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February 28, 2011

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

Re: Notice of proposed rulemaking: Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants (RIN 3038-AC96)

Dear Mr. Stawick:

The International Swaps and Derivatives Association, Inc. ("**ISDA**") appreciates the opportunity to comment on the notice of proposed rulemaking (the "**NPR**"), promulgated by the Commodity Futures Trading Commission (the "**Commission**") in accordance with Section 731 of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**"), which amends the Commodity Exchange Act ("**CEA**") by adding a new Section 4s(i), which in turn directs the Commission to adopt rules governing documentation standards for swap dealers ("**SDs**") and major swap participants ("**MSPs**"). Pursuant to the NPR, the Commission has proposed regulations (the "**Proposed Regulations**") that would prescribe standards for the timely and accurate confirmation of swaps and would require the reconciliation and compression of swap portfolios.

ISDA was chartered in 1985 and has 800 member institutions from 54 countries on six continents. Our members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end-users that rely on over-the-counter derivatives to manage efficiently the risks inherent in their core economic activities.

Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business through documentation that is the recognized standard throughout the global market, legal opinions that facilitate

enforceability of agreements, the development of sound risk management practices, and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

ISDA respectfully submits the following comments in response to the Proposed Regulations.

A. Confirmation (§ 23.501)

The proposed rules for confirmation place an unnecessary burden upon the inception of transactions, and they require substantially more than is necessary to create an initial record of a legally binding agreement. ISDA urges the Commission to consider that requiring more formality than necessary may actually increase risk in the swap markets because it may lead to, among other things, needless disputes and operational lapses. Also, requiring delivery of more information than is necessary delivers to the Commission more information than it can possibly assimilate. Most importantly, however, these additional confirmation requirements are at best redundant since, as more fully discussed below, multiple parallel processes already exist to effectively and efficiently mitigate the concerns these requirements are meant to address minus, the accompanying costs.

We think the proper role of the confirmation is that established decades ago in the swap markets. The confirmation is a record of a trade: the confirmation may evidence a prior binding agreement or be a binding restatement of a prior agreement or be the instrument that effects binding agreement. Whether or not each and every transaction needs an "executed" confirmation containing certain information is initially a question of contract law. If the answer to the question of contract law is "no," then there is still room for prudential regulatory requirements, but only those that successfully balance costs and benefits. With this in mind, we suggest that the Commission reconsider its proposal as against the way the swap markets now work. Is there actually a reason for same day or less confirmation procedures? Should the "negative affirmation" contract procedure institutionalized in certain sectors of the swap markets be discarded? Does market nomenclature relating to the confirmation process need to change, to the certain confusion of market participants of every type? How are counterparties that are not registrants to be compelled to cooperate with the proposed process? We think these are fair questions that must be asked (and answered) if the Dodd-Frank regulatory process is to enhance the market and the economy.

ISDA supports the Commission's objective of promoting the efficient operation of the swap market and facilitating market participants' overall risk management. Indeed, for many years ISDA has been at the forefront of industry efforts to improve the over-the-counter ("**OTC**") processing environment, which efforts have significantly reduced systemic risk and increased transparency by facilitating the timely and accurate

confirmation of swaps.[1] It is undisputable that documentation standards in the swap market have improved considerably.[2]

As the Commission notes, the industry has moved, at great expense and in a targeted manner to vastly improve the speed of the post-trade documentation process *without loss of accuracy*. The process can be, and is being, continued in an equally targeted manner and with equal regard for the integrity of the post-trade process, but the process requires both time and careful consideration of the appropriate balance between speed and accuracy. We also note the lack of any history of abiding problems that require the "solutions" proposed by the Commission, or even any substantive study positing real associated risks to mitigate. We recognize that there may be a prophylactic aspect to regulation, but that aspect must be limited by a genuine cost-benefit analysis. We are not aware of any such analysis that would support much of what is contained in the Proposed Regulations.

Given this marked improvement in post-trade processing, as well as continued industry efforts and commitments to enhance post-trade processing in a targeted, efficient and safe manner, it is now questionable whether the incremental benefits of the Commission's proposed standards applicable to all swap confirmations (such standards, the "**Proposed Confirmation Requirements**") will outweigh the significant compliance costs that the Proposed Confirmation Requirements will entail.

ISDA is concerned that the aggressive timeframes (same day or substantially less) embodied in the Proposed Confirmation Requirements may have numerous unintended consequences, not least of which is that the Proposed Confirmation Requirements may actually increase systemic risk by forcing market participants to focus on speed at the expense of accuracy. ISDA is also concerned about the "one size fits all" nature of the Proposed Confirmation Requirements. We note that the work done by the industry with the ODSG led to customization of documentation and confirmation timeframes to account for the differences between asset classes, and even between products within asset classes. In contrast, the Proposed Confirmation Requirements do not allow for this same flexibility. ISDA urges the Commission to take advantage of lessons learned by the industry. Rules for interest rate swaps, for example, may have good reason to be different from rules for energy transactions.

