ISDA®

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SIFMA®
Securities Industry and
Financial Markets Association

LIBA
LONDON INVESTMENT
BANKING ASSOCIATION

Monday, 31st August, 2009

Dear Sir/Madam,

Please find below the response of the three associations mentioned above.

Yours faithfully,

Richard Metcalfe, Head of Policy, ISDA

John Serocold, Director, LIBA

Bertrand Huet, Managing Director, EU Legal & Regulatory Counsel, SIFMA

ISDA represents participants in the privately negotiated derivatives industry and is among the world's largest global financial trade associations, measured by number of member firms. Chartered in 1985, it has over 830 member institutions from 58 countries. Members include the world's major institutions that deal in privately negotiated derivatives, as well as many businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Since its inception, ISDA has pioneered efforts to identify and reduce risk in the derivatives and risk management business. Among its most notable accomplishments are: developing the ISDA Master Agreement; publishing a wide range of documentation materials covering a variety of transaction types; producing legal opinions on the enforceability of netting and collateral arrangements; securing recognition of the risk-reducing effects of netting in determining capital requirements; promoting sound risk management practices; and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives. www.isda.org

The Securities Industry and Financial Markets Association brings together the shared interests of more than 600 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. **SIFMA** works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. www.sifma.org

LIBA is the principal trade association in the United Kingdom for firms which are active in the investment banking and securities industry. The Association represents its members on both domestic and international aspects of this business, and promotes their views to the authorities in the United Kingdom, the European Union, and elsewhere. www.liba.org.uk

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EXECUTIVE SUMMARY

General

Although the OTC markets have proved resilient, remained open and functioned effectively throughout the financial market turmoil since mid-2007, we recognise that further improvements in market infrastructure should continue to be made.

Despite much of the regulatory and political focus on OTC derivatives focusing on credit default swaps, it is crucial to recognise that other more mature asset classes have a long-standing history of market participants and regulators working together to develop infrastructure to mitigate trading, settlement and default risks. We encourage the European Commission to recognise that robust market infrastructure takes time to build and that hasty solutions that are imposed could be counterproductive. We stress the need for staggered, thoughtful implementation time frames, some of which may differ by product and will require a longer lead time.

We welcome the fact that the European Commission fully recognise that credit default swaps (CDS), interest rate swaps (IRS), foreign exchange (FX), equity and commodity derivative markets are very different in nature and design and that different approaches are required for each asset class. The risks faced by each OTC market are very different and markets have built infrastructure to mitigate the various risks relevant to their product and markets. This has differed substantially across each market:

- **Credit default swaps:** Worked with a range of CCPs to clear standardised OTC products to reduce counterparty risk. DTCC DerivSERV confirmation matching and trade information warehouse supports credit events and central settlement. Effective compression processes have been established to reduce and eliminate economically redundant trades.
- **Interest rate swaps:** Has been clearing bespoke interdealer trades through SwapClear at LCH.Clearnet since 1999 and has built Markit Wire T+0 confirmation platform.
- **Foreign exchange:** The biggest risk is non-delivery risk. The industry began using CLS in 2002 to match payments and settle trades.
- **Commodities:** Products have the potential to be particularly bespoke. Contracts whose underlyings are highly liquid have in general migrated to a cleared model.
- **Equity derivatives:** A significant portion of contracts, as well as standard listed derivatives, are already subject to clearing.

We strongly encourage the European Commission to coordinate closely with authorities in the US and Asia to: ensure similar and appropriate regulatory requirements; harmonise reporting and data requirements; set global standards for domestic infrastructure solutions for global markets; work together to develop infrastructures that are financially and technologically strong, in order to reduce systemic risk.

The Commission Staff Working Paper raises a number of areas for improvements that could be made to the OTC market infrastructure. We strongly support the following improvements, listed below:

Interest Rate Swaps

- Extend the scope of products cleared in terms of currencies included and maturity, basis trades and cross-currency trades
- Extend direct participation in SwapClear, while respecting stringent membership criteria to ensure robustness in member default
- Offer clearing services to clients of General Clearing members
- Continue to expand the use of electronic matching and confirmation
- Continue to develop and use compression processes to eliminate economically redundant trades

- Build out a trade repository, equally accessible by relevant supervisors globally

Foreign Exchange
Broaden CLS uptake by expanding the:
- Set of currencies covered
- Range of participants that can connect to CLS
- Settlement cycle

Equities
- Encourage uniformity of contractual product documentation across EU countries
- Encourage consistent treatment of corporate actions by different European derivative exchanges
- Increase electronic matching and confirmation
- Strengthening bilateral clearing arrangements

Credit Default Swaps
- Extend the scope of products cleared
- Extend direct participation in CCPs
- Offer clearing services to clients of General Clearing Members
- Encourage the continued roll out of electronic matching and processing for CDS product types, as appropriate, with a focus on trade data matching as industry best practice
- Continue to develop and utilise compression processes to eliminate economically redundant trades
- Increased utilisation of central settlement
- Implement universal registration of all trades in central repositories as industry best practice
- Implement a solution to ensure efficiency in novation consent

Summary of key messages from our response

Standardisation

Standardisation is not a prerequisite for delivering the systemic and operational risk improvements sought by regulators. We are generally in favour of standardisation of process and legal and documentation uniformity and support uniformity of practices that reduce systemic risk (e.g., collateral and margin procedures) and / or that reduce operational risk (e.g., electronic trade confirmation process).

Initiatives that would seek to standardise the terms of all OTC contracts are counterproductive. Such initiatives can lead to ineffective hedging and incomplete transfer of risk, leaving end users with unwanted and unmanageable basis, ie, a mismatch between the specific risks they face and non-specific, generic instruments that would be available in the market.

We believe that the regulatory focus should therefore be on process uniformity, legal uniformity and standardisation of documentation; not product uniformity. Non standardised products are not inherently more risky than plain vanilla products.

Exchange trading is not required in order to achieve standardisation of process and legal or documentation uniformity. It does not insulate from risk or reduce losses in challenging market environments and thus should not be a goal.

Eligibility of contracts for clearing

Central Clearing Houses (CCP's) mutualise risk amongst their members. It is these members that put collateral in place and who are at risk in the process that underpins the functioning of the CCP and it is therefore reasonable for the members to have significant influence in determining which products are eligible for clearing by the CCP.

