September 30, 2011

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

Re: RIN No. 3038-AD51 - Notice of Proposed Rulemaking — Clearing Member Risk Management (76 Fed. Reg. 45724)

Dear Mr. Stawick:

The International Swaps and Derivatives Association, Inc. ("ISDA") is writing in response to the Notice of Proposed Rulemaking regarding Clearing Member Risk Management (the "NPR", and the rules it describes, the "Proposed Rule") issued by the Commodity Futures Trading Commission (the "Commission"), seeking comments on proposed rules regarding risk management for cleared trades by futures commission merchants ("FCMs"), swap dealers ("SDs") and major swap participants ("MSPs") that are clearing members.

ISDA, which represents participants in the privately negotiated derivatives industry, is among the world's largest global financial trade associations as measured by number of member firms. ISDA was chartered in 1985 and today has over 800 member institutions from 54 countries on six continents. Our members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the risks inherent in their core economic activities.

Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business through documentation that is the recognized standard throughout the global market, legal opinions that facilitate enforceability of agreements, the development of sound risk management practices, and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

I. Introduction

ISDA supports the Proposed Rule's overarching goal of enhancing risk management safeguards at the clearing member level, whether the clearing members be SDs/MSPs who self-clear only or FCMs. We observe, however, that the Proposed Rules (a) do not take account of the multiple ways that swaps may be executed and access clearing, (b) bear differently on SDs/MSPs than on FCMs, (c) lack sufficient clarity in certain respects and (d) are based on an unrealistic cost analysis.

Our comments below offer a number of recommendations that we believe would address the observations noted above and improve the cost-benefit ratio of the Proposed Rules. In Section II below, we recommend a more flexible formulation of the "order-screening" element of the Proposed Rules. In Section III, we recommend that the elements of the Proposed Rules, as they would apply to SDs and MSPs, be consolidated into the Commission's previously proposed risk management framework for such entities. In Section IV, we suggest supplementing the Proposed Rules as they would apply to FCMs. Section V discusses specific elements of the Proposed Rules for which clarification is needed, and Section VI sets forth our observations on the Commission's cost analysis. Finally, Section VII highlights the importance of the Commission and market participants working together to create a rational implementation schedule.

Clearing members operate in a risk environment that is defined by the trading mechanisms established by swap execution facilities, derivatives clearing organization ("DCO") rules, the risk management framework for SDs and MSPs, customer documentation and clearing members' rights and responsibilities with respect to collateral for cleared swaps. A complete and meaningful assessment of clearing member risk management standards is possible only in the context of complete, published rulemakings in each of these areas and on other materially related matters. Accordingly, we may need to comment further on the matters discussed below in light of future developments in the rulemaking process.

Finally, as the Commission recognizes in its request for comment on the Proposed Rules, DCOs would be required to adopt and enforce rules addressing each clearing member's risk management policies and procedures. We urge the Commission to work with DCOs to ensure that DCO regulations in this area are compatible, and administered in a coordinated manner, with the Proposed Rules.

II. Order-screening and Access to Clearing

Proposed Rules 1.73(a)(2) and 23.609(a)(2) would require clearing members to use automated means to screen orders for compliance with risk-based limits. The examples given in the NPR of the types of limits that could satisfy this requirement, as well as the NPR's reference to the report, "Direct Electronic Access to Markets", issued in August 2010 by the International Organization of Securities Commissioners, indicate that the primary concern underlying these rules is the potential for the rapid and uncontrolled accumulation of the clearing member's financial exposure in an automated, high-speed trading environment. This is a valid concern, yet this type of trading environment is only one of several in which a clearing member may act. In

its "Notice of Proposed Rulemaking: Customer Clearing Documentation and Timing of Acceptance for Clearing," the Commission described three transaction acceptance scenarios[1], each of which may be suitable for a variety of trading environments, and each of which should be reflected within this rulemaking.

Specifically, ISDA recommends that proposed Rule 1.73(a)(2) be replaced with a requirement that the clearing member establish and maintain systems of risk management controls reasonably designed to limit the financial exposure that it could incur as a result of its contractual commitments to accept transactions for clearing, (including the use of automated order-screening procedures for those transactions for which it is providing electronic market access or accepting orders for automated execution). This formulation is better targeted toward the harm at which the rule is directed – namely, the uncontrolled acceptance of positions for clearing, regardless of whether the commitment to clear occurs at the time of execution or later – and recognizes that a variety of clearing models are contemplated, not all of which provide that the conditions for clearing acceptance be met at the time of execution. ISDA believes that this flexibility is appropriate in light of the fluid state of development of OTC clearing processes and the extensive build out that has yet to be done on connectivity between execution platforms and clearing organizations. As discussed in Section III below, ISDA recommends that proposed Rule 23.609(a)(2) be subsumed within proposed Rule 23.600(d) in the manner we describe in footnote 3.