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[1] The NPR discusses the effort led by the OTC Derivatives Supervisors' Group ("**ODSG**"), pursuant to which market participants (including buy-side participants) regularly set goals and commitments to bring infrastructure, market design and risk management improvements to all OTC derivatives asset classes. ISDA is a participant in this project.

[2] The industry is meeting or exceeding ambitious agreed targets. For example, by increasing automation and requiring end-users to obtain counterparty consent before assigning trades, the 14 largest credit derivatives dealers, pursuant to a joint regulatory initiative involving U.S. and foreign regulators after trading volumes in OTC credit derivatives grew exponentially between 2002 and 2005, reduced their total confirmations outstanding more than 30 days by 94 percent to 5,500 trades by October 2006. *See* U.S. Government Accountability Office, "Credit Derivatives: Confirmation Backlogs Increased Dealers' Operational Risks, But Were Successfully Addressed After Joint Regulatory Action," GAO–07– 716 (2007) at pages 3–4.

In considering the perceived benefits of the Proposed Confirmation Requirements, ISDA would ask the Commission to consider industry efforts that have led to increased use of procedures such as trade confirmation and affirmation processes,[3] which should help to allay concerns of mismatched trade terms in the time period between execution and final documentation. Furthermore, as discussed more fully below, the industry is generally supportive of the Commission's proposal to require regular portfolio reconciliation. Taken together and along with improvements in market automation and recordkeeping, the means to capture and rectify discrepancies in a timely manner will very shortly exist, without the need to impose a regime that is costly, impractical and fraught with unintended consequences.

The Proposed Confirmation Requirements, furthermore, will be particularly burdensome on end-users. The timeframe requirements do not take sufficient account of the nature and infrastructure of end-users. The additional operational costs of supporting a one-day turn-around for some of the smaller buy-side operations may prove too burdensome and prevent their participation in the market, thus harming liquidity and their own risk mitigation. It is worth noting that these same clients are also the most likely to be excluded from clearing and on-facility trading by cost considerations, and therefore the most disadvantaged by the new confirmation proposals.

Delivery of Draft Acknowledgment

The Proposed Confirmation Requirements call for delivery by or to an SD or MSP, and to any other counterparty, prior to execution of a swap with a counterparty that is neither an SD or MSP, a draft acknowledgment specifying all terms of the swap transaction other than the applicable pricing and other relevant terms that are to be expressly agreed at execution. This is an entirely novel mechanism in the swap markets and may have serious negative consequences, including, but not limited to:

- Loss of timely execution opportunities due to producing a draft acknowledgement in situations where no standard agreement exists.

- The Proposed Confirmation Requirements will impose significant compliance costs on end-users. For example, full pre-agreement of terms would require end-users to engage significant legal resources for all proposed transactions, rather than just executed transactions. Transactions are often contemplated but not executed; in order to attempt to comply with the Proposed Confirmation Requirements, market participants would be required to engage in substantial upfront work (and cost) for every contemplated transaction to ensure that the Confirmation Requirement would

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[3] For example, third party vendors offer confirmation and affirmation services for a wide array of OTC derivatives products, including credit, equity and interest rate contracts. Pursuant to this service, parties electronically view trades "alleged" against them and either accept the trade details or suggest modifications. When modifications are suggested, a new trade record is automatically created, which both parties can compare against their original records and continue to suggest modifications until the trade reaches "confirmed" status.

be satisfied if such transaction is executed. This would be an enormous drain on resources for no perceived benefit.

ISDA submits that the Proposed Confirmation Requirements, as currently contemplated, are unnecessary in markets limited to "Eligible Contract Participants" (within the meaning of the CEA) ("**ECPs**"), because the usual sophistication and orderly conduct of participants in those markets mean that the risks that the Proposed Confirmation Requirements attempt to address are remote. ISDA believes that ECPs, long accustomed to ironing out details at the point of trade, should, at a minimum, have the ability to waive the requirement for a complete, pre-trade acknowledgment of terms.

