Testimony of Scott O'Malia
Chief Executive Officer
International Swaps and Derivatives Association
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Chairman Conaway, Ranking Member Peterson and Members of the Committee. Thank you for the opportunity to testify today.

It has now been five years since the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law. In that time, significant progress has been made in implementing key elements of the Dodd-Frank Act, particularly in derivatives clearing, reporting and trade execution.

Today, approximately three quarters of interest rate derivatives and credit default swap (CDS) index average daily notional volumes are now cleared. More than half of interest rate derivatives and 65% of CDS index average daily notional volumes are traded on swap execution facilities (SEFs). All swaps are now required by the Commodity Futures Trading Commission (CFTC) to be reported to swap data repositories (SDRs), providing regulators with the ability to scrutinize individual trades and counterparties. Registration requirements are in place for swap dealers and major swap participants, with those entities subject to strict rules meant to protect their counterparties. And margin and capital requirements are being phased in to further mitigate risk.

Together, this represents a major step forward in the reform of derivatives markets. Today, the derivatives sector is more transparent than ever before, and counterparty credit risk has been substantially reduced.

It has become clear, however, that new challenges have emerged, and that certain areas need to be reassessed. For instance, the speed with which Dodd-Frank was implemented has resulted in divergences in the timing and substance of national rules. We now see significant differences in trading, clearing and reporting requirements, exposing derivatives users to duplicative and sometimes inconsistent requirements. These divergences not only increase compliance costs, but have led to a split in liquidity along geographic lines, which reduces choice, increases costs, and could make it more challenging for end users to enter into or unwind large transactions, particularly in stressed markets conditions.

In other words, fractured rules, fractured markets, fractured liquidity.

This is contrary to the G-20's 2009 commitments, which specifically called for the rules to be implemented in a way that does not fragment markets.

Discrepancies in regulatory reporting and data requirements within and across borders also mean no single regulator is currently able to get a clear view of global derivatives trading activity. This means a key objective of Dodd-Frank has not been fully met.

Even where global bodies have taken the lead in developing regulatory requirements – for instance, the capital requirements and margin for non-cleared derivatives – discrepancies have emerged in national implementations, creating competitive distortions. In some cases, certain elements of the capital rules appear to contradict the intentions of other requirements implemented as part of the G-20 objectives. For instance, the US supplementary leverage ratio acts to discourage banks from offering client clearing services. As the various rules have been developed in isolation, the cumulative impact of the capital requirements and the interaction with market-based reforms is unknown, and no comprehensive analysis on economic impact or the impact on market resilience and economic growth has been undertaken.

On the margin rules for non-cleared derivatives, a number of discrepancies have emerged in national-level proposals, which, in some cases, could put firms operating in the US at a competitive disadvantage internationally and reduce choice for US end users domestically.

And while a final framework for the margining of non-cleared derivatives was published by the Basel Committee on Banking Supervision and International Organization of Securities Commissions (IOSCO) in September 2013[1], final national-level rules have not yet been published. While the International Swaps and Derivatives (ISDA) has worked to prepare the industry for implementation, continued progress is dependent on the timely publication of final rules by both prudential and market regulators. These rules should be consistent.

I applaud the work that went into developing and implementing this ambitious piece of legislation from scratch. The fact that so much was done so quickly speaks volumes about the dedication of Congress and its staff, as well as the staff at the regulatory agencies. ISDA also welcomes the CFTC's flexibility and willingness to react quickly to snags by issuing no-action letters.

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[1] *Margin Requirements for Non-centrally Cleared Derivatives*, Basel Committee on Banking Supervision, International Organization of Securities Commissions, September 2013: http://www.bis.org/publ/bcbs261.pdf

But the wide-scale use of exemptive relief is a symptom of larger problems that need to be addressed. Ongoing uncertainty regarding Dodd-Frank implementation for global market participants and the resulting fragmentation of liquidity indicates that Congress and regulators need to move quickly to review where changes can be made to ensure the financial stability and transparency objectives of Title VII of the Dodd-Frank Act are successfully achieved.

ISDA and its members would suggest several concrete steps that could be taken to improve Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

- Regulators should work to harmonize their rules on a global basis within specified time frames. Organizations such as IOSCO could play a role here. Existing industry definitions and standards should be used to the extent possible. Regulators should also set out clear, transparent guidelines for achieving equivalence determinations, consistent with the approach set out in a report by the Financial Stability Board chairman to G-20 leaders in 2013[2]. This reflects an agreement that equivalency/substituted compliance assessments should be based on whether other regulatory regimes achieve broadly similar outcomes. ISDA has proposed specific fixes, which are outlined in more detail below.

- The CFTC and the Securities and Exchange Commission (SEC) should harmonize their cross-border rules and guidance. More effort is needed to turn the aspirational words on substituted compliance into action. In addition, where the Federal Reserve Board has jurisdiction over swap dealers and major swap participants, it should work with the CFTC and SEC to ensure the rules do not conflict or undermine the financial stability objectives of Title VII of the Dodd-Frank Act.