The eligibility of individual contracts should be determined by the relevant CCP's risk committee that oversees the overall soundness of the CCP's risk management process. The risk committee should consider the key characteristics of the product class in question, the capability of the CCP, and the ability of major market participants to support the default process. The process should ensure that no new products are added without the appropriate risk management testing and scenario analysis.

We support the clearing of eligible interdealer trades, while stressing that, as outlined above, CCP clearing is not possible for certain bespoke products. Market participants should partner with global regulators to set appropriate benchmarks, metrics and reporting to track individual institution and industry clearing performance.

Non-eligible contracts should be subject to operational best practices, with high levels of electronic trade processing, lifecycle management and appropriate levels of transparency applied to them where appropriate, even if they are not centrally cleared and remain collateralized bilaterally.

Regulatory capital incentives

The recently completed Basel II reform package forms an important part of the newly proposed amendments to the Capital Requirements Directive (CRD) and will result in significantly higher regulatory capital requirements for trading activities in the European Union (EU). This will not only considerably strengthen the resilience of the EU financial system, but these higher capital charges will also increase the significance of the existing incentives in the CRD to centrally clear OTC trades.

We do not support further / new penalties for contracts that are not cleared. There are benefits from having CCPs in OTC derivatives markets but valid reasons exist for why certain trades are not cleared. The existing capital charge benefit is already a significant incentive to use a central clearinghouse.

We do *not* support mandatory clearing.

Central data repository

We are supportive of efforts to build data repositories across the major OTC asset classes, with appropriate prioritisation, and full disclosure to regulators. However, the processes of collecting such data should be well considered and should not lead to additional efforts for the institutions having to provide such data on the one hand and the regulators having to efficiently use such data. Hence, there should only be one data repository for each asset class.

At the same time, it is crucial to avoid fragmentation of repositories, to ensure effectiveness in aggregating exposures.

The primary purpose of the data repository is to provide transparency on market activity to regulators. Access to data repositories should be granted to all relevant financial supervisory bodies on the same terms. Access to the data and the right to publish the data should be strictly governed, to ensure that only appropriate, aggregate data is released to the market and general public.

Repositories are in principle relevant for all asset classes; though, it is critical that their usage does not curtail the flow of new products to the market, does not violate any local regulatory or reporting restrictions, and fully respects the global basis on which these products trade.

Central clearing houses

CCPs need to demonstrate an exceptional level of financial and operational robustness (particularly via default management) and to price their services at rates that are economically viable. CCPs should work to ensure that key costs of clearing are minimised without compromising on risk management standards and financial robustness.

A CCP that does not demonstrate an exceptional level of financial robustness, could pose a great risk to the financial system and so care must be taken in order to develop fundamentally sound platforms and services, or in the addition of new products for clearing.

The EU along with other jurisdictions, such as the US, should recognise that CCPs do not necessarily have to be located within the EU or the US in order to provide effective counterparty risk reduction.

All regulators should continue to insist on high quality standards and stability for any CCP such that the market can be sure that any CCP operator is a strong and capable counterparty and that risk management is not compromised.

There should not be any possible regulatory arbitrage between CCPs operating in one jurisdiction versus another. CCPs should compete on commercial and service terms, without compromising on risk management standards and financial robustness. Regulation should define minimum standards for CCPs particularly with respect to margin processes so that CCPs cannot compete on the quality or amount of margin for cleared positions

We support the recommendations on CCPs by ESCB/CESR and would support their adherence in order to establish an EU legal framework for CCPs.

To fully exploit the risk mitigation possibilities and prevent an excessive burden to the industry, there should only be a limited number of CCPs for each asset class where clearing represents a risk. This is particularly important (on cost grounds) for smaller market participants.

While certain contracts may be eligible or made eligible, there are asset classes in which clearing does not alleviate meaningful risk, especially in the FX market, where it is settlement risk that is more pronounced.

Transparency and efficient trading venues

We fully support trading of OTC derivatives via transparent and efficient trading channels. However, market participants have valid reasons for choosing one trading channel over others. The needs of market participants change over time and as a consequence so may the choice of trading channel.

Forced migration could be counterproductive as liquidity could be reduced as market participants, who find they encounter execution risk, pull back from utilizing them.

The purpose of trade transparency is for assisting the price discovery process in all financial markets. As MiFID’s post trade transparency regime for cash equities demonstrates, mandatory transparency can damage market liquidity, especially for large trades. Therefore it is important that, in order to minimize the risk of losing market liquidity, transparency measures have to be tailored to meet the needs of each individual OTC market and to be meet the needs of market participants.

A significant amount of transparency in OTC markets, which are by definition inter-professional, currently exists for market participants.

Collateral

We support the collateralisation of all mark-to-market risk on all interdealer OTC derivatives trades.

Focus should also be placed on the quality of collateral posted and how quickly that collateral can be liquidated in a counterparty-default scenario.

We support initiatives to enhance dealers' internal Collateral Departments in order to improve their abilities and create efficiencies in frequent collateral reconciliations and dispute resolutions. We also support the continued automation and roll out of daily inter-dealer portfolio reconciliation, with the continued implementation of benchmarks, metrics and reporting to measure individual institution and industry performance.

Although considerable progress has been made over the last few years to harmonise the close-out netting and collateral regimes across Europe, significant areas of legal uncertainty remain. Further legislation to address these uncertainties would be beneficial, specifically harmonising close-out netting and collateral arrangements across the EU.

There are many users of privately negotiated derivatives for whom the posting of collateral is neither practical nor desirable, such as European sovereign debt management agencies, supra-nationals and certain corporates. Large corporate clients need tailor-made solutions as they often do not have collateral management systems and provide collateral by other means such as guarantees, cash deposits and the like.

Daily exchanges of collateral for many counterparties would be operationally challenging, while less frequent postings still provide meaningful risk reduction.

There are certain markets for which daily counterparty risk is not the biggest systemic risk, for example in FX where the major risk is settlement as FX trades are mainly short-dated.

Trade Compression

Trade compression is a valuable tool.