Delivery of Confirmation or Acknowledgment

Similarly, ISDA is concerned that the 15- and 30-minute confirmation requirements may hinder the way that investment managers presently conduct their business. Investment managers commonly execute a single block trade and then allocate positions across their clients. Frequently this process can take more than 15 or 30 minutes, or more than a day, and frequently, the ultimate duration of this process hinges on a variety of reasons, such as compliance processes or receipt by investment managers of instructions from their clients to the extent necessary, who would not be subject to the timing constraints set forth in the Proposed Regulations. Without an appropriate exception that allows investment managers the time to allocate positions appropriately to their clients, those investment managers may be forced to execute individual trades for individual clients, thereby reducing economies of scale and more importantly may cause harm by unnecessarily increasing pricing and operational costs for their clients. We urge the Commission to reconsider its proposed deadlines against these circumstances.

Even if all information is known, the proposed timing standards are impractical for products where no "master confirmation agreement" or other similar template exists. More fundamentally, certain terms required to be included in an acknowledgment or in a confirmation simply may not be known to the transacting parties on the same calendar day as execution. For example, initial rates may follow trade commitment by days.

It is also necessary to consider the interrelation of the Proposed Confirmation Requirements and the Commission's notice of proposed rulemaking regarding primary swap documentation (the "**Swap Documentation Rules**"), which would require the parties to agree valuation methodologies.[4] Valuation procedures themselves may be heavily negotiated and are likely to be variable in response to specific transaction type. Requiring the results of such negotiations (assuming results can be achieved) to be reflected in an acknowledgment or confirmation will inevitably slow down the confirmation process (as well as the overall documentation process, to the extent that parties may be required to agree valuation procedures within their basic agreements, *see* the Documentation

[4] 76 FR 6715 (February 8, 2011) (the "**Documentation Release**").

Release).[5] In such circumstances, the preference of market participants would be to execute the trade in a timely manner instead of waiting for the conclusion of any negotiations related to non-economic terms.

The process of confirming swap transactions is certain to change as the industry moves to a model based on clearing at Derivatives Clearing Organizations ("**DCOs**") and trading of swaps on Designated Contract Markets ("**DCMs**") and Swap Execution Facilities ("**SEFs**"). Trade confirmation is embedded in the clearing process (clearing workflows, which would capture the most standardized trades, currently *allow for undocumented trades to age into the next day*). Given the standardization of transactions and transaction practices inherent in clearing and facility execution, as well as the legal, operational and technological challenges that market participants face as the markets change (and the upfront costs associated with those changes), ISDA does not believe that the imposition of the Proposed Confirmation Requirements on cleared trades will be a worthwhile allocation of the industry's stretched resources.[6] ISDA would also be grateful for clarification from the Commission as to how trading of swaps on DCMs and SEFs will satisfy the Proposed Confirmation Requirements.

We also note certain additional practical difficulties posed by the Proposed Reconciliation Requirement, which include, but are not limited to, the following:

- Systems and practices for monitoring and recording of voice trade execution time do not currently exist;
- Cross-border transactions frequently necessitate more than one day to confirm due to business day and time zone differences;
- The Proposed Confirmation Requirements neglect to account for transactions executed on "close" or towards the "end of day"; and
- It is also unclear as to how counterparties that are not SDs or MSPs can be "bound" to comply (or even cooperate) with the Proposed Confirmation Requirements.

Based on these market realties, we encourage the Commission to adopt a flexible approach where the confirmation standard may differ based on asset type, trade type, counterparty

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[5] We believe that the Commission's emphasis on valuation content in documentation between parties is misplaced. We believe that valuation data may be made available by other means. Please see our recommendation regarding valuation data set forth in the joint comment letter from ISDA and the Securities Industry and Financial Markets Association (together, the "**Associations**") to the Commission, dated February 7, 2011, regarding the CFTC's notices of proposed rulemaking with respect to Real-Time Reporting, Swap Reporting and Recordkeeping by Swap Dealers and Major Swap Participants (the "**Data Letter**").

[6] At present, a third party vendor system is used for eligible credit default swap trades, enabling market participants to achieve a so-called "golden confirmation." The industry has already invested substantially in this infrastructure. Any investment in a new style of confirmation platform will divert resources away from preparations for the move to clearing.

type, event type and surrounding circumstances. Moreover, any approach should be practicable, such as establishing a timeframe in which a trade must be documented based on the date *and time* of execution rather than solely on the *date* of execution. More specifically, ISDA suggests that the Proposed Confirmation Requirements should be delineated as follows:

(a) *Cleared trades*

For the reasons outlined above, the Proposed Confirmation Requirements should not attach to cleared trades. If, however, the Commission were to apply the Proposed Confirmation Requirements to cleared trades, we would encourage the Commission to provide that clearing a swap through a DCO will be deemed to satisfy the Proposed Confirmation Requirements. DCO rules will be monitored by regulators, thus ensuring that DCOs are held to a sufficient standard for trade processing.