- Regulators should agree on common regulatory reporting requirements within and across jurisdictions and adopt common data standards such as unique legal entity identifiers (LEIs), unique trade identifiers (UTIs) and

[2] Report from the Financial Stability Board chairman for the G-20 Leaders' Summit, September 2013: "Instead, substituted compliance and equivalence assessments of others' regulatory regimes should be based on whether jurisdictions broadly achieve similar outcomes. At the same time, in applying such an overall broad approach, regulators will need to decide in different policy areas how much flexibility to apply in assessing the similarity of outcomes. For instance, there may be some particular policies (such as CCP margin rules) where differences in key requirements between jurisdictions could lead to regulatory arbitrage, and where further discussion between regulators is needed. Detailed work, and a timeline for action, is thus needed to address the challenges in translating the encouraging recent cross-border regulatory understandings into practice." http://www.financialstabilityboard.org/wp-content/uploads/r_130902a.pdf?page_moved=1

unique product identifiers (UPIs). ISDA has proposed a path forward, and has worked to develop common standards and reporting formats that could be used to ensure the reporting and analysis of transaction data is more effective.

- Divergences in national implementations of non-cleared margin rules should be reduced as far as possible to avoid an unlevel playing field and enable cross-border trading. Once national-level rules are finalized, adequate time must be provided for implementation and preparation, particularly as many market participants subject to the new requirements will be posting initial margin on their non-cleared trades for the first time. Implementation of global margining and segregation requirements will involve major changes to documentation, technology and business practices. ISDA has been leading efforts to prepare the industry for implementation, notably through the development of a common initial margin methodology. But work cannot be completed until final rules are released globally.

- Capital requirements should be globally consistent, coherent and appropriate to the risk of a given activity. The interplay of the various regulatory components should be comprehensively assessed to ensure the cumulative impact is fully understood to avoid excessively high financing costs for borrowers and increased hedging costs for end users, and to encourage appropriate risk management incentives.

- Negotiations with the European Securities and Markets Authority (ESMA) over the recognition of US clearing houses have stalled over technical differences in margin methodologies. Immediate recognition should be given to central counterparties (CCPs) that meet the Committee on Payment and Settlement Systems and IOSCO *Principles for Financial Market Infrastructures*[3]. Further work is also needed by regulators, CCPs and market participants to develop and implement best practices. ISDA has been active in this regard, and recently circulated a letter that recommends best practices on stress testing.

- Regulators must work to minimize the differences in trade execution rules to avoid the cross-border problems that have occurred in data reporting and clearing. An attempt by the CFTC in February 2014 to introduce a so-called qualifying multilateral trading facility (QMTF) regime[4] for

[3] *Principles for Financial Market Infrastructures*, CPSS/IOSCO, April 2012: http://www.bis.org/cpmi/publ/d101a.pdf
[4] CFTC Letter No. 14-16, February 12, 2014: http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-16.pdf

trading venues in Europe clearly showed that insisting on the adoption of US rules will not work.

- The CFTC should take action on ISDA's petition[5] to review and modify the SEF rules in order to increase use of US SEFs and facilitate cross-border trading. This includes allowing for more flexibility in execution mechanisms in limited circumstances, which would bring the rules more in line with European proposals. ISDA also recommends changes to the 'made-available-to-trade' process to give the CFTC the authority to make final determinations, following a short public consultation period.

- Regulators should ensure the costs and compliance burdens for end users are minimized to enable them to effectively hedge their risks. Regulators should consider the cumulative impact of the rules on end users, including indirect effects.

- The CFTC must provide final registration to swap dealers, SDRs and SEFs, which have been in regulatory limbo for as long as three years.

Congress also has role in reviewing and making the necessary adjustments to the Dodd-Frank Act. This includes:

- Examination of the misapplied cross-border authorities implemented by the CFTC and the SEC, which have expanded US regulatory reach well beyond US boundaries. This approach ignores the requirement of Section 2(i) of the Commodity Exchange Act (CEA), which states that the swaps provisions of the CEA shall not apply to activities outside the US unless those activities have a direct and significant connection with activities in, or effect on, commerce of the US.

- Legislators should oversee the process of finalizing the new margin regime to ensure US rules are aligned with those overseas, particularly on the issue of inter-affiliate trades, to ensure financial institutions operating in the US are not put at a competitive disadvantage. Without the ability to efficiently centralize risk management activity, banks may stop providing products in certain markets or to certain customers via local affiliates because inter-affiliate margin would make these products less economically viable. The result would be a further fragmentation of markets and reduction in liquidity.

[5] ISDA's petition to the CFTC: http://www2.isda.org/attachment/NzY2Mg==/ISDA%20CFTC%20Petition.pdf

- Repeal of Section 21(d) of the CEA, which requires indemnification of SDRs. This has become a barrier to sharing data among regulators in the US and internationally.