Successful trade compression requires the following: the products must be plain vanilla, a system must exist which can compress all the relevant trades, and all participating market participants must have access to that system. Each market participant must also be comfortable facing every other market participant.

DETAILED RESPONSE

1. What would be a valid reason not to use electronic means as a tool for contracts standardisation?

It is important to clearly define and clarify 'standardised' as a prerequisite. Standardised can refer to:

- **Product uniformity:** standard valuation, payment structures, dates
- **Legal uniformity**: standard (e.g. ISDA) legal relationships
- **Process uniformity / automation**: STP matching, confirmation, settlement, event handling

In general we are in favour of process and legal uniformity. We support uniformity of practices that reduce systemic risk (e.g., collateral and margin procedures) and / or that reduce operational risk (e.g., electronic trade confirmation process). We also support uniformity of product documentation wherever possible, and of computerized organisation of data (via the FpML language developed by industry).

Uniformity of process can however have negative implications if it stifles competition (leading to monopolistic behaviour) or if it creates single points of failure, which would potentially increase systemic risk. In this respect, it is preferable that market infrastructure providers operate as utilities or quasi-utilities.

However, for certain counterparties (governments, corporations, and commodities producers / consumers) building the infrastructure to support a more electronic trade cycle would be burdensome and undesirable. The burden will be disproportionately greater for smaller or more infrequent end users / market participants.

Electronic confirmation will not always be suitable for low volume or heavily tailored bespoke products. Requiring mandatory electronic trading and processing may have a negative impact on the availability of these products, reducing market participants' ability to hedge.

Product uniformity is not beneficial where clients have bespoke risks and need bespoke products to hedge these. We believe initiatives that seek to standardise the terms of all OTC contracts are counterproductive. Such initiatives can lead to ineffective hedging and incomplete transfer of risk, leaving end users with basis risks they do not want and cannot manage effectively.

We therefore believe that focus of these questions should therefore be on process uniformity and legal uniformity, not product uniformity. Hence in the context of these questions, 'standardised' does not, by itself, imply that a trade is clearable. Additional essential conditions for clearing (although by no means exhaustive) are: eligibility of counterparty membership to CCP; an acceptable risk model and CCP ability to calculate / handle cash-flows; liquid markets to ensure ability to novate trades in event of default and for valuation.

2. Should contracts standardisation be measured by the level of process automation? What other indicators can be used?

We believe that the industry should generally strive for process uniformity rather than product contract uniformity. Indicators that could be used are:

- Automation of cash-flow generation and settlement
- Electronic affirmation or confirmation at T+0
- Electronic management / processing of lifecycle events
- Broadly accepted standard market methodologies for valuation
- Availability of clearing – though we underline again, further to the answer to Q1, that clearing does not necessarily imply standardisation, or vice-versa

- Availability of liquidity during severe market dislocation (which is important for the purposes of valuation and default management), measured on a volume or notional basis
- Legal certainty and uniformity of contractual terms and documentation (ISDA Master Agreement/Credit Support Annex/Master Confirmation Agreements, and sets of 'Definitions')

3. Should non-standardised contracts face higher capital charges for operations risk?

A framework already exists for assessing (a) loss, and (b) the appropriate level of capital charges associated with operational risk. We therefore believe that the right incentive model already exists. If there is empirical evidence to prove that exotic trades operationally have experienced a higher number of problems then the current framework should be recalibrated.

Under the Advanced Measurement Approach, firms reflect loss experience (both their own and that of the industry more generally) arising from operational failures. Under The Standardised Approach, there is effectively a charge for OTC contracts, via the 18 percent charge on revenue on trading activities. This was calculated by looking at operational failure data for the industry.

Under Pillar 2 of the Basel II and the CRD framework supervisors already have adequate powers to impose additional capital requirements on outliers that run significant additional operational risk as a result of the risk profile of their activities.

We strongly support global harmonisation of regulatory capital charges, due to the global nature of derivatives markets.

4. What other incentives toward standardisation could be used, especially for non-credit institutions?

We believe that the operational benefits of automation are considerable and firms are committed, for products where liquidity and volume is sufficient, to continue to develop automated trade-processing capabilities. Thus, we would welcome additional international regulatory collaboration to ensure all jurisdictions support electronic matching of OTC Derivative contracts.

Exchange trading, which is often mistakenly assumed to be the only means of achieving process and legal and documentation uniformity, does not insulate or reduce losses in challenging market environments. Further there may be a risk (to product diversity) associated with having trading in an asset class concentrated in a few exchange-traded contracts and steps to mandate exchange trading would be a retrograde step for the efficiency and competitive gains arising from MiFID.

5. How could the coverage of collateralised credit exposures be improved?

In principle we support the collateralisation of mark-to-market risk for all interdealer OTC derivatives trades. Focus should also be placed on the quality of collateral posted and how quickly that collateral can be liquidated in a counterparty default scenario.

We would also support initiatives to enhance market participant's internal Collateral Departments to improve their abilities and efficiencies in frequent collateral reconciliations and dispute resolutions. Although considerable progress has been made over the last few years to harmonise the close-out netting and collateral regimes across

Europe, significant areas of legal uncertainty remain. Further legislation to improve the certainty of timely enforceability would be beneficial.

We support the continued automation and roll out of daily inter-dealer portfolio reconciliation, with the continued implementation of benchmarks, metrics and reporting to measure individual institution and industry performance.

It is important to note that the tightening of the large exposures requirements in respect of inter-bank exposures in the CRD will also encourage further use of collateral.

We believe it is important to assess the true levels of collateralisation and to compare that with the level of risk actually incurred.

In physical commodities markets, lines of credit, parent company guarantees and pre-payment may, among other methods replace collateralisation.

Interdealer

The levels of collateral in the interdealer segment are much higher than crude market averages and as such, mitigate systemic risk in the financial system. Supplementary data gathered by ISDA from 13 major firms[1] as of July 2009 show that, on average, among these systemic firms collateralisation by means of Credit Support Annex (CSA) runs at 83%, with even higher levels (ie, 91%) applying in credit derivatives, where the counterparty risk profile can be more significant[2].