(b) *Trades executed electronically and processed electronically*

As a preliminary matter, ISDA would request that the Commission clarify the meaning of a transaction that is "executed electronically" or "processed electronically." The bounds of these terms must be refined because there is a variety of systems and communication devices that may be used and that may have different assortments of features. We note that the term "processed electronically" is currently defined in the Proposed Regulations by reference to the SD's or MSP's computerized systems.

ISDA respectfully suggests that it would be inappropriate to include within these terms all transactions for which some element of the transaction is captured or processed through electronic means. Instead, we urge the Commission to define this term with reference to a platform's electronic processing system (or "middleware"), which will actually drive the process. Electronic systems and platforms now available are not uniform and cannot uniformly comply with the Proposed Confirmation Requirements. Indeed, those systems may presently have difficulty communicating with each other.

Although the timeline set forth in the Proposed Confirmation Requirements may become workable in years to come, appropriate platforms and processes will need to be developed by the industry before that is the case. In this context, ISDA recommends that any externally imposed confirmation standards be both phased and aspirational. ISDA also recommends that the Commission provide that executing a swap on a SEF or DCM, in accordance with the procedures of the trading venue, will be deemed to satisfy the Proposed Confirmation Requirements. Both SEF and DCM rules will be monitored by regulators, thus ensuring that SEFs and DCMs are held to a sufficient standard for trade processing.

(c) *Trades not executed electronically but processed electronically*

ISDA believes that it would be prudent to conduct a study in order to better understand the potential barriers to complying with any specific timeline in each asset class. For example, some markets would have particular trouble abiding by the Proposed Confirmation Requirements as presently proposed to the extent they rely on "negative affirmation," a contractual methodology relying on one-way confirmations that require no reply unless being disputed.

(d) *Trades not executed electronically and not processed electronically*

ISDA is concerned that the timeframes laid out in the Proposed Regulations are not achievable based on current market practice. Transactions in this category are heavily negotiated, bespoke in nature and the post-trade detail work, often negotiated by lawyers, is often protracted. As applied to such transactions, the Proposed Confirmation Requirements set forth by the Commission would impose significant challenges and costs, particularly on end-users. Specifically:

- Flexibility and "bespokeness" of contracts are keys to enabling clients to execute the transaction types in the form they require. Complete pre-agreement of terms would require end-users to engage significant legal resources for *all* proposed transactions, as compared to existing practice, which focuses on transactions that have actually been executed. It would also increase costs and so discourage end-users from hedging, all without any perceived benefit.

- ISDA is generally concerned that the timeframes laid out in the Proposed Regulations will impact the accuracy of trade acknowledgements sent. That accuracy is dependent on an investment of time in the internal controls that are part of the post-trade, pre-acknowledgment workflow.

Instead of rule implementation at this point, ISDA proposes an approach similar to that utilized by the ODSG. This approach would involve ongoing dialogue between the Commission and leaders in the swap industry, with the goal of obtaining a commitment from the industry to tighten the confirmation timeframe over a more extended period. As noted above, we believe that existing risk mitigants (*e.g.*, trade affirmation) may assuage the Commission's concerns in the interim.

Life Cycle Event Data

The Proposed Confirmation Requirements would mandate confirmation of events that are not currently confirmed by the swap industry. The imprecise timing and unpredictability of certain life cycle events means that it will be difficult for those events to be confirmed within the timeframes envisaged by the Proposed Regulations. Some "market" life cycle events (*e.g.*, option exercise notices, various notices sent by calculation agent, *etc.*) are

already described in the original confirmation and we see no benefit to confirming those events. These can be distinguished from "legal" life cycle events (*e.g.*, novations and terminations) which currently are confirmed. Industry methodologies have been developed around the confirmation of legal life cycle events at great time and expense. We encourage the Commission to defer to industry standards and to allow market participants to bilaterally agree that certain life cycle events do not require subsequent confirmation. Indeed, this proposed life cycle confirmation requirement in its present form will undermine the move to electronic execution and processing, because not all life cycle events are currently supported by electronic platforms across asset classes.

As similarly noted in our discussion of portfolio compression below, the confirmation of life cycle events varies across asset classes and products and is therefore not susceptible to a blanket rule. The following is a non-exclusive list of examples:

(a) *Equity derivatives*: Subject to various types of life cycle events which distinguish them from other OTC derivative products, including corporate action events, barrier events, and equity resets.

(b) *Commodities*: Physically and/or financially settled instruments include a varied range of potential post-trade life cycle events, including novations.