In the event that the Commission decides to adopt the order-screening requirement as originally proposed, it should clarify that clearing members' risk-based limits may include margins of safety to account for the possibility of near-contemporaneous transactions across multiple execution venues and DCOs, as the real-time aggregation and monitoring of such exposures is not technologically feasible given the level of sophistication of the systems currently available to even the largest dealer/FCMs.

III. Application of the Proposed Rule to Clearing SDs and MSPs

The Commission has previously proposed Rule 23.600 (the "Proposed SD/MSP Risk Management Rule"), which requires SDs and MSPs to establish, maintain and enforce certain risk management procedures. Under proposed Rule 23.600, an SD/MSP's risk management program must include policies and procedures to monitor and manage market, credit, liquidity, foreign currency, legal, operational and settlement risk, as well as controls on business trading units.[2] We believe that that the elements of proposed Rule 23.609 are already substantially present in the Proposed SD/MSP Risk Management Rule.

However, to the extent the Commission believes it is desirable to supplement the Proposed SD/MSP Risk Management Rule by prescribing that specific methodologies be utilized, we

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[1] See 76 Fed. Reg. 45730, 45733 (August 1, 2011), which contemplates that acceptance for clearing can occur by any of three means: (i) application of the clearing member's criteria (which presumably would include risk-based limits) at the point of execution, (ii) authorizing a DCO to accept/reject a transaction for clearing on the clearing member's behalf based on criteria supplied by the clearing member, or (iii) trade-by-trade notification from the clearing member to the DCO.

[2] Proposed Rule 23.600(c) and (d). 75 Fed. Reg. 71397, 71405 (November 23, 2010).

suggest that it would be more effective to incorporate these additional elements into the previously proposed rule rather than promulgating Rule 23.609 as a separate rule for SDs and MSPs. For example, the Commission could state that policies and procedures for managing relevant risks must take into account the results of stress testing.[3] This approach has the advantage of putting these methodological elements into the context of an integrated risk management program and eliminating any need for SDs/MSPs to devote resources to the unproductive task of parsing out which elements of their risk management program should be classified and documented under which of the two overlapping rules.

Clauses (5) through (8) of proposed Rule 23.609(a) appear to be related to the management of liquidity and funding risk, and, as currently proposed, do not appear to be meaningful additions to the liquidity risk provisions of Rule 23.600.[4] Clause (8), in particular, requires the SD/MSP to evaluate its ability to liquidate the positions it clears in an orderly manner, and estimate the cost of the liquidation. Requiring the SD/MSP to regularly assess its ability to liquidate all of its house positions may not be a helpful risk assessment given that such liquidations would only be necessary in the event of the clearing member's own default, when the transfer, hedging, auction, or liquidation of such positions would be the responsibility of the clearing house and its risk committee. Mandating regular default management drills by the DCOs, including liquidation of the largest clearing member portfolios, would seem to be a stronger approach to modeling the risk presented by liquidation of house positions.

IV. Application of the Proposed Rule to FCMs

ISDA agrees with the Commission that a regulation addressing risk management safeguards for clearing FCMs is desirable, particularly as some FCMs may not be subject to an express regulatory requirement to implement risk management controls. However, ISDA suggests that proposed Rule 1.73 should be supplemented so that it contains the essential elements of a risk management regime, as set out in ISDA's comment letter on DCO Risk Management Requirements (the "DCO Risk Letter").[5] Specifically, a clearing FCM should be required to

- evaluate its ability to meet potential guarantee fund assessments from the clearinghouses in which it is a member. In our DCO Risk Letter, we suggested that the clearing FCM conduct regular stress tests under 'extreme but plausible' market levels in relation to the potentially

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[3] As another example, clauses (1) to (3) of the proposed Rule 23.609(a) require the clearing member to establish risk-based limits, use automated means to screen orders for compliance with the limits and monitor for adherence to the limits on an intra-day and overnight basis. Proposed Rule 23.600(d) covers substantially the same ground by requiring that SD/MSPs: execute transaction only with counterparties for whom credit limits have been established (clause 2); provide specific quantitative or qualitative limits for traders and personnel able to commit the SD/MSP's capital (clause 3); monitor each trader throughout the trading day to prevent the trader from exceeding any limit, or from otherwise incurring undue risk (clause 4); establish means to detect unauthorized trading activities or any other violation of policies and procedures (clause 6); and ensure that use of algorithmic trading programs is subject to certain policies and procedures (clause 9). The Commission could require that SDs/MSPs make use of automated order screening, to the extent relevant and technologically feasible, as part of the trading controls mandated under this rule.

[4] We provide more detailed comments on these provisions in Section V below.

[5] ISDA Comment Letter on Notice of Proposed Rulemaking: Risk Management Requirements for Derivatives Clearing Organizations, page 4 (March 21, 2011), available at http://www2.isda.org/dodd-frank/.

numerous DCO assessments to which it could become subject and provide the results to the DCOs of which it is a member.