There are other means of mitigating counterparty exposure, ie other than collateralisation under a CSA (which is all that the ISDA Margin Survey measures). Any analysis of collateralised credit exposures should examine counterparty risk management by:

- Examining the true exposures after bilateral close-out netting (which are $5 trillion[3], taking into account the 85+% reduction in counterparty exposures that netting affords)
- Analysing the distribution of collateral posted under CSAs, noting the emphasis on its deployment in systemic relationships.
- Considering the wide variety of other techniques and factors available, including seniority of claims, letters of credit, parent/other guarantees, use of credit derivatives, forms of eligible collateral other than financial assets (eg, property/real estate), as well as termination rights, limits and diversification.

Client

There are many users of privately negotiated derivatives for whom the posting of collateral is neither practical nor desirable:

- European sovereign debt management agencies or supra-nationals that deem themselves more creditworthy than the dealers and therefore more creditworthy than the banks and therefore do not feel any need to collateralise a position;
- Corporates, for whom this could cause liquidity or working capital contractions.

More generally it is not clear why authorized firms should in effect be forbidden from extending credit to counterparties, as this is conceptually no different from their core credit-risk business. Imposing mandatory

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[1] Bank of America, Barclays, Credit Suisse, Citibank, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan, Morgan Stanley, RBS, Société Générale , Wachovia and UBS.

[2] In both cases, the median figures are higher than the average, showing that more of the market is more highly collateralized than the average

[3] BIS figure. The gross notional amounts in derivatives are not a measure of risk or of exposure, which arises only if -- and only to the extent that – the price of the underlying assets changes. Confusion on this point creates an unnecessary atmosphere of fear.
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collateral amounts to a restriction of this ability to extend credit. At the same time, powerful incentives exist (in the form of capital relief) to mitigate credit risk and industry clearly responds to such incentives

Increasing the overall level of collateralisation of bilateral exposures will become less of an issue as CCPs begin to clear large amounts of new trading volumes. As new, increasingly-collateralised business replaces old positions the proportion of trades outstanding that are collateralized will naturally increase.

6. Are there markets where daily valuation, exchange of collateral and portfolio reconciliation cannot be the goal? Please justify.

Valuations should be exchanged on a daily basis as part of the collateralisation process where possible and appropriate. In-house practices and procedures for the timing of mark-to-market fixes vary across institutions, given the 24-hour nature of these markets. The largest dealers in OTC derivatives markets, plus a number of leading buy-side firms have made a number of commitments to regulators addressing these goals for OTC equities, CDS and interest rate derivatives.

The exchange of collateral and mark to market reconciliation should be viewed as market best practice across all asset classes. However, practically there may be situations where, due to product complexity or type of counterparty they can prove difficult. These counterparties include (but are not limited to): European supra-nationals, corporates and commodities producers. Reducing daily counterparty risk for these entities would come at the expense of increasing liquidity risk and operational burden. On the other hand, requiring such major investment in technological infrastructure by these participants would be disproportionate and prohibitive, given the nature of their participation in OTC derivative markets.

There are also a number of bespoke structured trades that are typically collateralised on the issue date and do not therefore require daily margining and the subsequent exchange of collateral. Daily exchanges of collateral in certain markets such as commodities would be operationally challenging and would not necessary achieve improvements in risk management. For example in commodities the physical exchange of assets while possible to value on a daily basis, operationally cannot be exchanged within the same time fame.

There are certain markets for which daily counterparty risk is not the biggest systemic risk, for example in FX it is settlement risk, which is already addressed under the CRD.

Daily portfolio reconciliation can prove difficult for very large portfolios, even for the more sophisticated interdealer segment. Whilst precise reconciliation is not always possible, reconciliation to within acceptable levels of discrepancy should be targeted. For large portfolios, central repositories can obviate term disputes, via electronic confirmations reducing.

As noted in the response to Question 5, there are other methods in the physical commodities market for reduction counterparty risk. Annex 1 contains more details on what ISDA is undertaking on collateral management.

ISDA has commissioned a feasibility study concerning deployment of more frequent portfolio reconciliation by different types of market participant, which will be completed in October 2009.

7. How frequently should multilateral netting be used?

We understand this question as referring to trade compression. To successfully implement trade compression there are various considerations that must be made:

- The products must be plain vanilla and uniform
- A system must exist which can compress all the relevant trades, and all participating dealers must have access to that system; and

- Each market participant must be comfortable facing every other market participant

The industry has made great strides recently to reduce the amount of outstanding CDS in the market, running as many as 12 multi-lateral trade compressions per week. In the interest rate derivative space, TriOptima has been used for a number of years to compress trade portfolios. A regular schedule for compression in interest rates is now established and broadly accepted. In addition the netting technology of the CCPs themselves will be used to reduce notional at the clearing level. In addition to multi-lateral trade compression, the vast majority of major market participants participate in regular bilateral compression cycles.

In the FX market, as the Commission notes, CLS already provides a highly efficient mechanism for value date payment netting, and is currently developing a new mechanism for trade date transaction aggregation. The relatively simple nature of many FX products obviates any need for additional trade compression mechanisms of the kind deployed in other OTC markets.

Despite the benefits of trade compression, it should not be mandated through exchange trading or product uniformity that does not naturally occur through market forces. Given the complexity of the contracts, compression is extremely challenging in bespoke OTC contracts and in physical commodities markets

8. Should bilateral collateral management be left to the self-regulatory initiatives or does it need to be incentivised by appropriate legislative instruments?

Basel II and the EU's CRD provide an extensive framework and provide strong incentives for the receipt of collateral as an effective credit risk mitigant tool in risk management and regulatory capital calculations in both Pillar I and Pillar II.

In designing the Basel II credit risk mitigation framework, the Basel Committee pursued three objectives: improve the incentives for banks to manage credit risk in a prudent and effective manner; provide a range of approaches for recognising credit risk mitigation that may be applied by a wide range of banks; and relate the capital treatment to the economic effects of different credit risk mitigation techniques. Basel II / CRD include extensive lists of eligible financial collateral and unfunded protection providers and strict operational requirements for the recognition of collateral, credit derivatives and guarantees. The capital incentives are crucial and they form a necessary and effective regulatory tool for encouraging the widespread use of collateral in the OTC markets and also for facilitating the necessary regulatory oversight of the collateral management process.