(c) *Foreign exchange/currency derivatives*: Three types of life cycle events: (i) natural events, (ii) barrier events and (iii) term-modification events. However, life cycle event processing is not as critical in this context because foreign exchange derivatives are almost all single-cycle or "bullet" products with only one "natural" event per transaction – that event being an exercise or fixing event at the end of the cycle which turns into a 2-day (spot) settlement or simple single-currency cash flow. Confirming these natural events is then considered duplicative because they are already captured/confirmed in the settlement process.

Definitions

ISDA emphasizes that certain definitions discussed in the NPR will require sufficient clarity to avoid confusion in, and disruption to, the swap markets. For example, some might interpret an "acknowledgment"[7] to be equivalent to "economic affirmation," which refers to the matching of economic fields only. Because the Commission's terminology is foreign to participants in the swap industry, it will require much greater specificity than that set forth in the NPR.[8] Similarly, would "confirmation"[9] include matching services,

[7] Defined in the NPR as "a written or electronic record of all of the terms of a swap signed and sent by one counterparty to the other."

[8] Terms as basic as "processed electronically," require further clarification.

[9] Defined in the NPR as "the consummation (electronically or otherwise) of legally binding documentation (electronic or otherwise) that memorializes the agreement of the counterparties to all of the terms of a swap transaction. A confirmation must be in writing (whether electronic or otherwise) and must legally supersede

such as the Markit Trade Matching process, which many buy-side parties use to "affirm" trades?

Regulatory Harmonization

As noted earlier, ISDA supports the Commission's objective of promoting the efficient operation of the swap market and facilitating market participants' overall risk management. ISDA is concerned, however, that aspects of the rules proposed by the Securities and Exchange Commission ("**SEC**") with respect to trade acknowledgment and verification of security-based swap transactions (the "**SEC Rule**") are inconsistent with the Proposed Confirmation Requirements in ways not related to the differences in types of swaps under the jurisdiction of the respective commissions. This may lead to confusion in, and disruption of, the swap and security-based swap markets. ISDA urges the Commission and the SEC to ensure that their respective regulations are harmonized as far as possible.

B. Portfolio Reconciliation (§ 23.502)

The Proposed Regulations would require the reconciliation of swap portfolios (the "**Proposed Reconciliation Requirement**"). The Commission proposes rules that would require SDs and MSPs to reconcile their portfolios of trades with each other and also to provide reconciliation opportunities to their unregistered counterparties. The Commission proposes that this process be applicable to all transactions, collateralized and uncollateralized, as a means of identifying and resolving disputes both as to the value of transactions for collateralization purposes and as to the terms of trades generally. The Commission also intends to ultimately gain a better understanding of market disputes and a related oversight role through the portfolio reconciliation process (and dispute reporting required in the proposed Swap Documentation Rules).

Portfolio Reconciliation and Collateral Dispute Resolution in the Swap Markets

The Commission notes the substantial efforts made by participants in the swaps market to establish a portfolio reconciliation and collateral dispute resolution process over the past several years, and seeks to build on those efforts. ISDA, as a participant in those efforts, recently released to the ODSG certain work-in-progress drafts of the extensive documentation that is being developed in this endeavor, *i.e.*, the draft 2011 Convention on Portfolio Reconciliation and the Investigation of Disputed Margin Calls (the "**Convention**") and the draft 2011 Formal Market Polling Procedure (the "**MPP**" and, together with the Convention, the "**DR Drafts**").[10] We believe that the DR Drafts will add considerably to the improved management of disputes. The discussions taking place through the ODSG process is highly relevant to implementation of the Proposed

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any previous agreement (electronically or otherwise). A confirmation is created when an acknowledgment is manually, electronically, or by some other legally equivalent means, signed by the receiving counterparty."

[10] As part of ongoing discussions with the ODSG, ISDA plans to submit an updated draft of the DR Drafts to the ODSG shortly after the submission of this letter to the Commission. Ultimately, ISDA hopes to be able to have its offering dovetail with regulatory requirements.

Reconciliation Requirement, as discussed more fully below; the DR Drafts are being developed through extensive work involving both buy-side and sell-side firms, and are intended to be widely adopted by OTC derivatives market participants that use the current ISDA Credit Support Annexes.

In light of the Proposed Reconciliation Requirement, ISDA respectfully reminds the Commission that portfolio reconciliation is not meant to be a replacement for the confirmation process, which is focused on identifying discrepancies in trade terms, but is rather a means of identifying the source of a collateral dispute. Portfolio reconciliation, intrinsically, is only the first step in the dispute resolution framework represented by the DR Drafts. The primary purpose of portfolio reconciliation has been to be an initial phase in a multi-step process to keep collateral flowing; helping to ease disputes by identifying their causes and giving parties acting in good faith a commercially reasonable timeframe to find the appropriate resolution. A consultation process and time for consultation is intended to follow portfolio reconciliation within the Convention portion of the DR Drafts. If the Convention process does not succeed by itself, disputing counterparties are intended to transition to a highly directed process of dispute resolution.

