those agreed-upon principles, and providing targeted reform recommendations to the U.S. financial regulators.

RATIONALIZING AND HARMONIZING THE FEDERAL FINANCIAL REGULATORY FRAMEWORK

One of the unique features—and great benefits—of the OTC derivatives markets is their global nature. This global liquidity pool allows commercial end-users—which are the Main Street job creators, manufacturers and producers in the United States—to affordably protect against and hedge specific risks associated with their commercial operations.

The global reach of this business means that the OTC derivatives markets are particularly sensitive to regulatory requirements that are duplicative or contradictory. Duplication can occur in three forms. First, duplication can occur in respect to cross-border transactions when a U.S. entity transacts with a foreign counterparty or when a non-U.S. affiliate of a U.S. entity transacts generally, subjecting those transactions to comply with the same requirements (*e.g.*, reporting, trading and clearing requirements) under two or more rulesets. Second, duplication can occur with respect to OTC derivatives transactions that occur in the United States when the product traded falls within the jurisdiction and oversight of both the U.S. Commodity Futures Trading Commission ("**CFTC**") and the U.S. Securities and Exchange Commission ("**SEC**").[13] Third, duplication can occur when an OTC derivatives market participant's transactions are regulated by the CFTC and/or SEC, but the entity is principally regulated as a banking entity by a U.S. prudential regulator such as the Office of the Comptroller of the Currency ("**OCC**"), the Federal Deposit Insurance Corporation ("**FDIC**") or the Board of Governors of the Federal Reserve System ("**Federal Reserve**").[14] In any form, duplicative requirements increase

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[12] *See* Executive Order on Core Principles, *supra* note 1, at 9965.

[13] *See* the definition of "swap," as defined by section 1a(47) of the Commodity Exchange Act, 7 U.S.C. § 1a(47), and "security-based swap," as defined by Section 3(a) of the Securities Exchange Act, 15 U.S.C. 78c(a), as adopted in Section 1a(42) of the Commodity Exchange Act, 7 U.S.C. § 1a(42).

[14] Depending on the context, the term "U.S. prudential regulator" as used herein will have different meanings. With respect to U.S. rules related to bank capital standards, the term refers to the OCC, FDIC and the Federal Reserve. With respect to U.S. rules related to margin for non-cleared OTC derivatives, the term refers to OCC, FDIC, Federal Reserve, the Farm Credit Administration and the Federal Housing Finance Agency. With respect to the Volcker Rule, the term refers to the OCC, FDIC and the Federal Reserve.

regulatory burdens, compliance costs and ultimately cause adverse impacts on market pricing and efficiency. Additionally, contradictory requirements may have the same impact, with the added dangers of potential noncompliance. As a result, it is vital that the regulatory framework among the U.S. regulatory community, as well as the global framework across the United States and foreign jurisdictions, is appropriately harmonized and that an effective system of regulatory recognition (*i.e.*, “substituted compliance” or “equivalence”) is established.

We provide examples below of how the three types of duplication and inconsistencies have had an adverse impact on U.S. OTC derivatives markets, U.S. banks complying with Basel III capital and liquidity standards and compliance with other regulatory requirements.

A. CFTC/SEC Harmonization. Under Dodd-Frank, the CFTC has adopted a comprehensive regime for the regulation of swaps and supervision of the largest swap market participants. In contrast, the SEC has not adopted all of the security-based swap rules that are necessary to implement the main components of Title VII of Dodd-Frank. Certain aspects of the SEC’s proposed and final security-based swap rules would require separate and materially different registration requirements, separate compliance regimes and duplicative technological builds. For example, the SEC’s security-based swap dealer registration rules contain certain compliance requirements, which have no comparable requirement in the CFTC ruleset. [15] These requirements may create artificial and arbitrary barriers to entry for non-resident dealers, limited customer choice and, potentially, market liquidity. Another example is the SEC’s rules for the reporting of security-based swaps[16] which have been finalized but are not yet subject to full compliance. Key requirements, such as the ability of data to be held by a swap data repository prior to public dissemination, are in direct contrast with the trade reporting requirements of the CFTC,[17] thus adding cost and complexity to compliance. Further, another requirement, the rule to report Unique Identification codes (“**UICs**”), including those for identifying individual traders, is inconsistent with CFTC rules, as well as many other global trade reporting rulesets. The SEC’s rule effectively requires the direct counterparty on the non-reporting side, who may otherwise not have to build to report under SBSR, to implement a way to identify traders and trading desks, among other things, using UICs in order to provide missing information to an SDR upon request.[18] Requirements which are inconsistent with many other trade reporting rules, as well as global standards, are inefficient and result in unnecessary costs for the industry. Additionally, the SEC should re-propose its proposed

[15] *See e.g.*, 17 C.F.R. 240.15Fb2-4(c).

[16] 17 C.F.R. Parts 232, 240, 242, & 249.

[17] 17 C.F.R. Parts 43 & 45.

[18] SEC Rule 242.906(a), 17 C.F.R. 242.906(a).

rule[19] on margin for uncleared security-based swaps to better align it with the CFTC's final margin rule.[20]

In an effort to foster more efficient and effective regulation, the SEC should harmonize its proposed security-based swap rules with the analogue rules that the CFTC has adopted for swaps, together with any reforms to those rules that the CFTC may adopt in response to the President's Executive Order. Further, the agencies should recognize substituted compliance and equivalency among finalized rulesets in order to remove redundancies and inconsistent requirements as between the two U.S. market regulators' rulesets.

B. Harmonization of U.S. Rules with Those in Non-U.S. Jurisdictions. There are many areas where U.S. rules under Dodd-Frank and Basel III are not harmonized with their analogue non-U.S. rules. This disharmony places U.S. market participants at a competitive disadvantage to their non-U.S. counterparts. To ensure deep, robust global markets, regulators should allow for the recognition of similar regulatory regimes through so-called "substituted compliance" or "equivalence" determinations, which holistically focus on the outcomes achieved through foreign regulatory regimes and foreign regulators' market supervision capabilities.

The need for harmonization with non-U.S. jurisdictions is most apparent in the U.S. regulatory regime for OTC derivatives under Title VII of Dodd-Frank.[21] As noted above, the OTC derivatives markets are global in nature. Thus, if cross-border swap transactions directly implicate U.S. regulatory interests, then for these transactions, the CFTC should adopt a substituted compliance regime that considers the rules of other jurisdictions in their entirety, based on their outcomes, rather than a rule-by-rule analysis of each element of the foreign jurisdiction's regulatory framework. A lack of recognition of foreign regulatory regimes requires U.S. and U.S. affiliated firms to build-out duplicative compliance systems for trading, reporting, recordkeeping and other requirements in overlapping jurisdictions. Needless to say, a duplicative compliance regime considerably increases operational costs, decreases the competitiveness of U.S. entities in relation to other foreign entities and leads to market fragmentation and diminished liquidity as foreign entities are trying to avoid trading with U.S. counterparties for fear of being captured by the U.S. regulatory regime.