In order to reflect the benefits of collateral in risk and regulatory capital calculations under the CRD, banks are required: to conduct extensive legal reviews of the necessary documentation; ensure collateral is binding on all parties and legally enforceable in all relevant jurisdictions; consider the correlation risks between obligor risk and collateral risk, consider currency and maturity mismatches between the exposure and the collateral; and among other things (e.g. conservative valuations, and adequate systems to requesting and receiving collateral), fully consider the time it would take to realize collateral values and the potential for a decline in collateral value over this period.

Therefore there is already every incentive for market participants to request collateralisation from their counterparties wherever possible as it reduces exposures (and so attracts a smaller credit charge) and is funding efficient. The largest market participants have already committed to improve collateralisation practices and, inter alia, are actively working on improving dispute resolution. Therefore it should be left to self-regulatory initiatives to increase collateralisation of positions. There is no need to provide greater incentive from new legislation.

We believe that bilateral collateralisation, for systemically important parts of the market, has the potential to achieve equivalent resilience outcomes to central clearing when applied in an automated and daily basis – and therefore should not be subject to differential capital treatment in the future.

9. Are there market segments for which a central data repository is not necessary or desirable?

Repositories are in principle relevant for all asset classes; though, it is critical that their usage does not curtail the flow of new products to the market and fully respects the global basis on which these products trade. In practice, it may be important to prioritise among asset classes, focusing primarily on those with the highest proportion of exposures and systemically important firms.

We are supportive of efforts to build data repositories across the major OTC asset classes with full disclosure to regulators. DTCC DerivServ, with its 'Gold' and 'Bronze' records, provides a helpful precedent (although the DTCC CDS warehouse includes extensive functionality which is not relevant for other asset classes). One should recognise that some product areas/sub areas are a long way from the required process standardisation. It is also important regulatory authorities co-ordinate their approach, as multiple e-trade repositories for each asset class increase the risk of data duplication, fragmentation or omission and increases the risk that regulators do not get a clear and unambiguous picture of the market. Multiple repositories within the same asset class can in addition lead to unnecessary administrative costs for the industry.

The primary purpose of the trade repository as providing transparency to regulators on the market activity in each asset class, rather than to manage lifecycle events or become the central 'golden source'. Where lifecycle event management is a significant issue - primarily within the CDS markets - then the additional functionality provided by a full warehouse is of benefit. For other asset classes, including FX and interest rate derivatives, the additional overhead (implied by lifecycle event management services) is not justified.

10. Which regulatory requirements should central data repositories be subject to?

The regulatory requirements should be an internationally agreed upon standard, which allows for reasonable supervisory oversight and access to data, where the regulator guarantees strict protocols and controls with respect to protection of the confidentiality and IT security of the data being disclosed. One practical example of why this matters is in the FX market, where the central banks will be in a potentially conflicted position if they have access to commercial banks' entire positions in their sovereign currency.

Access to data repositories should be granted to all relevant major financial regulatory bodies on the same terms. Once data is reported to the repository it should provide all the relevant data straight to the relevant regulators.

11. What information should be disclosed to the public?

As mentioned above, the purpose of these repositories is to provide full transparency to regulators. Only aggregated industry-level data can be disclosed to the public. The public should not have access to any counterparty specific information, as this increases the execution risk to market participants (whose capital is exposed via such transactions) and introduces major client confidentiality issues.

12. Do you agree that the eligibility of contracts should be left to the CCPs? Which governance arrangement might be necessary for this decision to be left to the CCPs' risk committees?

The desire/ability of CCPs to accept contracts for clearing is a necessary condition. However it is important to recognize that CCPs mutualise risk amongst members and it is these members that put collateral in place and who are at risk in the process that underpins the functioning of the CCP. As such the determination of eligibility should not be left to the CCPs alone. New product extension should not be a purely consultative process between the CCP's clearing members and the CCP. Members should be fully involved in the decision to clear products, as they need to be satisfied that the risks can and will be managed appropriately.

Eligibility of individual contracts should be determined by the CCP's risk committee who oversee the overall soundness of the CCP's risk management process. They should consider the key characteristics of the product class in question, the capability of the CCP, and the ability of major market participants to support the default process. The success or failure of a CCP is determined through its ability to handle a member default; itself a function of the level of margin accumulated and the ability to move risk from the defaulting member to the non-defaulting members, while minimizing slippage in the portfolio value. It should be ensured that no new products are added without the appropriate risk management testing. CCP should work in conjunction with clearing members when testing the process to guarantee that clearing members can fulfill their obligation in default situations.

Most CCPs are not market utilities; they are subsidiaries of commercial for-profit entities (e.g. publicly listed exchanges), who are not willing to cede the level of control to a risk committee that members may deem desirable for the wider market. Such CCPs are driven by revenue and commercial drivers, which are not obviously aligned with the core purpose of a CCP, namely risk reduction.

Risk governance of CCPs becomes more important as they increasingly have a more prominent role in the market. With this comes greater potential for an increase in systemic risk. The potential for systemic risk is another reason for appropriately considering the suitability of products for clearing. Risk committees should be responsible for reviewing and determining required margin levels and reviewing results of the stress testing of portfolios on a regular basis.

13. What additional benefits should the CCP provide to secure a broader use of its services?

CCPs need to demonstrate an exceptional level of financial robustness and to price their services at rates that are economically viable. Market participants should be free to choose their CCP and should not be forced to deal with a CCP where they are uncomfortable with the default management process, other aspects of the robustness of the CCPs structure or where the cost structure or the CCP makes the market meaningfully less efficient. CCPs should regularly convene their default management groups and constantly reassess the strength of the default management process

The CCP should work to ensure that key costs of clearing, such as funding of initial margin, are not onerous but are at the same time appropriate to withstand the stresses of a default. CCPs that are utilities are more likely to give favourable interest terms on initial margin, which can materially impact the costs of clearing for General Clearing Members and their clients.

Incorporating trade tear-up termination or compression with CCPs which do not yet incorporate such processes could reduce the operational burden of clearing positions.