- evaluate its financial and operational capabilities to discharge its duties under DCO rules, including participation in default management procedures. The clearing FCM should not be able to fulfill this requirement by outsourcing default management to unaffiliated third parties. As we explained in our prior comment letter, such outsourcing arrangements may not be sufficiently reliable in times of stress and are inherently prone to conflicts of interest that could disadvantage the clearing member. (Though we believe strongly that shared risk management functions within affiliate groups should be treated the same as entity-specific risk management functions.)

- provide in its organizational structure and policies for board and senior management oversight of the risk management function;

- ensure that the risk management function is independent from the clearing FCM's business units; and

- evaluate the impact of its customer documentation terms on its ability to liquidate positions and comply with DCO requirements.

V. Clarifications

Several elements of the proposed rules require further development and clarification. Unless formulated more precisely, these elements could be subject to varying interpretations, which would create compliance uncertainty and a lack of comparability across market participants.

Stress testing

The Commission should clarify that in selecting customer accounts for stress testing, the FCM may apply its own reasonably designed, risk-based criteria to determine which customers are likely to pose material risks to the FCM. It is important that FCMs have the flexibility to develop methodology that allows them to focus on accounts for which stress testing would yield meaningful risk mitigation benefits, rather than being required to perform tests that will be costly to implement on an overly broad segment of an FCM's customer base.

Ability to meet initial margin requirements

It is unclear what evaluation the clearing member is being required to perform. Initial margin amounts are generally known at the time of each transaction, and the volume of transactions that a clearing member accepts for clearing is constrained by the limits imposed by the clearing member on its customer and proprietary activities.

Ability to meet variation margin requirements in cash

For FCM clearing members, one relevant factor in assessing the FCM's ability to meet variation margin calls will be the FCM's ability to collect from its customers the cash margin that the

FCM has demanded of them in margin calls issued by the FCM. We note that certain categories of customers (such as pension funds) rely on collateral transformation or liquidity facilities for the cash required to meet variation margin. The Commission should specify that the FCM may consider, and should assess, the availability to customers of such facilities in performing this evaluation.

Another relevant factor in performing this evaluation is whether the initial margin collected from customers provides an adequate buffer for possible market movements during the period allowed to customers for satisfying the FCM's variation margin calls. The Commission should specify that FCMs may rely on a DCO's determinations of initial margin adequacy, provided that the FCM must maintain (either on its own or through an affiliated group member) the capability to assess independently the initial margin models used by the DCO.

Ability to liquidate positions and estimates of the cost of liquidation

Estimating the cost of liquidation requires complex judgments regarding market conditions at the time, the actions of other participants, "crowded trades" and other factors about which information may not be available. As a result, such cost estimates are likely to be speculative, and it is unclear how their generation would contribute to better risk management. ISDA suggests that, instead, clearing member be directed to take into account in their risk assessments liquidity measures such as the size of positions relative to average daily trading volume or open interest.

Testing all lines of credit

The reference to "lines of credit" is unclear. Presumably, the proposed rule is referring to the clearing member's funding sources rather than the credit risk limits assigned to the clearing member's counterparties. If that is the intent, then the clause should be rephrased as a requirement to assess the availability of the clearing member's funding sources. The Commission should also clarify that "testing" does not require the clearing member to actually draw funding, but entails assessments such as whether any conditions precedent to drawing funding are currently satisfied.

VI. Cost-Benefit Analysis

As stated at the outset, ISDA is a proponent of strong risk management. This does not mean, however, that the true cost of strong risk management should not be known and revealed. The cost-benefit analysis contained in the NPR is deficient in many respects. For example, the analysis understates the complexity and time intensiveness of certain of the activities, such as by suggesting that weekly liquidation testing of customer portfolios can be accomplished in 2 hours per week, or that FCMs will on average spend 16 hours per year drafting and updating written policies and procedures to ensure compliance, and 4 hours per year maintaining records of compliance.[6] We understand that liquidation testing for a large clearing member's default takes a matter of days, not hours. The time required for testing a customer portfolio, although likely to be less, will depend on the size and complexity of the portfolio. We believe that the

[6] 76 Fed. Reg. at 45727.

Commission's assumptions regarding the time required for liquidation testing, as well as for documentation and recordkeeping, substantially understate the actual requirements.

The derivatives industry and the Commission (and the Securities Exchange Commission, as well) need to come to a common understanding of what the real costs are for moving the derivatives market to clearing. This understanding will properly illuminate every aspect of the regulatory and business decisions that must come in the near term. We hope the Commission will give more thought to this, both in the instant rulemaking and with respect to the aggregation of swaps rules now in process.

VII. <u>Implementation Timing</u>

The question of adequate assessment of costs necessarily raises the related question of the time required to implement the change from an over-the-counter market to a cleared market. As we have noted in other comment letters, it is important to both regulator and regulated that sufficient time be provided to allow a smooth transition. We believe it is of the utmost importance that the Commission and market participants work together to create, well in advance of implementation, a rational schedule that will serve both regulatory goals and market stability.

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ISDA looks forward to working with the Commission as you continue the rulemaking process. Please feel free to contact me or my staff at your convenience.

Sincerely,

Robert Pickel
Executive Vice Chairman