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[19] U.S. Securities and Exchange Commission, Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 Fed. Reg. 70214 (Nov. 23, 2012), *available at* https://www.gpo.gov/fdsys/pkg/FR-2012-11-23/pdf/2012-26164.pdf.

[20] *See* CFTC Final Margin Rule, *supra* note 10.

[21] Section 722 of Dodd-Frank added section 2(i) of the Commodity Exchange Act and section 30(c) of the Securities Exchange Act of 1934, both of which provide that Title VII of Dodd-Frank will not apply to OTC derivatives activities that occur outside of the United States unless those activities either: (1) have a direct and significant connection with activities in, or effect on, commerce of the United States; or (2) contravene such rules or regulations as the CFTC or SEC may prescribe or promulgate as necessary or appropriate to prevent evasion of any provision of Title VII. *See* 7 U.S.C. § 2(i); 15 U.S.C. § 78dd(c).

With respect to the CFTC's approach to cross-border transactions in general, Section 2(i) of the Commodity Exchange Act stipulates that Dodd-Frank should only apply to activities outside the United States if those activities have a "direct and significant connection with activities in, or effect on," U.S. commerce.[22] The CFTC's current approach to regulating cross-border transactions and activities goes well beyond the statutory provision to capture overseas business of U.S.-based entities. The CFTC should provide clarity around the cross-border scope of its regulations and ensure that such scope is appropriately balanced within the statutory limitations of Section 2(i).

Further, U.S. financial regulators should be mindful of the competitive and market implications of their approach to aggressively regulate cross-border transactions, as well as non-U.S. actors and activities that are truly foreign in nature.

C. <u>Harmonization Across U.S. Federal Financial Regulatory Agencies</u>. Inefficiencies and discrepancies have occurred among several U.S. financial regulators responsible for the rules affecting the same transactions and market participants. There are several examples of these inefficiencies and discrepancies occurring under Dodd-Frank and Basel III. Some of the most notable examples are discussed below.

- *Volcker Rule*. While not part of Title VII of Dodd-Frank, we believe that the statutory and regulatory provisions commonly known as the Volcker Rule also require significant amendments.[23] Congress passed the Volcker Rule to limit two types of risks to banking entities: (i) the risks created by proprietary trading activities of banking entities, including insured depository institutions, foreign banks with certain U.S. operations and affiliates of the foregoing entities; and (ii) the risks created by investments and certain relationships by and between banking entities and private equity funds and hedge funds.[24] While Congress' goals of limiting these types of activities were well-intended, the implementation of the Volcker Rule has resulted in several inadvertent consequences, most notably, reduced capital markets liquidity and stunted capital formation due to its over-breadth and over-complexity. Therefore, the Volcker Rule must be amended statutorily or, in the absence of a statutory change, by re-drafting the U.S. financial regulators' regulations, in the following ways: (i) limit the definitions of (A) proprietary trading to "standalone" proprietary trading (*i.e.*, redefine proprietary trading as short-term trading conducted by a business unit that is wholly unrelated to financial

[22] *Id.*

[23] Section 619, Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds ("Volcker Rule"), Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1 (2010), 12 U.S.C. § 1851.

[24] *See, e.g.*, Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs, 111th Cong. 5-8, 49-53 (2010) (statement by Paul Volcker, Chairman, President's Economic Recovery Advisory Board), *available at* https://www.gpo.gov/fdsys/pkg/CHRG-111shrg57709/pdf/CHRG-111shrg57709.pdf.

intermediation, risk management or asset-liability management and not based on a vague standard of intent), and (B) "covered fund" to Section 3(c)(1) or 3(c)(7) funds that are principally engaged in such impermissible proprietary trading; (ii) create a single-regulatory oversight model, whereby a single regulator would be responsible for implementing, interpreting and examining compliance with the rule's provisions;[25] (iii) exempt from the definition of prop trading, trading activity not only in government obligations but also the derivatives on government obligations, thereby permitting the purchase, sale, acquisition or disposition of all government obligations and their related derivatives; (iv) establish more understandable and meaningful safe harbors for activities that may be regarded permissible (*e.g.*, a safe harbor from the trading account test for any purchase or sale as principle for the purpose of, or in connection with financial intermediation activities or asset-liability management, and a *de minimis* safe harbor for incidental activity); and (v) simplify the requirements in relation to market making (specifically, "reasonably expected near-term demand") and "risk mitigating hedging" in order to promote and encourage capital markets liquidity and prudent risk management.

- *Margin Rules for Non-cleared OTC Derivatives*: While the CFTC's final rules regarding margin requirements for non-cleared swaps include an exemption for transactions between affiliates of a consolidated holding company,[26] in a manner consistent with non-U.S. regimes, the U.S. prudential regulators' rules

[25] Former Federal Reserve Board Governor Tarullo, in his parting remarks, has described the 5-agency rulemaking model for the Volcker Rule as a statutorily created problem and disadvantage. Among other things, he believes this problem has led to time-consuming, and at times unsuccessful, efforts to achieve consistency, and has led to an intent-based approach by regulators to define market making a failed approach. *See* Governor Daniel K. Tarullo, Bd. of Governors of the Fed. Reserve Sys., Departing Thoughts: Address at the Woodrow Wilson School of Princeton University (Apr. 4, 2017), *available at* https://www.federalreserve.gov/newsevents/speech/tarullo20170404a.htm.F Further, we believe that such 5-agency rulemaking model has led to unhelpful compromises, the FAQ process is broken down, with 21 separate FAQs in 2.5 years that are conflicting at times, and the chance at improving the rule in a timely fashion is daunting because of such 5-agency model. *See* Prudential Regulators, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Final Rule, 79 Fed. Reg. 5536 (Jan. 31, 2014), *available at* https://www.gpo.gov/fdsys/pkg/FR-2014-01-31/pdf/2013-31511.pdf; U.S. Commodity Futures Trading Commission, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships Hedge Funds and Private Equity Funds; Final Rule, 79 Fed. Reg. 5808 (Jan. 31, 2014), *available at* http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2013-31476a.pdf; *see also*, Board of Governors of the Federal Reserve System, Volcker Rule: Frequently Asked Questions (Mar. 4, 2016), *available at* https://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm; U.S. Securities and Exchange Commission, Responses to Frequently Asked Questions Regarding the Commission's Rule under Section 13 of the Bank Holding Company Act (the "Volcker Rule") (Mar. 4, 2016), *available at* https://www.sec.gov/divisions/marketreg/faq-volcker-rule-section13.htm. U.S. Commodity Futures Trading Commission, Frequently Asked Question Regarding Certain Requirements under Section 13 of the Bank Holding Company Act of 1956 and Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (Feb. 27, 2015), *available at* http://www.cftc.gov/idc/groups/public/@externalaffairs/documents/file/volckerrule_faq022715.pdf.

[26] *See* CFTC Final Margin Rule, *supra* note 10, at 673.

do not provide for a similar exemption.[27] The absence of an affiliate exemption not only has the obvious impact of creating disharmony between domestic regulators in the implementation of the same statutory provision,[28] but also leads to competitiveness concerns between those entities regulated by the U.S. prudential regulators when compared to those entities that are regulated by the CFTC or non-U.S. regulators.