- Legislative action to make clear commercial end users that hedge their risk through centralized treasury units are not denied the end-user clearing exemption.

- Congress should continue to use its oversight role by asking regulators to conduct a quantitative assessment on new capital, liquidity and leverage rules to ensure the cumulative impact on the economy and market liquidity is fully understood.

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I would like to address each of my points in more detail. Before I do, I would like to stress that ISDA supports the intent of Dodd-Frank to strengthen financial markets and reduce systemic risk. That includes the reporting of all derivatives trades and clearing of standardized derivatives products where appropriate. ISDA has worked constructively and collaboratively with policy-markers in the US and across the globe to achieve these objectives. In fact, this work began even before the passage of Dodd-Frank, as part of the 'voluntary commitment process' overseen by the Federal Reserve Bank of New York.

This is very much in line with our mission statement: to foster safe and efficient derivatives markets for all users of derivatives. Since ISDA's inception 30 years ago, the Association has worked to reduce credit and legal risks in the derivatives market, and to promote sound risk management practices and processes. This includes the development of the ISDA Master Agreement, the standard legal agreement for derivatives, and related collateral documentation, as well as our work to ensure the enforceability of netting.

Today, ISDA has over 800 member institutions from 67 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, clearing houses and repositories.

End users of derivatives are the largest constituent, accounting for roughly half of our membership. Approximately a third is located in North America.

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Before I expand upon the challenges faced by derivatives market participants, I would like to briefly summarize the commitments made by the G-20, which were reflected in Dodd-Frank. They were:

- Non-cleared derivatives should be subject to higher capital requirements;
- Standardized derivatives should be cleared through CCPs;
- Derivatives should be reported to a trade repository;
- Standardized contracts should be traded on exchanges or electronic trading platforms where appropriate.

A requirement for non-cleared derivatives to be subject to margin requirements was also later agreed by G-20 leaders.

Underlying these commitments was a pledge that regulators “are committed to take action at the national and international level to raise standards together so that our national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage”.

As noted earlier, significant progress has been made in meeting the clearing, trading and reporting requirements included in Dodd-Frank. This progress will continue as clearing houses expand their product offerings and new clearing and trading mandates come into force.

Unfortunately, much less progress has been made on ensuring consistency and harmonization and in avoiding the fragmentation of markets.

Cross-border Harmonization

The derivatives markets are, and always have been, global markets. European banks can trade with US asset managers; Asian banks can trade with European hedge funds; US banks can trade with Asian companies. That choice has benefited end users. They can easily tap into a global liquidity pool with few barriers and choose who they want to trade with.

That global liquidity pool is now at risk because of a lack of consistency in the timing and substance of national-level rules. This lack of harmonization is a particular concern because of the extraterritorial reach of some domestic rules, meaning counterparties are potentially subject to two or more possibly contradictory sets of requirements – those of their own jurisdiction and the extraterritorial rules of foreign jurisdictions.

Section 2 of the CEA (7 U.S.C. 2) stipulates that Dodd-Frank should not apply to activities outside the US, unless those activities have a "direct and significant connection with activities in, or effect on, commerce of the United States". However, the CFTC's cross-border guidance[6] takes a much broader approach to capture overseas activities. This has resulted in non-US firms turning away from any trade or counterparty that would result in them being subject to US rules and regulatory oversight, on top of their own jurisdiction's rules.

CFTC Staff Advisory 13-69[7] is an example of US regulatory overreach. It clarifies that a non-US swap dealer should comply with Dodd-Frank transaction-level requirements when trading with another non-US person if the trade is arranged, negotiated or executed by personnel or agents of the non-US swap dealer located in the US.

ISDA believes US regulators should focus on practices that pose a risk to the US. It is difficult to see why a trade between two non-US entities that is booked overseas should be subject to CFTC oversight and Dodd-Frank transaction-level rules, simply because a US-based employee has provided input to the transaction. In these cases, the trade would be subject to US clearing, trading and reporting rules, as well as potentially inconsistent requirements from the non-US entity's home regulator. These kinds of personnel-based tests could result in firms excluding their US-based personnel from certain trades, or relocating them elsewhere.

The CFTC has issued four successive no-action letters since November 2013 to exempt market participants from compliance with Staff Advisory 13-69. But concerns about being subject to multiple sets of requirements are prompting market participants to change behavior in some cases. This is causing liquidity to fragment along geographic lines.

The CFTC's recent proposed cross-border treatment for margin on non-cleared derivatives transactions[8] is another example of regulators taking an expansive approach, as it captures non-guaranteed non-US affiliates in certain cases. That's despite the fact the non-cleared margin rules were agreed at a global level, and will likely be applied in the US, Europe and Japan at the same time.

[6] *Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations; Rule*, Federal Register / Vol. 78, No. 144 / July 26, 2013:
http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-17958a.pdf

[7] CFTC Staff Advisory No. 13-69, November 14, 2013:
http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-69.pdf

[8] *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements; Proposed Rule*, Federal Register / Vol. 80, No. 134 / July 14, 2015:
http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2015-16718a.pdf

This approach could further contribute to the fragmentation and regionalization of liquidity pools.