Resolution of Discrepancies in Transaction Terms

Although the Proposed Reconciliation Requirement contemplates the use of portfolio reconciliation as a method of resolving trade term discrepancies, it may be helpful to point out that these discrepancies are susceptible to discovery through a number of other mechanisms that the Commission proposes to regulate. The clearing of trades at DCOs produces an authoritative record in and through the clearing house and will work to reduce the population of trades that need to be reconciled bilaterally. Execution of trades at DCMs and SEFs similarly will produce an authoritative transaction record, potentially obviating the need for, or to be leveraged in, the bilateral portfolio reconciliation matching process. Further, as the Commission observes, swap data repositories also will have records helpful in disposing of controversy over trade terms. Confirmation and affirmation processes are also designed to identify potential differences.

Given that portfolio reconciliation is surrounded by processes that are designed to reveal discrepancies in transaction terms, it would be wise to use the relatively expensive and labor intensive portfolio reconciliation process solely as part of a valuation dispute discovery and resolution process that has immediate economic meaning reflected in adjustment of collateral between the parties.

Resolution of Valuation Disputes

ISDA, as described above, has been working intensively with member firms and supervisors in the ODSG for the past two years to develop an improved market practice, now represented by the DR Drafts, for the investigation and resolution of valuation disputes that lead to disputed margin calls. We commend the overall approach taken by the Commission in the Proposed Regulations with respect to portfolio reconciliation and

the management of disputed margin calls. In particular, we support the Commission's decision to avoid prescribing a specific method for the resolution of valuation disputes and we appreciate the Commission's recognition of industry-led efforts to facilitate the resolution of such valuation disputes. As you will see in our comments below, however, ISDA believes that the new industry methodology, which is being developed with much deliberation, negotiation and industry-wide participation, should play a more significant role in shaping the Proposed Reconciliation Requirement.

Reconciliation Frequency

The Proposed Reconciliation Requirement requires that reconciliations be periodic, with frequency established according to number of transactions and whether or not a non-SD/non-MSP party is involved. ISDA urges the Commission to accept the portfolio size/frequency gradation established by the ODSG process, as that may change over time. ISDA also believes it is unnecessary to distinguish among counterparty types in establishing frequencies. Transaction population alone is an adequate guide. Taking heed of the ODSG learning process in this respect and others has the advantage of providing an internationally consistent standard developed as a result of public and private sector collaboration that more readily lends itself to evolution as circumstances require.

What is "Reconciliation"?

The Proposed Regulations reflect an overly rigid view of "reconciliation." In our view, depending on a variety of factors, reconciliation may be a more or less automated process, perhaps involving third party vendors (or not). ISDA suggests that "reconciliation" be defined by reference to generally-accepted industry standards, as evolved through the ODSG process (and bilaterally between counterparties), with particular reference to data standards and best practices as published by ISDA from time to time.

Reconciliation and resolution both will be meaningful only if considered on a whole, nettable portfolio basis, without regard to the artificial boundaries of regulatory jurisdiction. From a prudent risk management perspective, this means that "swaps" and "security-based swaps" within the same portfolio need to be subject to the same requirement and any resolution tolerances should be applied with a single portfolio of both "swaps" and "security-based swaps" in mind.

Portfolio Level Discrepancy Should be the Sole Basis for Resolution

The Proposed Reconciliation Requirement would dictate that dispute resolution be conducted on a transaction by transaction basis. ISDA urges instead that only discrepancies underlying material portfolio level collateral transfer disputes be subject to a resolution requirement. Resolution, even more than reconciliation, is frequently a labor intensive and, in fact, management intensive process. Economics dictate that resolution take place only when needed, that is, when transfers of collateral are in issue.

Some, but not all, valuation discrepancies may represent elevated risk, but it is widely accepted (including in the NPR itself) that two counterparties to a particular transaction may generate legitimately different valuations of a derivative instrument at a given point in time. It is therefore unlikely that the parties to such a transaction will precisely agree on values, and some level of discrepancy is to be expected. Market participants typically predicate their intensive investigation of transaction level discrepancies on the existence of a portfolio level margin dispute (as discussed more fully below). This is a rational approach, that allows for the possibility that material but offsetting differences may exist in a portfolio; individually and in the abstract, such differences are deserving of investigation and resolution,[11] but their net effect is to cancel out one another. The key, in our view, is to determine when a discrepancy is significant and needs to be investigated, and when it does not. Only discrepancies underlying material collateral disputes should be subject to a resolution requirement.