- *Supplementary Leverage Ratio:* Applicable only to the largest of U.S. financial institutions, the supplementary leverage ratio ("**SLR**") establishes a regulatory capital ratio that accounts for both on-balance sheet and certain off-balance sheet assets and exposures.[29] Exposures accounted for under the SLR include financial institutions' derivatives transactions, effectively requiring the bank to retain at least 3% capital for each of its derivative transactions; however, in its current form, the SLR prohibits banks from offsetting, or otherwise reducing, their derivatives exposures by margin received from clients for cleared derivatives, even when such margin is segregated into a separate account. Segregation in these instances would prevent the bank from otherwise rehypothecating this collateral (*i.e.*, lending or using the funds for other purposes); rather, such assets must remain in the account for the life of the transaction. Given that it solely functions as a risk mitigant to reduce exposures with respect to derivatives that a bank clears for clients, it is particularly burdensome on banking institutions to otherwise retain additional capital to offset what is already sitting in a segregated account. In addition to increasing costs of doing business, the failure to recognize the exposure-reducing effect also serves as a disincentive to clearing derivative transactions for clients, as margin received from such clients will substantially increase a firm's total leverage exposure, leading to an increase in the amount of capital required to support client clearing activities. Recognizing the intricacies and safeguards built into segregated margin, the CFTC has opined that the margin posted by clients for cleared derivatives should not be counted against banks for purposes of the SLR.[30] However, this position is in direct conflict with the U.S. prudential regulators' position that margin posted by clients for cleared

[27] *See* Prudential Regulators Final Margin Rule, *supra* note 10, at 74845.

[28] 7 U.S.C. § 6s(e).

[29] *See* Prudential Regulators, Regulatory Capital Rules: Regulatory Capital, Revisions to the Supplementary Leverage Ratio, 79 Fed. Reg. 57725 (Sept. 26, 2014), *available at* https://www.gpo.gov/fdsys/pkg/FR-2014-09-26/pdf/2014-22083.pdf.

[30] *See e.g.*, Chairman J. Christopher Giancarlo, Statement of Commissioner J. Christopher Giancarlo for the Market Risk Advisory Committee Meeting (June 1, 2015), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlostatement060115 ("The supplementary leverage ratio (SLR) rule issued last year by U.S. prudential regulators will make it more expensive for bank-owned FCMs to clear customer trades. That is because the SLR requires banks to hold more capital for every asset on their books, even margin held for clients on cleared trades of commodity futures, leading to diminished FCM income and increased client costs.").

derivatives should be counted against banks for purposes of the SLR.[31] To address this discrepancy, U.S. financial regulators should follow the CFTC's position and make clear that margin posted by customers should not be counted against banks for purposes of the SLR.

- *Capital Models.* The CFTC's final rules for capital requirements for swap dealers and major swap participants[32] should accept market risk and credit risk models that are approved by another regulator other than the CFTC or the CFTC's designated self-regulatory organization, the National Futures Association ("**NFA**"). To mitigate the unnecessary burdens of seeking a separate, duplicative approval from the CFTC or NFA for such market risk and credit risk models, the CFTC's final capital rules should accept as a substitute those models that have been approved by a U.S. prudential regulator, the SEC or a qualifying foreign regulator. Incorporating such changes would streamline the CFTC's model approval process and ease implementation burdens in a manner that is consistent with the President's Executive Order 13771 titled "Reducing Regulation and Controlling Regulatory Costs."[33]

FURTHERING AMERICAN INTERESTS BY ENSURING A LEVEL PLAYING FIELD

A level playing field across jurisdictions is important for the healthy functioning of, and fair competition in, global financial markets. Today, there is the potential for significant divergences in rulesets across jurisdictions in such key regulatory areas as bank capital standards, margin requirements and OTC derivatives clearing requirements. Unfortunately, Dodd-Frank regulatory requirements and the United States' implementation of Basel III have in some cases unfairly established regulatory burdens, which tilt against firms operating in the United States, as well as American companies operating businesses globally. The adverse effects of the divergences between these rulesets are further explained in the sections that follow.

A. Bank Capital and Liquidity. The cumulative effects of U.S. implementation of Basel III and other bank capital and liquidity requirements are an oppressive burden on U.S. banks, which hampers their ability to provide capital in the U.S. financial system.[34]

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[31] As discussed below, this position is, however, consistent with recent EU proposals.

[32] The CFTC has not finalized its capital rules yet for swap dealers and major swap participants. The CFTC's most recent proposal can be found at 81 Fed. Reg. 91252 (Dec. 16, 2016), *available at* https://www.gpo.gov/fdsys/pkg/FR-2016-12-16/pdf/2016-29368.pdf.

[33] *See* Exec. Order 13771, Reducing Regulation and Controlling Regulatory Costs, 82 Fed. Reg. 9339 (Jan. 30, 2017), *available at* https://www.federalregister.gov/documents/2017/02/03/2017-02451/reducing-regulation-and-controlling-regulatory-costs.

[34] *See generally* BASEL III IMPLEMENTATION, FEDERALRESERVE.GOV, https://www.federalreserve.gov/bankinforeg/basel/USImplementation.htm (last visited Apr. 24, 2017).

In our view, some significant components of these requirements are inconsistent with the core principle of establishing a level playing field, including: the Fundamental Review of the Trading Book ("**FRTB**"); leverage ratio; Net Stable Funding Ratio ("**NSFR**"); Credit Valuation Adjustment ("**CVA**"); and the treatment of variation margin for cleared OTC derivatives. We provide additional detail on each requirement below.

- *Fundamental Review of the Trading Book.* The FRTB is a finalized Basel III concept,[35] which governs the amount of capital banks would need to hold against the market risk relating to their "trading book" activities. Such activities would include wholesale market intermediation whereby banks provide end-users with access to capital markets. It is important that intermediary activities are not unduly burdened as it would have significant cost implications for end-users, including U.S. commercial business. Therefore, it is crucial that the design and calibration of the FRTB framework are improved to avoid having a disproportionate impact on the availability of products and cost of intermediation. Based on ISDA's studies,[36] the overall capital impact of the FRTB is estimated between 1.5 and 2.4 times the current market risk capital depending on the results of the profit and loss attribution test that will determine banks' ability to use internal models for market risk capital. In addition, the U.S. prudential regulators should monitor the international implementation of the FRTB requirements to ensure a level playing field for firms active in the U.S. markets. As part of the foregoing, U.S. prudential regulators should be especially mindful of the potential for existing laws, like the Collins Amendment,[37] to disproportionally increase FRTB capital requirements on U.S. firms. U.S. prudential regulators should also ensure that the calibration and implementation timeline for the FRTB in the United States is consistent with other jurisdictions. Accordingly, we note that the European Commission has proposed to apply a transitional 35 percent "market risk capital discount" over three years due to concerns that the FRTB could have a potential detrimental impact on the functioning of the EU financial markets.[38]

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[35] Basel Committee on Banking Supervision, Minimum Capital Requirements for Market Risk; Final (Jan. 2017), *available at* https://www.bis.org/bcbs/publ/d352.pdf.