ISDA research shows 87.7% of regional European interdealer volume in euro interest rate swaps was traded between European dealers in the fourth quarter of 2014, compared with 73.4% in the third quarter of 2013[9]. The change in trading behavior coincided with the introduction of US SEF rules, which required all electronic venues that provide access to US entities to register with the CFTC as SEFs. Many non-US platforms chose not to register, meaning US persons were no longer able to access liquidity on these platforms. Following the first SEF trading mandates in February 2014, non-US participants opted to avoid trading mandated products with US counterparties, so as not to be required to trade on CFTC-registered SEFs that offer restrictive methods of execution for these instruments. US entities, conversely, are unable to access the most liquid pool for euro interest rate swaps, which is centred in Europe, away from SEFs.

Many of the problems could be resolved through an effective process for granting equivalence/substituted compliance. A transparent substituted compliance mechanism based on broad outcomes, rather than a granular rule-by-rule comparison, would help minimize the compliance challenges and fragmentation of liquidity. The CFTC should clearly articulate how substituted compliance decisions will be made in order to shed light on this currently theoretical and opaque process.

Regulators should also work to harmonize rules sets as far as possible, particularly in clearing, trading and reporting. The CFTC and the SEC must resolve the differences in their respective rules to foster greater consistency and clarity within the US. Greater harmonization with global regulations is also necessary. Differences in national-level rules have already led to protracted – and still unresolved – negotiations over whether US clearing houses should be recognized by the ESMA. A restrictive interpretation of Dodd-Frank SEF rules by the CFTC means a similar outcome may emerge for trading rules, further exacerbating the fragmentation of markets, to the detriment of end users.

Congress should give careful consideration to legislative changes based on the following principles:

- Emphasize the results and outcomes of foreign regulatory requirements, rather than the design and construction of specific rules;

[9] ISDA research on fragmentation of global derivatives markets, April 2015: http://www2.isda.org/attachment/NzUzMQ==/Market%20fragmentation%20FINAL.pdf

- Make clear that the location of personnel should not be a factor in determining whether activities have a direct and significant connection with activities in, or effect on, commerce of the US;
- Establish separate criteria regarding the application to end users and transactions involving end users, and mitigate the direct and indirect costs or other burdens imposed on end users.

Reporting

Cross-border issues have also hampered the effectiveness of derivatives reporting.

A lack of standardization in reporting formats across different repositories, and inconsistencies in what is reported, mean accurate data aggregation is currently impossible. Differences in regulatory reporting requirements within and across jurisdictions also mean regulators are unable to gain an accurate picture of risk exposures on a global basis. These differences increase operational complexities for end users and make aggregation across corporate groups difficult. It also increases the cost of reporting for firms that have reporting obligations in multiple jurisdictions.

To resolve this, regulators across the globe should identify and agree on the trade data they need to fulfill their supervisory responsibilities, and then issue consistent reporting requirements across jurisdictions. Further work is also needed by the industry and regulators to develop and then adopt standardized product and transaction identifiers, as well as reporting formats. ISDA has played a leading role in this area through its taxonomies, FpML reporting standard and unique trade identifier prefix service (UTIPrefix.org), among other things.

Even then, it will be difficult for regulators to obtain an accurate picture of global risk exposures because of the Dodd-Frank SDR indemnification requirement and privacy laws in some jurisdictions prohibiting the disclosure of certain counterparty information. Until these two issues are resolved, the ability of regulators to build a comprehensive picture of derivatives positions across the globe and to spot potential systemic risks will be stymied.

Reporting mandates have been in place in the US for over two years, while Europe has had similar rules in place for nearly 18 months. However, little tangible progress has been made over that time to resolve differences in their respective requirements and facilitate the sharing of information. As a first step to resolving this, global regulatory institutions such as IOSCO could play a greater role to agree common requirements. Regulators and market participants

should also work to identify, develop and adopt common data standards where necessary.

ISDA has recently joined with 10 other international trade associations to send a letter[10] to global regulators that calls for rule harmonization consistent with a set of principles developed by ISDA[11].

The principles are:

- Regulatory reporting requirements for derivatives transactions should be harmonized within and across borders.
- Policy-makers should embrace and adopt the use of open standards – such as LEIs, UTIs, UPIs and existing messaging standards (eg, FpML, ISO, FIX) – to drive improved quality and consistency in meeting reporting requirements.
- Where global standards do not yet exist, market participants and regulators can collaborate and secure agreement on common solutions to improve consistency and cross-border harmonization.
- Laws or regulations that prevent policy-makers from appropriately accessing and sharing data across borders must be amended or repealed.
- Reporting progress should be benchmarked. The quality, completeness and consistency of data provided to repositories should be tracked, measured and shared with market participants and regulators in order to benchmark, monitor and incentivize progress in reporting.