There is a need to ensure consistency of treatment between CCPs, e.g. in equity derivative markets, the treatment of corporate actions is not consistent between Eurex and B-Clear, giving rise to legal basis risk and hence slowing market acceptance of and submission of trades for clearing. This inconsistency also encourages higher prices and creates a barrier to entry. To this end agreed standards for securities processing such as the market standards for corporate actions processing should be implemented expeditiously by all CCPs. We welcome the priority given to such actions in the European Commission staff working paper published alongside the Consultation Paper and Communication on Derivatives.

Facilitation of reporting to authorities could be a valuable added service, if it reduces the burden of reporting on the individual institution. If however the CCP represents merely a subset of trading in a specific asset class, and individual institutions are required to report all trades in that asset class, it adds little value.

To fully exploit the risk mitigation possibilities and prevent an excessive burden to the industry, there should only be a limited number of CCPs for each asset class where clearing represents a risk. This is particularly important (on cost grounds) for mid-sized market participants.

14. Is the zero-risk weighting a sufficiently effective incentive for using CCPs across different market segments?

The zero-risk weighting has only been available to firms from 1 Jan 2007 (for most firms 1 Jan 2008). Furthermore we believe that there is clear evidence to show that the zero-risk weighting has positively impacted the growth of central clearing in the OTC space since it became available to firms under the Basel II/CRD over the last few years.

We do not support further / new capital penalties for contracts that are not cleared, as these products will continue to play a valuable role in allowing market participants to hedge their risks. The current capital regime differentiates between bilateral and cleared trades. In particular, OTC contracts can generate significant counterparty credit risk capital requirements as a function of the underlying risk of the contract and of the counterparty with which the derivative is transacted.

We understand that the Basel Committee's Risk Management and Models Group (RMMG) is undertaking a review of the current capital treatment of counterparty credit risk (CCR), including a separate work stream on CCPs. Given the importance of international agreement on minimum regulatory capital requirements, we urge the Commission to continue to actively engage in shaping an internationally agreed regulatory approach to regulatory capital incentives.

15. Should additional requirements, such as appropriate account segregation, be introduced to apply the zero-risk weighting to indirect participants?

Customer-fund segregation and position portability are the basic tenets under which client clearing is to be facilitated. Furthermore, legal certainty should be introduced wherever possible. Where legal certainty is not the case, local laws should be changed to make this the case.

There are a variety of models for account segregation that should be made available to clients at various economic costs. Choosing the segregation offering should be a commercial agreement reached between clearing house members. Clients of clearing members should only receive the benefit of zero-risk weighting when the legal arrangements are such as to effectively give them a direct claim on the clearing house equivalent to that of a clearing member (or equivalent legal security).

16. Should bilateral clearing of CCP-eligible CDS be penalised and, if so, to what extent? Is there a need to extend regulatory incentives to clear through a CCP to other derivative products?

We do not support further / new penalties for contracts that are not cleared. There are benefits from having CCPs in OTC derivatives markets, however there are real reasons why certain trades are not cleared (see answers to question 6, 12 and 14). There is no need for additional / further penalties for clearing of eligible CDS outside of a CCP, as the capital charge benefit is already a significant incentive to use the central clearinghouse.

(The current capital regime appropriately differentiates between bilateral and cleared trades. If, however, in spite of this, any further incentives are in fact introduced, they should be in the form of higher charges rather than mandatory use or alternative venues as forcing clearing will hinder effective hedging and the transfer of risk.)

Customized contracts are entered into by commercial users to reduce business risks, allowing them to invest in their businesses in a prudent manner. Such penalties would be passed onto commercial users one way or the other. Imposing such penalties on these users, for sound risk management practices, seems illogical and counter-productive.

17. Under which condition should exemptions be granted and by whom?

We believe the existing system of incentives (via the Regulatory Capital requirements) is more appropriate, rather than designing a mandatory legislative system with exceptions. We would suggest a more objective based approach rather than relying on prescriptive rules. If participants are highly restricted then there is the risk of shutting some OTC markets completely and losing hedging benefits provided to end users. Furthermore, it increases the likelihood of the risks migrating and accumulating outside the regulated sector. While private contract exists, so does the ability for risk to be transferred outside classical, established classes of financial instrument.

The question of discretion, for risk management reasons, to exclude from clearing a certain proportion of otherwise eligible contracts requires further, careful discussion.

18. What is the minimum acceptable ratio of CCP cleared / eligible contract? What is the maximum acceptable number of non-eligible contracts?

We support the clearing of eligible interdealer trades. However, this is not a numerical exercise. It is important to bear in mind that risk management contracts do not exist in isolation from each other or the risk positions of a firm more generally. Bearing this in mind, it is essential to retain some degree of flexibility as to which contracts are submitted for clearing, such that firms retain the ability and discretion to manage risk as is best achieved at the time and to manage their own counterparty exposures.

Placing an absolute figure on the maximum number of non-eligible trades that would be acceptable is not an effective method to achieve risk reduction. Non-eligible contracts should be subject to operational best practices, with high levels of electronic trade processing, lifecycle management and appropriate transparency applied to them, even if they are not centrally cleared but remain collateralized bilaterally or are mitigated by other risk mitigation techniques. Systemic risk should not be measured by simply numbers of contracts outstanding. Having a minimum acceptable ratio would be a poor metric.

While certain contracts may be eligible or made eligible, there are asset classes in which clearing does not alleviate meaningful counterparty risk. Specifically, in the FX market, the biggest systemic risk by order of magnitude is settlement risk. The industry would benefit a great deal more from increasing the percentage of contracts settled in CLS than from clearing spot FX.

It is also important to note that the benefits of central clearing are cumulative over time. In any one time period, a limited amount of business may be cleared, but the continuous availability is what contributes to systemic risk management, just as it does with bilateral close-out netting under the ISDA Master Agreement. So, rather than providing an instantaneous, ‘overnight’ benefit for firms’ whole books of transactions, central clearing will gradually absorb a greater proportion. (Please also note that optically this may appear to leave an ever greater proportion of exposures un-cleared – since netting will by definition be reducing the contribution to credit exposure of cleared trades. As a result of this, there could be an apparently increasing proportion of the outstandings that are not cleared – in other words, it is important to factor in what has already been submitted for clearing in the past in assessing the impact of clearing as of a given date.)

The ultimate test remains the degree and concentration of counterparty credit exposure.