[36] ISDA's study, which was based on data gathered from 21 banks, is *available at* http://www2.isda.org/attachment/ODM0OA==/QIS4%202015%20%20FRTB%20Refresh%20Report_Spotlight__FINAL.pdf; *see also* ISDA, DERIVATIVIEWS: FRTB: ONE PIECE OF THE CAPITAL PUZZLE (Apr. 21, 2016), *available at* https://isda.derivativiews.org/2016/04/21/frtb-one-piece-of-the-capital-puzzle/ (discussing the study ISDA conducted on the impact of the FRTB final rule).

[37] Section 171 of Dodd-Frank, which is commonly referred to as the Collins Amendment, sets a statutory minimum capital floor for depositary institutions, thus requiring banks to calculate FRTB capital requirements in a manner consists with the minimum floor. *See* 12 U.S.C. § 5371.

[38] *See* Article 501b, Regulation of the European Parliament And of the Council, Proposal to Amend Regulation (EU) No 575/2013 As Regards the Leverage Ratio, the Net Stable Funding Ratio, Requirements For Own Funds and Eligible Liabilities, Counterparty Credit Risk, Market Risk, Exposures to Central Counterparties, Exposures to Collective Investment Undertakings, Large Exposures, Reporting And

- *Leverage Ratio.* The Basel III leverage ratio was designed to require banks to hold sufficient capital for its exposures, calculated in a non-risk-based manner. These include exposures associated with on-balance sheet and off-balance sheet OTC derivative transactions: (i) exposure arising from the fair value of the derivative contract; and (ii) potential future derivative exposure. However, banks oftentimes cannot appropriately reduce the exposure level of an OTC derivative transaction to reflect actual economic exposure to the bank. For example, as discussed above, U.S. prudential regulators do not support the recognition of initial margin as an exposure reducing mechanism for client cleared derivatives, despite arguments from U.S. market regulators that the lack of recognition disincentivizes client clearing, a risk reducing practice. This outcome is contrary to a 2009 G20 objective to clear derivatives transactions.[39] This treatment is also inconsistent with recent proposals in the EU, which would provide for recognition of initial margin received from clients for transactions cleared with qualified central counterparties ("**CCPs**"). A similar issue occurs for the treatment of initial margin for non-centrally cleared derivatives. By requiring two-way margin, there will always be a surplus of segregated initial margin relative to default risk. Yet, not recognizing initial margin will cause both parties to record increased, rather than decreased, leverage despite reduced exposure.

- *NSFR.* The U.S. prudential regulators' proposed NSFR rulemaking would implement certain funding requirements on banks (*i.e.*, available capital and liabilities expected to be reliable over 1 year) commensurate with the composition of their assets and off-balance sheet activities.[40] As part of the Basel III framework, the NSFR concept underwent a lengthy public comment period at the international level, where market participants, academics and regulators all participated in numerous meetings, comment periods and collaborations. However, one component of the NSFR—the provision implementing a 20 percent add-on funding requirement on a bank's gross OTC derivatives liabilities—was hastily adopted by the BIS without being subject to public comment or discussion.[41] If implemented, it will result in an additional funding requirement of $377 billion for banks globally, negatively

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Disclosure Requirements And Amending Regulation (EU) No 648/2012, at 271 (Nov. 23, 2016) ("Until [date of application + 3 years], institutions that use the approaches set out in Chapters 1a and 1b, Title IV, Part Three to calculate the own funds requirement for market risks shall multiply their own funds requirements for market risks calculated under these approaches by a factor of 65%.").

[39] *See* G20 Leaders: Pittsburgh Summit, Framework for Strong, Sustainable and Balanced Growth (Sept. 24-25, 2009), *available at* http://g20.org.tr/wp-content/uploads/2014/12/Pittsburgh_Declaration_0.pdf .

[40] *See* Prudential Regulators, Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements; Proposed Rule, 81 Fed. Reg. 35124 (June 1, 2016), *available at* https://www.gpo.gov/fdsys/pkg/FR-2016-06-01/pdf/2016-11505.pdf.

[41] *Id.* at 35155.

impacting markets and derivatives end-users.[42] While the Basel Committee is currently revisiting this measure, U.S. prudential regulators have adopted the BIS's provision in their proposed NSFR. In contrast, the BIS and other jurisdictions (such as the EU) are exploring alternative approaches to better capture future funding risks for OTC derivatives. Moreover, other jurisdictions have proposed different requirements that are better calibrated to capture contingent liquidity risks for OTC derivatives**,** including allowing high quality variation margin to reduce derivative asset amounts. More generally, the EU has adopted a proposal that deviates from the Basel requirements, reflecting the weaknesses in the standard. U.S. prudential regulators should withdraw the proposed rule given that U.S. firms are already subject to duplicative and overlapping requirements, including the Liquidity Coverage Ratio and TLAC that ultimately result in higher costs for end users. Numerous market participants expressed concerns about the proposed NSFR, including the Coalition of Derivatives End-Users, who noted that "costly funding requirements under the proposed NSFR are likely to be passed onto end-users or may force banks to exit such business lines altogether, thereby decreasing liquidity and affecting end-users' access to credit. At the very least, the U.S. should monitor developments on this issue at the international level and in other key jurisdictions and re-propose the U.S. rule only after the Basel Committee has finalized changes to the standard to ensure U.S. firms are not a competitive disadvantage.

- *Credit Valuation Adjustment.* The regulatory CVA capital charge imposed on banks aims to capture the risk of future CVA variability, which results from changes in the risk of default by a bank counterparty.[43] Associated capital costs are typically passed onto banks' derivatives counterparties. It has been observed that the CVA capital charge causes increased costs to domestic commercial businesses that seek to manage their risks through OTC derivatives transactions. These end-users do not utilize OTC derivatives to speculate on markets or otherwise trade these instruments for financial profit. Rather, these end-users employ OTC derivatives to make their business more stable by hedging risks. Indeed, the value of end-user hedging practices has been codified by Congress in several exemptions from clearing and margin requirements for qualifying OTC derivatives transactions. Applying the CVA to these hedging transactions with U.S. commercial end-users undermines

[42] Please *see* Industry Analysis of the 2015 QIS on the Net Stable Funding Ratio for Derivatives. The analysis was based on the July 2015 submissions of 12 G-SIBS and internationally active banks. *See also* ISDA Comment Letter to the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Board of Governors of the Federal Reserve System, Re: Notice of Proposed Rulemaking – Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements, at 2 (Aug. 5, 2016), *available at* http://www2.isda.org/attachment/ODY5NQ==/ISDA%20US%20NPR%20NSFR%20Response%20FINAL%20[050816].pdf.

[43] *See generally* Basel Committee on Banking Supervision, Review of the Credit Valuation Adjustment Risk Framework (July 2015), *available at* http://www.bis.org/bcbs/publ/d325.pdf.

legislative provisions by increasing the costs of prudent risk management. Perhaps more concerning is the current disadvantage that the CVA creates for U.S. commercial business. Currently, the EU has exempted such end-user transactions from their CVA charges, making risk management more affordable and allowing such savings to be reinvested into EU growth and passed onto EU consumers. Burdensome capital charges like the CVA, if passed onto end-users, serve as an impediment to sustainable growth, American job creation and prudent risk management.