Margin Requirements for Non-cleared Derivatives

Dodd-Frank recognizes there is a place for bespoke derivatives instruments that enable corporate and financial institution end users to closely match and offset risks. It also acknowledges that less liquid derivatives instruments, currencies and/or maturities may not be suitable for clearing. This point was echoed in a recent speech by CFTC Chairman Timothy Massad, before the District of Columbia Bar Association[12].

These non-cleared instruments are not necessarily more complex than cleared transactions, nor do they pose significantly more risk. Clearing houses typically consider the depth of the market, liquidity and availability of prices, among

[10] Industry trade association letter, June 2015: http://www2.isda.org/attachment/NzY1OA==/Joint%20Trade%20Association%20Data%20Harmonization%20letter.pdf

[11] ISDA principles on improving regulatory transparency of global derivatives markets, February 2015: http://www2.isda.org/attachment/NzI4NQ==/Improving%20Regulatory%20Transparency%20FINAL.pdf

[12] Keynote address, Timothy G. Massad before the District of Columbia Bar (Washington, DC), July 23, 2015: http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-26

other factors, when deciding whether to clear a derivatives instrument – criteria also considered by regulators when deciding whether to apply a clearing mandate. Those products with non-standard terms that are used to meet specific end-user hedging needs may not meet those requirements.

Nonetheless, these instruments are vital elements in the risk management strategies of corporates, insurance companies, pension funds, sovereigns, smaller financial institutions and others. Without them, these entities may experience greater earnings volatility due to an inability to qualify for hedge accounting, or be unable to offset the interest rate, inflation and longevity risks posed by long-dated pension or insurance liabilities.

To give an example: a US exporter has issued a US dollar bond to grow its domestic business, but earns most of its revenue from exports to Europe. If the dollar strengthens against the euro, the company will face financial statement and cashflow volatility. It will therefore need to allocate a larger amount of its euro cashflow to service its dollar-denominated debt. To hedge this risk, the firm could swap the loan into euros using a cross-currency swap, allowing it to match the currency in which revenues are received and interest expense is paid. Cross-currency swaps are currently not cleared.

While clearly recognizing the need for a robust and competitive non-cleared derivatives market, the Dodd-Frank Act requires regulators to set margin requirements for non-cleared derivatives – in other words, requiring collateral to be posted against those trades to mitigate counterparty risk.

These rules are now close to finalization. The Basel Committee and IOSCO published a final global margining framework in September 2013, which calls for eligible counterparties to post initial and variation margin on non-cleared derivatives trades. US prudential regulators[13] and the CFTC[14] published separate national-level proposals building on this framework in September and October 2014, and final rules are expected to be released in the third quarter of this year.

The implementation of this regime on a global basis will require significant work, particularly as many derivatives users have not posted initial margin on their non-cleared swaps before. For some non-bank users, it will also be the first time they've had to post variation margin.

[13] *Margin and Capital Requirements for Covered Swap Entities; Proposed Rule*, Federal Register / Vol. 79, No. 185 / September 24, 2014: http://www.gpo.gov/fdsys/pkg/FR-2014-09-24/pdf/2014-22001.pdf

[14] *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; Proposed Rule*, Federal Register / Vol. 79, No. 192 / October 3, 2014, http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2014-22962a.pdf

ISDA has worked very hard to develop the infrastructure, processes and documentation necessary for the new margining regime. The Association is also working to develop the ISDA Standard Initial Margin Model (ISDA SIMM), a common calculation methodology for computing initial margin amounts, which will be available to all market participants.

Use of a standard methodology provides a number of benefits. For one thing, it provides regulators with a consistent, transparent model to enhance market oversight. Second, by creating a model that everyone can use, it reduces the potential for disputes between counterparties over the initial margin amounts that need to be exchanged.

In addition to the ISDA SIMM, ISDA is working on a number of other initiatives. Existing ISDA Credit Support Annexes (CSAs) and other collateral documentation will need to be replaced or revised in order to comply with the new non-cleared margin rules. A number of key terms in the CSA will need to be modified, including collateral eligibility, collateral haircuts, calculation and collection timing, dispute resolution, and the procedure for exchanging initial margin. In addition, derivatives users will need to set up new custodial agreements or make changes to existing arrangements to comply with initial margin segregation requirements. Given the changes, new or updated netting opinions may be needed for some jurisdictions.

Given this workload, it is important that national-level margin rules are finalized as soon as possible. While significant progress has been made in ISDA's implementation efforts, certainty in the final rules in each jurisdiction is required in order to progress these initiatives. It is also important that enough time is given to development and testing between finalization of the national rules and implementation, to ensure these rules can be introduced safely with minimum disruption to markets.

Achieving global consistency in the rule sets is also imperative. The initial proposals from US regulators contained a number of divergences from the Basel Committee and IOSCO framework[15]. There were also discrepancies between the national rules proposed by Europe and Japan.