19. What statistics need to be provided to regulators to make sure they have all the information necessary to perform their duties?

With transparency provided by central data repositories, all relevant regulators should be able to obtain market and firm-level information across all products. This should also cover notional, tenor, currency and counterparty on an individual trade basis. In principle we would support provision of this data on a weekly basis, and offer regulators the ability to drill down into the detail. This, however, is subject to client confidentiality and data protection issues around the provision of such information across national borders.

All information should be made available from the various data repositories in a consistent manner so that individual market participants only have to report to a single entity for each asset class.

20. How could European legislation help ensuring safety, soundness and a level playing field between CCPs?

We support both the recommendations on CCPs by ESCB/CESR and the UK FSA Recognised Investment Exchange and Recognized Clearing House regime, which serves to enforce high standards for CCPs. All regulators should continue to insist on high standards and stability for any CCP, such that the market can be sure that any CCP operator is a strong and capable counterparty and that risk management is not compromised. In order to reduce the risk of regulatory arbitrage between CCPs operating in one jurisdiction versus another, such standards should apply to all CCPs globally. It should be made clear that CCPs in Europe (both within and without the Eurozone) operate on a level playing field, in line with the concept of a single European market.

The financial stability role CCPs play should drive the way in which CCPs' structure and operating processes are designed, including effective risk management; transparent and robust default management process for orderly and timely close-out of a defaulted member; strong membership base supported by minimum eligibility criteria; strong ownership; robust operational controls; and strict legal enforceability.

Legislation should ensure that CCPs are subject to minimum standards particularly with respect to margin so that CCPs cannot compete on the quality or amount of margin for cleared positions. (In fact, this is an area where we have already started to witness such actions.) Furthermore there should be a more defined regulatory framework in relation to the default management process, including mandatory fire drills and stress-testing of the default fund. Such best practices can give the market confidence that all CCPs are robust and creditworthy and avoid the "race to the bottom" dynamics that might otherwise arise.

21. Should MiFID type pre and post trade transparency rules be extended to non-equities products? Are there other means to ensure transparency?

The purpose of trade transparency is to assist the price-discovery process in all financial markets. As MiFID's post trade transparency regime for cash equities demonstrates, mandatory transparency can damage market liquidity, especially for large trades. The OTC markets vary substantially from the cash equities market, where transactions are predominately small in size due to the presence of retail traders. By contrast, OTC transactions are much larger by nature and undertaken by professional investors and therefore post trade transparency becomes less relevant, while the negative implications for liquidity are much greater[4]. Therefore it is important that, in order to minimize the risk such as losing market liquidity, transparency measures have to be tailored to meet the needs of each individual OTC market and to meet the needs of market participants.

A significant amount of transparency in OTC markets currently exists in a form that is appropriate for the professional nature of market participants. Pre-trade transparency is currently provided by composite price sources based on market makers' live indicative or tradable pricing. Publicly disclosed individual information should be very limited, in order to protect the counterparties to the trade.

Given the range of OTC markets and the potential negative impact on liquidity, it is essential to ensure a cost / benefit analysis of any greater trade transparency is conducted at least to identify any area at which measures are to

[4] For more information please see the SIFMA response to CESR's consultation on Post-trade transparency for non-equity markets.

be targeted and what information is the most suitable to address any shortcoming to balance benefits of trade transparency with negative market impacts.

22. How should transaction reporting of OTC derivatives to competent authorities be envisaged? Should it be extended to all contracts or to certain categories? If so, which ones? Are there other means to ensure that the competent authorities receive the relevant information on OTC derivatives transactions?

All trade data on OTC contracts should be available to regulators, on a post-execution, non-real time basis. Competent authorities should receive relevant information by querying the trade repositories. The DTCC Trade Warehouse has proved to be a valuable source of information for international regulators in the case of CDS contracts in particular (as well as providing many other operational benefits for industry and regulators, including facilitation of central clearing and trade compressions). The DTCC Trade Warehouse makes information available to all international regulators.

As the European Commission will be aware, the June 2 2009 'OMG' letter to international regulators made commitments concerning the submission and storage of trade data at trade repositories (like the DTCC Trade Warehouse), for non-centrally cleared transactions in the interest rate and equity derivative markets.

It is important to ensure that the methodology through which transaction reporting would be implemented does not become unnecessarily complex. Duplicative reporting requirements would add inefficiencies and additional costs to the system and should be avoided. We would recommend leveraging existing transaction reporting processes in Europe as national supervisors aim to coordinate and increase information sharing. A straightforward, universal system of transaction reporting should also be beneficial not only to market participants, but also for regulators.

We would caution against a situation where transaction reporting is made more cumbersome through a proliferation of clearing houses or trade repositories in one or several OTC derivative asset classes. This would make reporting and analysis of transaction reports more complicated for the market and for regulators, and in the case of clearing houses, would have negative effects in terms of netting and cross-margining.

Authorities should make full use of the 'FpML' (Financial Products Mark-up Language) 'vocabulary' already developed and widely used to describe individual OTC derivative contracts in automated communications.

23. How should positions reporting of derivatives to competent authorities be envisaged? Should it be extended to all contracts or to certain categories? If so, which ones? Are there other means to ensure that the competent authorities receive the relevant information on the exposures to particular contracts?

All OTC contracts should be available to all relevant regulators, on a post-execution, non-real time basis. Position reporting has to encompass the whole OTC books; otherwise a distorted view of risk positions will be given. We believe that competent authorities should receive all relevant information via the trade repositories.

As with transaction reporting, authorities should make full use of the 'FpML' (Financial Products Mark-up Language) 'vocabulary' already developed and widely used to describe individual OTC derivative contracts in automated communications.

24. How can further trade flow be channeled through transparent and efficient trading venues? What would be the appropriate level of transparency (price, transaction, position) for the different derivatives markets?