- *Treatment of Variation Margin as Settlement for Cleared Derivatives*. The capital rules, including Basel III and prior iterations, have long allowed for legally settled derivative transactions to be treated as having a shorter maturity than collateralized derivatives. This treatment is already applied to futures, but despite industry efforts to legally settle cleared OTC derivatives, U.S. regulators are holding U.S. banks back from applying the same treatment to cleared OTC derivatives. This is unfounded, and creates a competitive disadvantage for U.S. banks, given that in the EU, firms have been explicitly allowed to treat variation margin as settlement at a number of CCPs, significantly easing capital costs associated with OTC derivatives clearing. U.S. banks should similarly be explicitly permitted to re-characterize variation margin as settlement for cleared products where legal and accounting requirements are met. While we note that U.S. regulators have not raised any concerns with this approach, for the sake of regulatory clarity, we believe that U.S. prudential regulators should explicitly permit such treatment as EU regulators have done.

B. Margin. U.S. regulators have taken a stricter approach than all other jurisdictions in implementing several areas of the margin rules for non-cleared derivatives thereby placing U.S. firms at a competitive disadvantage vis-à-vis their non-U.S. competitors. Further, this approach may result in driving business out of U.S. markets as non-U.S. firms may be reluctant to do business with U.S. firms as the transactions between U.S. firms and non-U.S. firms are subject to the more stringent requirements. Accordingly, it is our view that the CFTC's and U.S. prudential regulators' margin rules for non-cleared derivatives are inconsistent with the core principle of establishing a level playing field in the following areas, among others: (i) settlement time; (ii) inter-affiliate transactions; (iii) calculations of initial margin and variation margin; (iv) cross-border application; and (v) application to non-netting counterparties. Each of these areas is discussed in more detail below.[44]

[44] We note that in addition to the areas discussed herein, there are a number of other items that add complexity and operational burdens on firms with little or no offsetting benefit in the context of margin rules for non-cleared OTC derivatives. For example, re-documentation efforts have been particularly burdensome on the resources of smaller counterparties whose transactions are subject to such margin rules for non-cleared OTC derivatives.

- *T+1 Settlement*. U.S. rules require the calculation and settlement of both initial margin and variation margin within one business day ("**T+1**").[45] This requirement is more stringent than in any other jurisdiction and puts U.S. entities at a trading disadvantage with: (i) parties in different time zones, which renders T+1 settlement impractical or impossible; and (ii) smaller counterparties (including U.S. counterparties) that lack the capability to settle on T+1. In particular, the T+1 settlement requirement may be particularly punitive to U.S. entities (*e.g.*, pension funds and other asset managers) that may not have the operational means to transfer certain eligible collateral within that timeframe placing them at a disadvantage when compared to non-U.S. entities that are not subject to the requirements and to larger entities that have the operational capabilities to meet the T+1 requirement.

- *Inter-affiliate Initial Margin*. Inter-affiliate transactions, regardless of their cross-border nature, should be exempted from margin requirements. These inter-affiliate transactions are insulated internally within the corporate structure and do not present systemic risk. Further, there are already existing regulatory safeguards for inter-affiliate transactions and the application of initial margin requirements to these transactions presents commercial obstacles for U.S. entities. CFTC rules currently provide for a general exemption subject to certain conditions, while the U.S. prudential regulators' rules require initial margin collection.[46] The disadvantage to U.S. markets is abundantly clear as non-U.S. jurisdictions provide for either a total exemption from non-cleared OTC derivatives margin requirements for inter-affiliate transactions (*i.e.*, Japan, Canada, Switzerland, Hong Kong, Singapore, and Australia) or offer the ability to qualify for an exemption (*i.e.*, EU).

- *Broad Product Set*. Initial margin and variation margin calculations are determined based on a specific product set defined by each relevant U.S. financial regulator and each foreign regulator. The use of these jurisdiction-specific product sets for initial margin and variation margin calculations forces parties subject to the margin rules of multiple regulators and/or multiple jurisdictions to perform separate calculations in order to use the highest calculation for their margin call to ensure compliance with all applicable regulations. Certain jurisdictions (*e.g.*, Japan and the EU) allow for the inclusion of OTC derivatives products that are out-of-scope or exempted under their regulations to be included in the product set for purposes of the calculation (a "broad product set"). A broad product set approach allows all trades under a netting agreement to be included in the portfolio on which initial margin or variation margin is calculated and reduces the number of

[45] 12 C.F.R. §§ 237.3(c), 237.4(b); 17 C.F.R. §§ 23.152(a), 23.153(a).

[46] CFTC entities with affiliates regulated by the U.S. prudential regulators must also collect initial margin. *See* Prudential Regulators Final Margin Rule, *supra* note 10, at 74845.

calculations that must be made among jurisdictions. The ability to perform a single global calculation would reduce operational complexity as well as the cost of implementation and disputes that may arise from disparate treatment of product sets. While we appreciate that CFTC staff issued No-Action Letter No. 16-71,[47] which allows for the inclusion of security-based swaps in the product set used for margin calculations, the CFTC should adopt this approach through a formal rulemaking instead of relying on less permanent no-action relief. In addition, the CFTC, the SEC and U.S. prudential regulators should explicitly allow for the use of a broad product set for initial margin and variation margin calculations, including products that may not be subject to their non-cleared margin regulations (*e.g.*, equity options).

- *Non-netting Jurisdictions*. In certain jurisdictions, the legal enforceability of netting agreements may not be certain. Accordingly, global regulators implementing margin rules for non-cleared OTC derivatives have addressed how their requirements for non-cleared OTC derivatives should be applied for trades with counterparties in these non-netting jurisdictions. The U.S. margin rules for non-cleared swaps implemented by the CFTC and U.S. prudential regulators require collection of initial and variation margin on a gross basis but permit posting of initial and variation margin on a net basis.[48] Many other jurisdictions instead have either adopted *de minimis* exceptions, which allow parties not to post margin to a counterparty located in a non-netting jurisdiction up to a certain *de minimis* threshold (*e.g.*, the European Union provides an overall cap of 2.5 percent on OTC derivatives business), or have exempted such transactions entirely from initial margin and variation margin requirements (*e.g.*, Japan, Korea, Hong Kong, Singapore, and Australia). U.S. regulators should either exempt transactions against non-netting counterparties from the non-cleared margin requirements or else adopt a similar *de minimis* exemption for such transactions.

- *Cross-Border Requirements*. OTC derivatives transactions between a non-U.S. Covered Swap Entity ("**CSE**")[49] (whether or not guaranteed or affiliated with a U.S. person and whether or not acting through a U.S. branch) and a non-U.S. counterparty (which is not guaranteed by a U.S. person), should not be subject to U.S. margin rules for non-cleared OTC derivatives. If a non-U.S.

[47] CFTC No-Action Letter, RE: Request to Include Security-Based Swaps in Product Set for Initial Margin for Uncleared Swaps (Aug. 23, 2016), *available at* http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/16-71.pdf.