Where there is a margin dispute, collateral in the swaps market is usually transferred on a net portfolio basis. Small discrepancies in assessments of portfolio value, or any discrepancy in the absence of either a collateralization requirement or a live dispute as to collateralization, may be allowed to subsist as potentially harmless and may disappear through changes in portfolio composition over time. Accordingly, a materiality standard should apply to any regulatorily-mandated resolution requirement, so as to avoid the time and expense of uneconomical dispute resolution procedures. ISDA's work with the ODSG should not be disregarded in this respect. ISDA respectfully recommends that ODSG resolution tolerances be accepted by the Commission, as such tolerances may be amended over time.[12] We also reiterate the advantages of leveraging the ODSG learning process noted above.

What is "Resolution"?

On a practical level, we suggest that the Commission should define "resolution" to mean that the difference in a portfolio level margin dispute, as the case may be, is reduced such that it is within the applicable resolution tolerance. In other words, "resolution" should not require exact agreement between the parties and "resolution" should not require the parties to make adjustments to their books and records. Importantly, portfolio reconciliation and the associated dispute resolution process are not principally intended to cause, and do not require parties to make, adjustments in parties' books and records or changes to trade terms. Such changes of course should be made by a party only in accordance with its own internal policies, subject to relevant regulatory and accounting requirements, and with a view to the potential need for conforming changes in still other parts of the party's books

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[11] Parties have the contractual ability to seek resolution of specific transaction level valuation disputes that may not reflect a portfolio level dispute above the proposed materiality standard and parties often actively investigate and resolve such disputes. However, parties should maintain the flexibility to prioritize resolution of disputes that do not cumulatively rise above the portfolio level materiality standard.

[12] The vast majority of portfolios are collateralized. To the extent portfolio reconciliation has a role to play with respect to uncollateralized portfolios, ISDA would ask the Commission to defer to the approach developed by the ODSG.

and records. However, to the extent that through the process of dispute resolution, where parties have agreed to move collateral on the basis of a mutually agreed value, an amendment to books and records might be considered appropriate in accordance with such internal policies. Lastly, parties should be free to "agree to accept that there is a difference in opinion as to value," so long as appropriate capital is held against any potential collateral shortfall.

Timing for Resolution

Proposed section 23.502(a)(5) specifies one day for resolution of valuation discrepancies. ISDA would support the most rapid resolution possible, but in practice resolution on this timeframe is infeasible, especially when it applies to parties across vastly different time zones (*e.g.*, the U.S. and Asia). In reality, a one-day resolution requirement could yield many unintended consequences. For example, this may result in a market participant either being required to move more assets than its calculations show to be appropriate to its counterparty or, alternatively, experiencing an increase in exposure to its counterparty due to what it considers to be an increased collateral shortfall, as compared to its own calculations. Certainly, the resolution process can begin within a day of establishing that there is a dispute beyond applicable tolerance. Resolution should be permitted to progress using the full methodology of the DR Drafts, however, through the timing discussed with the ODSG.[13]

Some reasons for allowing more than a day for resolution are as follows:

- The portfolio reconciliation results must be analyzed to determine the root causes of the dispute, which may also take time. If this process must be conducted across different time zones, it will take even longer.

- Some disputes require trader-to-trader discussion to resolve, and may need to be escalated to senior management for further discussion.

- A small number of disputes prove to be intractable throughout the foregoing process, and must be resolved by some kind of independent reference process, such as a market poll or other agreed upon dispute resolution methodology. The MPP is one example of a polling process, but others are possible. However, all polling processes require some time to prepare, conduct and then assess. Depending on the product concerned, substantial effort may be required to price transactions; although quotes for a vanilla interest rate swap might be obtainable within a few

[13] The current DR Drafts contemplates such an extended timeframe to allow for resolution in a cooperative and systematic manner. For example, the Convention allows for 30 business days for the Convention to operate, plus 18 local business hours where the MPP is required to achieve resolution.

minutes,[14] for a complex structured derivative the time taken to build and populate a valuation model may be measured in hours or even days.

- Where clear and present credit default risk exists, there may not be time to proceed through all of the steps above that are employed in the ordinary course of business. It may be necessary to accelerate directly to the final stage of market polling or other agreed upon dispute resolution methodology. The potential for acceleration remains under study within ISDA.