Proposals from US prudential regulators, for example, would subject transactions between affiliates of the same financial group to margin

[15] ISDA's response to US prudential regulators' proposal for the margining of non-cleared derivatives, November 2014: http://www2.isda.org/attachment/NzExOA==/ISDA_-_PR_Proposed_Margin_Rules_Letter%20112414.pdf

requirements. This does not appear in European and Japanese proposals, potentially putting financial institutions operating in the US at a competitive disadvantage internationally and reducing choice for US end users domestically.

Analysis conducted by ISDA members shows that the inter-affiliate margining requirement would result in double the amount of initial margin being posted, relative to rules that only require initial margin to be posted to external parties. We welcome the recent bipartisan letter from Chairman Conaway and Ranking Member Peterson that highlighted this issue, and agree with their concerns that the cost of funding this initial margin would likely be passed on to end users.

It would also run counter to the objective of reducing systemic risk. These internal risk management trades enable firms to consolidate their swaps within a single entity, resulting in substantial risk management and operational benefits. Inter-affiliate margin requirements could discourage this behavior. This could deter firms from offering products in certain markets that can only be accessed through an affiliate, as the cost of posting inter-affiliate margin would make these products uneconomic.

Attention also needs to be paid to how these rules will be applied on a cross-border basis. Under recent proposals from the CFTC, US covered swap entities would be able to rely on substituted compliance when trading with a non-US entity (assuming the home rules of the non-US entity are deemed equivalent), but this would only apply to initial margin posted. Initial margin collected would have to meet US rules.

In addition, non-US entities whose obligations are not guaranteed by a US person but whose financial statements are included in those of a US ultimate parent entity would be subject to the US regime. This goes further in extraterritorial reach than other US rules. Unless US rules are harmonized with those in Europe and Japan, it is conceivable that a trade between a US and overseas counterparty will be required to comply with two sets of rules simultaneously.

Finally, regulators need to make some accommodation for non-cleared derivatives conducted with counterparties in jurisdictions that haven't applied the margin rules. For example, regulators should consider making a transitional equivalency determination, valid for two years, for jurisdictions that have yet to implement the Basel Committee/IOSCO framework for margin rules.

ISDA recommends that:

- Regulators harmonize the margin rule sets to avoid an unlevel playing field and the potential for fragmentation.

- Final US rules should be published as soon as possible so implementation efforts can be progressed.
- These rules should provide sufficient time (at least 12 months between publication of the final rules and the implementation date) in order to give to market participants adequate time to develop and test the necessary models, documentation and infrastructure, and ensure all parties sign legal documentation compliant with the final rules.

Capital Requirements

Dodd-Frank also requires swap dealers to be subject to strict capital requirements to mitigate risk. A key driver has been a desire to incentivize clearing through higher capital requirements for non-cleared trades. Changes to the capital rules have been agreed at a global level through the Basel Committee, and are then implemented in each jurisdiction by national authorities.

The capital reforms include increased bank capital requirements, higher quality capital, enhanced market risk rules, greater focus on counterparty credit risk, new liquidity requirements, a leverage ratio, a capital surcharge for systemically important banks and total loss-absorbing capital requirements. The Basel Committee has set a phase-in schedule from 2013 through to 2019[16].

The full impact is unlikely to be known until after 2019, when the full array of requirements is fully phased in. Following the finalization of Basel III in December 2010, banks have had to prepare for a succession of follow-up consultations and implementations, at the same time as complying with numerous other regulations relating to trading, reporting and clearing. The Basel Committee phase-in period for higher and better quality capital requirements began from January 2013, with the minimum common equity capital ratio and tier-one capital requirement rising to 4.5% and 6%, respectively, from this year. Other changes to capital – the introduction of new capital conservation and countercyclical buffers, along with a surcharge for systemically important banks – will be phased in from January 2016.

The first stages of the new liquidity risk management regime have also been implemented. The liquidity coverage ratio is being incrementally rolled out from this year until 2019. The net stable funding ratio, meanwhile, is meant to ensure banks fund their activities with sufficiently stable sources of funding to avoid liquidity mismatches. Following an observation period, the requirements

[16] *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems*, Basel Committee on Banking Supervision, December 2010, http://www.bis.org/publ/bcbs189.pdf

are scheduled to come into force from January 2018. ISDA's own industry analysis suggests this will significantly increase costs for derivatives users.

Other changes, such as a charge for bank exposures to central counterparty default funds, have also been introduced.

But plenty of other components have yet to emerge – and, in some cases, even to be finalized. The Fundamental Review of the Trading Book (FRTB) is a case in point[17]. This initiative is meant to replace the current framework implemented through Basel 2.5 with a more coherent and consistent set of requirements and to reduce the variability in the capital numbers generated by banks.