[48] *See* U.S. Commodity Futures Trading Commission, Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements, 81 Fed. Reg. 34818, 34834 (May 31, 2016), *available at* http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2016-12612a.pdf; Prudential Regulators Final Margin Rule, *supra* note 10, at 74867-74869.

[49] A CSE refers to either a swap dealer, security-based swap dealer, major swap participant or major security-based swap participant.

CSE enters into trades with a U.S. counterparty, or a U.S. CSE enters into a swap with a non-U.S. counterparty, substituted compliance should be available to avoid unnecessary and duplicative requirements to comply with multiple rulesets aimed at achieving the same outcomes. Similarly, an OTC derivatives transaction of a non-U.S. CSE should not be subject to additional requirements because it is arranged, negotiated or executed through or by a U.S. branch or personnel at an affiliated U.S. entity. Further, non-U.S. branches of U.S. swap dealers and non-U.S. affiliates of U.S. CSEs are subject to U.S. OTC derivatives regulations that often conflict with non-U.S. laws and regulations. Imposing non-cleared OTC derivatives margin requirements on the non-U.S. branch's or affiliate's transactions with local financial end-users would likely result in those end-users refusing to trade with the non-U.S. branch. The CFTC and U.S. prudential regulators should grant no-action relief or a *de minimis* "emerging markets" exemption from non-cleared OTC derivatives margin requirements to foreign branches and affiliates of U.S. swap dealers located in jurisdictions that have not yet implemented non-cleared OTC derivatives margin requirements. This exemption will allow such non-U.S. branches and affiliates to continue to participate in the local OTC derivatives market and to hedge their own risks by trading in those local markets.

C. Clearing. The 2008 financial crisis revealed significant concerns raised by the interconnectedness and resolvability of the largest financial market participants. Congress sought to address these systemic concerns, in part, by mandating in Dodd-Frank that market participants clear standardized OTC derivatives on CCPs.[50] The United States was not alone in requiring centralized clearing of standardized OTC derivatives. Following an international agreement reached during the G20 meeting in Pittsburgh in 2009, several other jurisdictions have issued, or are in the process of issuing and implementing, similar clearing mandates.[51] It is estimated that more than 87.5 percent of average daily U.S. interest rate derivatives notional volume[52] and as of June 2016, 75% of dealers' outstanding OTC interest rate derivatives contracts were against central counterparties (CCPs).[53] Overall, 62% of the $544 trillion in notional amounts outstanding was centrally cleared.[54] As a result, CCPs play a critical role in the proper functioning and stability of both the U.S. and global financial systems. For that reason, it

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[50] 7 USC § 2(h).

[51] G20 Pittsburgh Summit, Framework for Strong, Sustainable and Balanced Growth (Sept. 24-25, 2009), http://g20.org.tr/wp-content/uploads/2014/12/Pittsburgh_Declaration_0.pdf.

[52] These figures are available on ISDA's website at: www.swapsinfo.org. These figures will also be available in the SwapsInfo First Quarter 2017 Review which should be published and added to our website early next week.

[53] BANK FOR INTERNATIONAL SETTLEMENTS, STATISTICAL RELEASE: OTC DERIVATIVES STATISTICS AT END-JUNE 2016, at 4 (Nov. 2016), *available at* http://www.bis.org/publ/otc_hy1611.pdf.

[54] *Id.*

is important that the regulations impacting OTC derivatives clearing and CCPs (which, if registered or exempt from registration with the CFTC in the United States, are referred to as derivatives clearing organizations ("**DCOs**")): (i) are harmonized internationally; (ii) do not impose undue restrictions on U.S. market participants; and (iii) properly focus on addressing the increased concentration risks posed by the proliferation of centralized clearing. ISDA believes that promoting these objectives would be consistent with the Executive Order's core principle of ensuring a level playing field for American interests. More details on each of these objectives are provided below.

- *Reducing Disparities between the CFTC Clearing Mandate and Foreign Clearing Requirements.* Harmonization is crucial to effective and efficient implementation of all of OTC derivatives reforms, especially centralized clearing. Yet, the CFTC's current clearing requirement differs in entity scope from the clearing mandates in other jurisdictions and is notably broader than clearing mandates in certain APAC jurisdictions.[55] This disparity impairs U.S. market participants' ability to effectively compete in global financial markets. Cross-border transactions subject to the CFTC's jurisdiction should be aligned with non-U.S. requirements. For example, under the Australian, Singapore and Hong Kong OTC derivatives clearing mandates, there are some locally-based market participants (*e.g.*, small financial end-users and pension funds) that are exempted from local OTC derivatives clearing mandates because those counterparties trade OTC derivatives below certain notional thresholds.[56] However, those same market participants would be subject to the U.S. clearing mandate if they were to transact in products subject to the CFTC's clearing mandate with U.S. banks as opposed to non-U.S. banks. These non-U.S. based market participants are generally not yet set up to clear their OTC derivatives and, therefore, will likely seek to trade OTC derivatives with the non-U.S. banks that are not subject to the U.S. clearing mandate. This issue was amplified by the recent expansion of the CFTC's clearing mandate to cover interest rate swaps denominated in non-G4 currencies. ISDA believes that the CFTC should consider whether it would be appropriate to exempt U.S. banks from mandatory clearing when those banks transact certain OTC derivatives with market participants that are not subject to their relevant local clearing mandate.[57] Alternatively, as noted below, we support a full review of

[55] *See* U.S. Commodity Futures Trading Commission, Clearing Requirement Determination Under Section 2(h) of the Commodity Exchange Act for Interest Rate Swaps: Final Rule, 81 Fed. Reg. 71202 (Oct. 14, 2016), *available at* http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2016-23983a.pdf.

[56] *See, e.g.*, Monetary Authority of Singapore, Chapter 289 of the Securities and Futures (Clearing of Derivatives Contracts) Regulations (2015), *available at* http://www.mas.gov.sg/~/media/MAS/News%20and%20Publications/Consultation%20Papers/Annex%20B%20%20Securites%20and%20Futures%20Clearing%20of%20Derivatives%20Contracts%20Regulations.pdf; Australian Securities & Investment Commission, Derivative Transaction Rules (Clearing) 2015 (Dec. 3, 2015), *available at* https://www.legislation.gov.au/Details/F2015L01960.

the scope of entities to which the CFTC's clearing mandate applies to determine whether it would be prudent to shift from asset-size-based thresholds for small institution exemptions to thresholds that are more risk-based. A financial end-user exemption from mandatory clearing based on appropriate risk-based thresholds would address the issues described above for non-U.S. market participants that fall below such thresholds and, at the same time, would address issues faced by U.S. market participants whose derivatives transactions do not pose a risk to the U.S. financial system but are nonetheless subject to the CFTC's existing clearing mandate.[58]

DCO Requirement Unfairly Disadvantages U.S. Participants. Under current CFTC regulations, while U.S. banks are permitted to become clearing members of, and clear OTC derivatives on, CCPs that are registered with the CFTC as DCOs or are expressly exempted from DCO registration by the CFTC, U.S. clients are only permitted to clear OTC derivatives with CCPs that are registered with the CFTC as DCOs.[59] This requirement ultimately prevents U.S. banks from providing liquidity and hedging for clients in non-U.S. markets where local CCPs have obtained a DCO registration exemption from the CFTC instead of registering with the CFTC. ISDA believes that the CFTC should amend its regulations to permit U.S. clients to clear with DCOs that are expressly exempted from registration by the CFTC.