We fully support trading of OTC derivatives through transparent and efficient trading channels. However, market participants have valid reasons for choosing one trading channel over others. The needs of market participants change over time and as a consequence so may the choice of trading channel. In addition, central order book execution, for example, is not suitable for all contracts but only for those that trade with a very high frequency. Forced migration could be counterproductive as liquidity could be reduced as market participants, who find they face execution risk, pull back from utilizing them. (This problem will be compounded by any rigid definition of contract specifications through over-standardisation.) For example, voice execution through brokers, because of process standardisation, through straight through processing is a highly efficient trading channel. By way of example, in interest rate derivatives, such voice trades are immediately sent to MarkitWire for confirmation on T+0 and, where appropriate, routed to SwapClear for clearing on T+0 (or T+1, if the daily clearing window has already closed).

We notice and support the rise in electronic matching for highly vanilla products and support the use of electronic platforms either on a single dealer basis or on a multi-dealer RFQ / RFS basis. However, we note that during the highest points of market stress, liquidity disappeared from the electronic screens and reverted to the voice market as participants preferred to speak to a person.

We concur with the European Commission's view that trading based on competition between different venues is advantageous for market efficiency. OTC markets, exchanges and MTFs should be encouraged to serve users' needs.

ANNEX ONE

We support daily valuation, exchange of collateral and portfolio reconciliation where appropriate. The largest market participants in OTC derivative markets have made a number of commitments to regulators addressing these goals.

With regard to collateral management, we highlight commitments made by the industry and laid out in a letter written to international regulators (dated 2 June), which, in summary:

- Pledges to publish a 'best practices' document for collateral management by 30 June 2010, covering issues such margin calls, data quality, valuation and calculation of margin exposure, handling of special life cycle events (e.g. novations), portfolio reconciliations and dispute resolution
- Pledges to standardize communication of margin calls and interest payments in order to increase automation, allow for scalability, enhance security, and provide an audit trail of message exchanges (proposal by end-October 2009)
- Pledges to develop an agreed set of options for industry regarding independent amount/initial margin for bilaterally cleared transactions that is 'bankruptcy remote' from the secured third party, by 30 September 2009 (options will include pros, cons, and pre-conditions for each stated option)
- Recognizes that changes such as those outlined above may require changes to the CSA (Collateral Agreement)

The European Commission may also be aware of existing commitments (to regulators) made by the major market participants in OTC derivative markets, covering e.g. *Best Practices*, agreed and implemented risk-based thresholds, daily portfolio uploads, and weekly portfolio reconciliation for portfolios above 500 trades. This last commitment has now been upgraded, with these market participants now pledging to execute daily[5] collateralized portfolio reconciliations[6] for collateralized portfolios in excess of 500 trades between with other major market participants.

ISDA has also been working with industry specialists from sell- and buy-side and law firms to develop and implement a dispute resolution mechanism for bilateral collateral calls. This protocol is intended to be delivered by end September 2009 and there is general consensus that the mechanism should:

- Achieve timely identification of the root causes of disputed collateral calls
- Ensure the prompt movement of as much collateral as the parties can mutually agree
- Provide the parties with a flexible range of methods to narrow and/or resolve their dispute to be consistent with their risk tolerance
- Create consistent and predictable process, timing and behaviour in case of disputes across the market
- Eliminate or reduce present uncertainties and delays that increase risk for the parties

We also highlight that the sell-side members of the ISDA Collateral Committee are working with the buy-side/non dealer firms on developing a plan for further portfolio reconciliation improvements and goals. To achieve this we will publish a feasibility study by September on market-wide portfolio reconciliation that will set out how the discipline of regular portfolio reconciliations can be practically extended beyond the current OMG dealers to include smaller banks, buy-side participants and derivative end-users. The study will look to capture market requirements, challenges, potential solutions and dependencies. It will be undertaken by representatives of dealer and buy-side firms under the auspices of the ISDA Collateral Committee.

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[5] Daily is defined as at least 16 reconciliations per month to be consistent with existing portfolio reconciliation metrics provided to the supervisors.

[6] Collateralized Portfolio Reconciliation is defined as 1) Uploading the collateralized portfolio 2) Reconciling/Matching the collateralized portfolio 3) Releasing/publishing the results to both parties involved. Parties are expected to follow their own internal procedures for the investigation of portfolio reconciliation differences, consistent with their risk assessment of each counterparty situation and any investigation already on-going in respect of differences previously identified.

Whilst portfolio reconciliation is clearly a subject of interest to buy-side and non-dealer firms alike, take-up throughout the industry is still generally at an emerging stage. A number of large buy-side firms have experience in reconciling portfolios using in-house tools, and market vendors provide services in this area. The industry engagement process has been encouraging and productive resulting in a general agreement and willingness to work together to *onboard* further counterparties.

ISDA observes that a number of challenges exist and, from a practical perspective, will need to be overcome, to succeed in this regard:

- **Transparency**: All parties will need to utilize a reconciliation model which enables both sides to view the results and work on any breaks
- **Technology and inter-operability:** A practical solution is required for those firms using in-house reconciliation tools and those requiring to use different market services. At a minimum reconciliation results will need to be transparent and accessible by both parties, but service providers must offer functionality which enables reconciliations to take place between users of different services to an agreed quality standard
- **Data quality**: Adoption of a minimum market standard for data presentation and field formats applicable to all users when presenting portfolios for reconciliation
- **Bi-lateral commitment**: Both parties need to agree to provide data and to commit to reconcile trade portfolios to common market standards (Best Practices)

The industry engagement process is addressing a number of these issues through Portfolio Reconciliation Best Practices due to be published by the end of this year. The Data Quality and Minimum Market Standards is a major piece of work covering all OTC product classes to provide guidance for new entrants and ensure consistent standards from more experienced firms. When this work is finished by the end of 2009, the Major Dealers working alongside non-dealers and buy-side firms will be better positioned to recommend a Portfolio Reconciliation implementation roadmap for 2010 and will have gauged the industry's interest and appetite for implementing new measures. To this end, buy-side and sell-side firms will work collaboratively and with vendors to identify technology solutions to support a wider rollout of portfolio reconciliation during 2010.

ISDA will be happy to share the conclusions of this feasibility study (to identify infrastructure and other dependencies for wider portfolio reconciliation rollout across OTC participants) with the European Commission by October 31, 2009.

ISDA would observe that participants in OTC derivative markets include a large number of small buy-side firms and end-users who at any one time may be acting as counterparties in a small number of contracts, for which daily or very frequent portfolio reconciliation may be of marginal benefit.