The rules are scheduled to be finalized at the end of this year, with implementation by 2018. But market participants say it's too early to determine what the impact of these rules will be. That's largely because the analysis conducted so far has been hampered by data-quality issues, which have made it difficult to assess the impact on individual business lines. Nonetheless, the rules as they stand are likely to lead to punitive capital increases in certain business lines, and will potentially cause some key markets, such as securitization and small- and medium-sized entity credit, to become uneconomic. This could lead to lower liquidity and increased financing costs for borrowers. End users could also experience higher hedging costs and a reduction in the ability to hedge effectively as capital, liquidity and leverage charges are passed on by banks.

On top of this, the Basel Committee recently issued a new consultation on credit valuation adjustment[18] to bring it into line with the FRTB and address other perceived weaknesses, which is likely to further increase charges for counterparty risk.

Other issues still to be finalized include the possible introduction of capital floors – essentially, a backstop to internal models, likely to be set at a percentage of the standard model output. A consultation paper was published last December[19], and final rules are likely sometime this year – although it is not clear when the requirements will be implemented.

[17] *Consultative Document: Fundamental Review of the Trading Book: Outstanding Issues*, Basel Committee on Banking Supervision, December 2014: http://www.bis.org/bcbs/publ/d305.pdf
[18] *Consultative Document: Review of the Credit Valuation Adjustment Risk Framework*, Basel Committee on Banking Supervision, July 2015: http://www.bis.org/bcbs/publ/d325.pdf
[19] *Capital Floors: The Design of a Framework Based on Standardised Approaches*, Basel Committee on Banking Supervision, December 2014: http://www.bis.org/bcbs/publ/d306.pdf

Other components of the Basel III package are finalized but not yet implemented, including the leverage ratio. Under the Basel III implementation schedule, banks had to begin public disclosure of their leverage ratio numbers from this year, with the rules subject to final calibration in 2017 and full implementation in 2018.

However, these various rules may interact in countervailing ways. For instance, regulators globally have been working to ensure incentives are in place for the central clearing of standardized derivatives, but those incentives are being undermined by the leverage ratio.

For the purposes of calculating derivatives exposures as part of the leverage ratio, segregated margin received from clients is not allowed to offset the potential future exposure associated with such off-balance sheet exposures. The policy rationale is that margin can increase the economic resources at the disposal of the bank, as the bank could use the collateral to increase leverage. However, margin that is segregated cannot be leveraged by a bank to fund its operations – it solely functions as a risk mitigant to reduce exposures with respect to a bank's cleared derivatives. Failure to recognize the exposure-reducing effect of margin acts as a significant disincentive to central clearing, as margin will substantially increase a clearing firm's total leverage exposure, leading to an increase in the amount of capital required to support client clearing activities. This will:

- Lead to more clearing firms exiting the business, therefore concentrating risk among a smaller set of providers;
- Result in a reduction of clearing-member capacity to clear for end users, potentially forcing some participants to abandon use of derivatives;
- Increase counterparty risk for clearing members, as many will be discouraged from collecting excess margin; and
- Increase costs to end users that use non-cleared derivatives, as their counterparties face increase costs to hedge their risks in the cleared swap markets.

The leverage ratio should therefore be amended to recognize the exposure-reducing effect of segregated margin.

How each of these elements will interact is not entirely clear. While each rule may make sense in isolation, the cumulative impact is unknown, and individual requirements may duplicate or even contradict the intention of other rules.

ISDA and its members are trying to understand the interplay between the capital, leverage and liquidity rules as a result. This could lead to lower liquidity

and increased financing costs for borrowers. End users could also experience higher hedging costs as capital, liquidity and leverage charges are passed on by banks.

ISDA recommends that:

- The impact of the capital rules, and how each component interacts with other regulatory requirements, is comprehensively assessed before progressing further.
- Congress should engage with global regulatory bodies to better understand the overall goals and objectives, as well as the potential impact on liquidity, borrowing costs and economic activity as a whole.

Clearing

ISDA and its members have been in the vanguard of clearing even before the financial crisis and the enactment of the Dodd-Frank Act. ISDA documentation and industry implementation groups were crucial to transforming mandatory clearing from an idea into reality in the US and Japan. ISDA is playing the same role in Europe ahead of the first clearing mandates in Europe in 2016.

ISDA believes clearing mitigates risk. However, as a proponent of safe, efficient markets, ISDA has observed the ever increasing volume of trades passing through CCPs due to mandatory clearing, and believes these entities have become a systemically important part of the derivatives market infrastructure.

Supervisors and regulators are conscious of this fact, and have collectively taken action. International standard-setting bodies have established CCP risk management principles, as well as provided guidance on CCP recovery and resolution plans. In many respects, CCPs are held to higher standards now than ever before.

But further work is required. It has been three years since supervisors and regulators issued CCP risk management principles. Now is the time to re-examine these principles, as well as ascertain whether and to what extent the G-20 jurisdictions have implemented them.