- *CCP Resiliency, Recovery and Resolution*. While CCPs reduce systemic risks in the markets that they serve, CCPs also warehouse or concentrate risks that, if not properly managed in times of significant market volatility, could inflict major financial damage on clearing members, trading venues and other market participants. For these reasons, regulators and policymakers cannot ignore issues related to CCP resiliency during periods of market stress, the development of robust CCP recovery and risk management frameworks, and

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[57] That relief would, for example, specifically exempt U.S. banks when they trade interest rate swaps denominated in Australian dollar, Singaporean dollar and Hong Kong dollar with local non-U.S. counterparties.

[58] ISDA, RESEARCH NOTE: KEY TRENDS IN CLEARING FOR SMALL DERIVATIVES USERS 10 (Oct. 17, 2016), *available at* https://www2.isda.org/functional-areas/research/research-notes/.

[59] *See e.g.*, CFTC Exemptive Order, In the matter of OTC Clearing Hong Kong Limited for Exemption from Registration as a Derivatives Clearing Organization, at 2, *available at* http://www.cftc.gov/idc/groups/public/@otherif/documents/ifdocs/otccleardcoexemptorder12-21-15.pdf (granting a non-U.S. CCP an exemption from registration as a DCO but restricting the CCP from providing its clearing services to clients or customers of U.S. persons); *accord* CFTC Exemptive Order, In the matter of Korex Exchange, Inc. for Exemption from Registration as a Derivatives Clearing Organization, at 2, *available at* http://www.cftc.gov/idc/groups/public/@otherif/documents/ifdocs/krxdcoexemptorder10-26-15.pdf; CFTC Exemptive Order, In the matter of Japan Securities Clearing Corporation for Exemption from Registration as a Derivatives Clearing Organization, at 2, *available at* http://www.cftc.gov/idc/groups/public/@otherif/documents/ifdocs/jsccdcoexemptorder10-26-15.pdf; CFTC Exemptive Order, In the matter of ASX Clear (Futures) Pty Limited for Exemption from Registration as a Derivatives Clearing Organization, at 2, *available at* http://www.cftc.gov/idc/groups/public/@otherif/documents/ifdocs/asxclearfutdcoexemptorder.pdf.

CCP resolution in the event that CCP recovery is unsuccessful or would jeopardize financial stability. ISDA is aware of the inter-agency focus on CCP resilience-, recovery- and resolution-related issues. We look forward to continuing our discussion with U.S. financial regulators regarding the implementation of key guidance expected from the Financial Stability Board and other international bodies on these topics in 2017 as they consider these issues and their impact on the safety and efficiency of U.S. cleared OTC derivatives markets. We also note that appropriate implementation of global standards in these areas is crucial to equivalence determinations for U.S.-based CCPs operating globally.

MAKING REGULATION EFFICIENT, EFFECTIVE, AND APPROPRIATELY TAILORED

The regulatory burdens placed on American companies since the enactment of Dodd-Frank and the implementation of U.S. Basel III bank capital and liquidity standards are significant and often the result of inefficiencies and redundancies in U.S. regulations. There are several areas where these regulations go well beyond the explicit statutory language to provide unnecessarily prescriptive rules. We discuss several examples of this overreach in the sections that follow.

A. Capital and Liquidity Requirements. It is vital that the U.S. prudential regulators perform a comprehensive review of the various new capital and liquidity related requirements to determine their impact on both U.S. financial markets and financial institutions operating in the United States (including related impacts on their customers and impacts on individual business lines). Such a review should look at both those rules that are currently in effect, as well as requirements that have not yet been implemented, and include review of reporting and public disclosure requirements. Further, the review should look across regulatory agencies to address duplication and the impact of such capital and liquidity requirements in the context of other rules. For example, capital and liquidity requirements should take into consideration the impact on margin and clearing requirements or exemptions.

We take some comfort from recent testimony and public remarks by Basel Committee on Banking Supervision officials[60] that indicate significant changes to the proposals to revise the risk capital framework are actively being discussed in order to fulfill the Basel Committee Governors and Heads of Supervision's commitment not to significantly increase overall capital above current levels. In this context, we believe it is particularly important that this commitment not be arbitrarily restricted to a subset of the proposed revisions. Accordingly, all of the changes that the Basel Committee proposes, including

[60] William Coen, Secretary General of the Basel Committee, Panel Discussion at the 2016 Annual Membership Meeting of the Institute of International Finance (Oct. 7, 2016), *available at* http://www.bis.org/speeches/sp161007.htm; William Coen, Secretary General of the Basel Committee, Introductory Remarks before the European Parliament's Committee on Economic and Monetary Affairs (Oct. 12, 2016), *available at* http://www.bis.org/speeches/sp161012.htm.

the FRTB, should be considered by U.S. prudential regulators when they seek to fulfill this commitment.

Lack of clarity regarding whether a bank can use internal models for market risk in the context of the FRTB is an area where a potential lack of risk sensitivity is of particular concern. The standardized approach that would apply absent the ability to use internal models produces capital requirements that are considerably higher, creating an undesirable cliff effect if approval for internal models is not granted or withdrawn. ISDA's analysis shows the increase in market risk capital under the FRTB to be between 1.5 and 2.4 times current capital, depending on the outcome of the profit and loss attribution test, which is the key determinant for whether a bank can use internal models.[61] There is a large gap between internal models and the standard rules that warrant further review of the calibration of the framework to provide to regulators a credible fall back scenario in the event internal models do not meet the new eligibility requirements. Accordingly, it is essential that there is clarity regarding that test, as well as a phased implementation for FRTB in the United States to avoid a severe reduction in the use of internal models, a consequent increase in market risk capital and the further reduction in risk sensitivity, risk management standards and potentially market liquidity.

B. Disparate Treatment of Liquidation Periods for Margin Calculations. One of the key determinants in the calculation of margin for futures and swaps is the "minimum liquidation period." The minimum liquidation period is the estimated amount of time that it would take a counterparty or a DCO (in the case of cleared transactions) to liquidate its derivatives positions with its counterparties or clearing members (on behalf of themselves and their clients), as applicable. Minimum liquidation periods vary by product and the longer the minimum liquidation period is for a product, the greater amount of initial margin that must be collected for that product. The CFTC's margin rules require a one-day liquidation period for all futures contracts, a five-day liquidation period for cleared financial swaps,[62] and a 10-day liquidation time for all uncleared swaps.[63]

In our view, the minimum liquidation periods currently set by the CFTC create clear inefficiencies in the derivatives markets as they arbitrarily make economically equivalent transactions more or less expensive without regard to the liquidity of the underlying instruments. That is, the CFTC's current rules relating to minimum liquidation periods

[61] ISDA's study, which was based on data gathered from 21 banks, is available at http://www2.isda.org/attachment/ODM0OA==/QIS4%202015%20%20FRTB%20Refresh%20Report_Spotlight__FINAL.pdf; *see also* ISDA, DERIVATIVIEWS: FRTB: ONE PIECE OF THE CAPITAL PUZZLE (Apr. 21, 2016), *available at* https://isda.derivativiews.org/2016/04/21/frtb-one-piece-of-the-capital-puzzle/ (discussing the study ISDA conducted on the impact of the FRTB final rule).

[62] *See* Derivatives Clearing Organization General Provisions and Core Principles, 76 Fed. Reg. 69334, 69438 (Nov. 8, 2011) *available at* http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2011-27536a.pdf.

[63] *See* U.S. Commodity Futures Trading Commission, Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants: Final Rule, 81 Fed. Reg. 636, 656-657 (Jan. 6, 2016) *available at* http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2015-32320a.pdf.

are not appropriately tailored to liquidity and should be revised so that estimated minimum liquidation periods for the calculation of margin are based on the true liquidity profile of the underlying instruments, rather than arbitrarily based on the type of transaction (*i.e.*, futures contract, cleared swap, or uncleared swap). While type of transaction certainly affects the liquidity profile, so does the underlying instrument and the specific terms of the product (*e.g.*, optionality and tenor). We maintain that all such criteria should be taken into account when setting margin period of risk ("**MPOR**") for a particular product, which will likely mean that the MPOR for transactions based on the same underlying instruments should have less divergent MPOR than under the CFTC's current rules.

C. U.S. Regulatory Ruleset Divergences. The CFTC, the SEC and U.S. prudential regulators should analyze the appropriateness of divergent margin requirements for cleared versus non-cleared OTC derivatives. In particular, U.S. financial regulators should reexamine the initial margin regime for non-cleared OTC derivatives to ensure that it is appropriately risk-sensitive. Similarly, the CFTC should review the scope of entities to which the clearing mandate applies to determine whether it would be prudent to shift from asset-size-based thresholds for smaller institution exemptions to thresholds that are more risk-based ones.

D. CFTC Regulatory Reform. ISDA supports the CFTC's "Project KISS" initiative and looks forward to participating and providing detailed comments and proposed solutions in the context of that initiative.[64] In particular, ISDA advocates:

- *Standardizing and Simplifying Data and Reporting Requirements*.

  The lack of clarity around the CFTC's data and reporting requirements for swaps places significant burdens on firms seeking to comply with such rules in good faith. The prescriptive nature of the CFTC's reporting rules leads to significant ambiguities and leaves market participants seeking clarity on how certain products or data fields must be reported or maintained in order to comply with the rules. As a result, it is regularly the case that identical data fields are represented in the swap data repository in different ways. Accordingly, this lack of clarity and consistency around data and reporting is not only a problem for market participants, but it also obscures transparency for regulators. Standardizing and simplifying the data and reporting requirements under the CFTC's rules, and more broadly across global jurisdictions, will increase efficiency for market participants and will make the data that is available to regulators more effective and useful in overseeing the markets.

[64] Chairman J. Christopher Giancarlo, U.S. Commodity Futures Trading Commission, Address at the U.S. Chamber of Commerce's 11th Annual Capital Market Summit: Transforming the CFTC, (Mar. 20, 2017), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-21 (noting that the CFTC, in complying with the President's Executive Order is starting "Project KISS," which "stands for 'Keep It Simple Stupid'. . . an agency-wide review of CFTC rules, regulations and practices to make them simpler, less burdensome and less costly.").

- *Making Exchange (Swap Execution Facility) Trading Rules More Efficient and Flexible.*

  The CFTC rules for swap execution facilities ("**SEFs**") contain unnecessary restrictions on swap execution mechanisms. Such restrictions make it difficult to execute less standardized swaps on SEFs and defeat the overall goal of encouraging centralized trading of swaps. Moreover, these restrictive execution mechanisms make it difficult for U.S. regulators to recognize foreign trading rules and allow U.S. traders to execute trades based on their commercial interests and not regulatory requirements.

- *Improving Swap Dealer Registration Process and Business Conduct Rules.*

  It has been nearly four and a half years since the CFTC's requirements that certain entities register as swap dealers and comply with a heightened regulatory regime became effective. During that time, over 102 entities have submitted registration materials to the CFTC and the NFA. Despite the fact that the CFTC treats them as permanently registered, no swap dealer has been permanently registered with the CFTC, labeling them as "provisionally registered" swap dealers. We would urge the CFTC and NFA to remove this uncertainty around the registration status by removing the "provisional" status for such swap dealers to ensure their status accurately reflects compliance with all CFTC requirements.

  Moreover, the NFA and swap dealers have been charged with a challenging task of interpreting numerous complex, conflicting and at times, unworkable regulatory requirements. Many business conduct rules inappropriately transform the nature of the relationship between swap dealers and their counterparties, create confusion regarding their respective responsibilities, and increase compliance costs. The rules include requirements, not mandated by Dodd-Frank, for a swap dealer to "know its counterparty"; protect confidential counterparty information; provide mid-market values; and provide a scenario analysis. In essence, the rules require swap dealers to act as advisors to their counterparties and impose a full range of retail customer protection requirements, whereas the swap markets are almost entirely institutional. In addition, many standards included in the rules are subjective or unclear, or are adopted from industry best practices. By design, best practices presume flexible compliance. Codified best practices subject counterparties to serious legal consequences, such as enforcement actions, private right of actions or rescission actions based on ambiguous legal standards. In addition, the rules require the chief compliance officers to report annually to the Board of Directors and certify compliance to the CFTC under criminal liability.
  Over the course of five years, to ease the compliance burden, the CFTC has issued various no-action letters. However, they are limited in scope and, due to their rushed issuance, may, in some instances, have caused additional

confusion. A better approach is to streamline the regulatory requirements and the registration process to ensure that the regulatory framework addresses the fundamental policy goal of reducing risk in derivatives transactions.

- *Adopting and Implementing a Flexible Outcomes Based Approach For Cross-Border Equivalence and Substituted Compliance Determinations*.

  As discussed more fully above, the CFTC should focus on making substituted compliance determinations and base such determinations on outcomes rather than a line-by-line or rule-by-rule determination. A reasonable outcomes-based approach for cross-border equivalence and substituted compliance determinations will decrease the occurrence of duplicative compliance obligations in multiple jurisdictions.

CONCLUSION

Thank you in advance for your consideration of ISDA's comments. ISDA believes that Treasury's review of U.S. financial regulations is well timed and is a major step towards encouraging U.S. economic growth and the reduction of systemic risks to the U.S. financial system. We hope that this letter marks the beginning of a constructive, ongoing dialogue between the Administration and the OTC derivatives industry.

Please contact me, or Christopher Young, Head of U.S. Public Policy (202-683-9339), if you have any questions or need any additional information relevant to your review of U.S. financial regulations.

Sincerely,

Scott O'Malia
Chief Executive Officer