Given the increasing systemic importance of CCPs, all supervisors, regulators and market participants have an interest in CCP resiliency. ISDA has actively supported supervisory and regulatory initiatives in this area. Most recently, ISDA circulated a letter on CCP stress testing, which sets out specific best practices. In the letter, ISDA notes that consistent application of these best practices across G-20 jurisdictions would minimize the risk of CCP failure, and

may form a path forward for the US, the European Union and other G-20 jurisdictions towards CCP equivalence. ISDA looks forward to further coordinating and cooperating with supervisors and regulators on other aspects of CCP resiliency.

More regulatory input and detail is also needed on acceptable CCP recovery mechanisms, as well as on the circumstances and processes for CCP resolution to ensure that the failure of any clearing service can be managed in an orderly way with the least possible disruption to financial stability. No recovery and resolution action should involve the use of public money. Given the large clearing houses have global operations, close cooperation and coordination between national authorities across borders is paramount.

In addition, legislative action is needed to make clear that end users that hedge through centralized treasury units (CTUs) in order to net and consolidate their hedging activities are eligible for the clearing exemption. Many CTUs classify as financial entities under Dodd-Frank, subjecting them to clearing requirements. While the CFTC has issued no-action relief, legislation clarifying that end users using these efficient structures are exempt would provide much-needed certainty.

Trade Execution

ISDA has proposed a series of targeted fixes to US SEF rules to encourage more trading on these venues and facilitate cross-border harmonization.

Specifically, ISDA believes allowing for greater flexibility in execution mechanisms will foster further growth of centralized trading venues. While the Dodd-Frank Act allows derivatives to be traded by "any means of interstate commerce", the CFTC's SEF rules restrict the execution of mandated products to order-book or request-for-quote-to-three mechanisms. These execution methods may not be appropriate for certain, less liquid instruments, discouraging trading on SEFs. The CFTC's restrictive interpretation of Dodd-Frank also differs from the more flexible approach taken by European regulators in their trade execution proposals, which could impede future attempts to obtain equivalence or substituted compliance determinations.

The CFTC attempted to find a solution to the fracturing of liquidity last year, issuing two conditional no-action letters on February 12, 2014 (CFTC No-Action Letter 14-15[20] and 14-16) that allowed US entities to continue trading on European multilateral trading facilities (MTFs), without the need for those

[20] CFTC Letter No. 14-15, February 12, 2014, http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-15.pdf

platforms to register with the CFTC as SEFs. However, those European venues were required to report all swap transactions to a CFTC-registered SDR as if they were SEFs, submit monthly reports to the CFTC summarizing levels of participation and volume by US persons, and meet other SEF requirements as well as their own home regulations. Not surprisingly, no MTF applied within the time frame for this so-called QMTF status.

This validates my belief that it is better for the CFTC to conduct a review of its rules now, rather than reach a point where divergent trading rules are in place elsewhere, forcing cross-border counterparties to try and comply with two different sets of requirements.

ISDA has published a set of principles[21] aimed at promoting consistency in the development and application of centralized trading rules for derivatives. They include:

- The trading liquidity of a derivatives contract (and consequently the regulatory obligations to which the contract is subject) should be determined by reference to specific objective criteria. The process should be based on concrete, transparent and objective standards so that market participants have a clear understanding of when swaps will be required to move from the bilateral market to centralized trading venues.

- Derivatives contracts that are subject to the trading obligation should be able to trade on a number of different types of centralized venues. It is important for regulators to achieve a flexible trade execution regime that would allow contracts to be traded across jurisdictions, and not be subject to costly duplicative compliance obligations and regulatory arbitrage.

- Trading venues must offer flexible execution mechanisms that take into account the trading liquidity and unique characteristics of a particular category of swap. We believe that regulators will encourage centralized trading by permitting parties to communicate and execute trades freely, so long as the parties comply with the requirement to execute trades on a centralized venue.

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[21] ISDA's *Path Forward for Centralized Execution of Swaps*, April 2015: Http://www2.isda.org/attachment/NzM1Ng==/Path%20Forward%20for%20Centralized%20Execution%20of%20Swaps%20FINAL.pdf

Conclusion

US legislators moved quickly to draw up and finalize the Dodd-Frank Act in response to the financial crisis. Five years on from its enactment, the vast majority of the key requirements on derivatives have been implemented. The first US clearing mandates, for example, were introduced in 2013. All swaps transactions involving a US person are now required by the CFTC to be reported to SDRs, and SEF trading volumes increased rapidly following the first trade mandates in 2014.

But this first-mover status has also created problems. The speed with which the legislation was drawn up meant little time was given to coordination and cooperation with non-US legislators. Differences in implementation schedules and in the substance of the regulation in different jurisdictions have emerged as a result.

With other jurisdictions now developing or implementing comparable rules, there is now an opportunity to harmonize the various regulations to facilitate cross-border trading. Critical to this initiative is an effective and transparent substituted compliance framework. Efforts to achieve equivalence between jurisdictions have floundered on several occasions because regulators have conducted a granular, rule-by-rule comparison of the requirements. Substituted compliance determinations based on broad outcomes would maximize the potential for cross-border harmonization, and would align the regulatory framework more closely with the G-20 commitments.