Taking the above factors into account, and combined with sensible portfolio reconciliation, it is anticipated that the Convention, given adequate time to function, should prove sufficient to settle the vast majority of disputes. Moreover, as discussed above, the DR Drafts contemplate the ability for either party to accelerate directly to the final stage of market polling or other agreed upon dispute resolution methodology thereby shortening the amount of time under the Convention. This would be rarely done in practice but could be suitable in a situation where a party feels the need to resolve the valuation dispute quickly such as in a crisis situation or when a party believes that its counterparty poses an intolerable credit risk. Therefore, the DR Drafts offers parties both the flexibility to resolve valuation disputes in a cooperative and systematic manner while also providing for the ability to resolve significant valuation disputes quickly when time is of the essence.

Recordkeeping

Provided that the Commission were to adopt our recommendations outlined above, the recordkeeping requirements set forth in proposed section 23.502(d) would have to be revised accordingly. We believe that a simplified regime for record retention could provide more targeted information to permit supervisory review, at materially lower cost to industry participants. It is important to target data retention towards those items where action was taken, not the full results of the portfolio reconciliation itself.

Specifically, we believe that, for any portfolio with a margin dispute requiring resolution in accordance with ODSG tolerances, a record must be kept detailing, at a minimum, the date of the initial dispute, the resolution and the date of resolution and the net portfolio valuations of the two parties. Portfolios not requiring resolution would not need to be recorded. This exception-based approach would dramatically reduce the amount of data to be stored and the cost thereof, while retaining the important records for supervisory inspection. To the extent that additional structural data about transactions is needed, this could be looked up from the SDRs, and if additional time series data about portfolio values were needed, this could be sourced from the CER.

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[14] Of course, in the future it is likely that vanilla products will be cleared, and therefore this particular question will not arise. The result of this is that all of the relatively easy to value products are highly unlikely to feature in disputed bilateral margin calls, and it is therefore more likely that trades requiring dispute resolution will be of more complex varieties and take more time to evaluate.

We suggest that it be explicitly permitted that access to a third party reconciliation service provider's records shall satisfy the obligation to permit inspection of these records by supervisory agencies.

Reporting to Supervisors

Proposed section 23.502(d) sets forth certain recordkeeping requirements for each swap portfolio reconciliation, but the Proposed Regulations do not impose any reporting requirements. Nevertheless, recognizing the importance of reporting to an effective portfolio reconciliation process, the DR Drafts would require SDs and MSPs to prepare reports in order to facilitate internal compliance and to aid Commission oversight. ISDA suggests that the Commission accept the benchmark established by the ODSG process, as amended from time to time.[15]

International Coordination

Because portfolio reconciliation and dispute resolution necessarily require the interactive cooperation of both parties in real time, ISDA believes it is vital that the relevant international rules be perfectly synchronized. This will avoid situations where two parties have a dispute but each is subject to rules that are mutually incompatible. Synchronization must extend to the content of the rules, the timing of actions under the rules and the implementation phasing thereof. *See also* "Extraterritorial Application" below.

C. Portfolio Compression (§ 23.503)

The Commission proposes to broadly mandate portfolio compression under certain circumstances (the "**Proposed Compression Requirement**"). Although ISDA agrees that the benefits of portfolio compression should over time become more generally available, we wish to emphasize that this process took several years to develop and is asset specific. Compression as now known, furthermore, works by virtue of involving a relatively small and homogenous group of participants. This narrow participant pool and homogeneity limits both the level of difficulty in engineering compression and the range of attendant risks. ISDA is concerned that establishing a broader compression process in additional asset classes and products would be extremely costly, while the benefits would be limited. ISDA further believes that the move to clearing of swaps will reduce the need for bilateral/uncleared trade compression (multilateral compression will become less effective as a greater portion of fungible, liquid products across credit and rate markets become cleared and, as a result, the frequency of good compression opportunities outside of DCOs will be reduced). In short, there are costs and risks involved in mandated portfolio compression. It is by no means clear that the process should be institutionalized. Given the lack of an explicit statutory basis for the Proposed Compression Requirement (Section 4(s(i)) of the CEA makes no reference to portfolio compression), we believe that the

[15] Under the current ODSG framework, all SDs and MSPs would be required to send a monthly report to their primary supervisor and the Commission listing all margin disputes where the ODSG resolution threshold was exceeded and the dispute remained unresolved after 15 days.

specifics around portfolio compression are best left to market participants, instead of being prescribed by regulation.[16]

ISDA urges the Commission to forego the Proposed Compression Requirement. Should the Commission decide otherwise, ISDA offers the additional comments that follow with respect to specific aspects of the Proposed Compression Requirement.

ISDA supports the Commission's recognition that compression participants should be permitted to set appropriate credit, market and cash payment risk tolerances, to manage their counterparty risks appropriately. Mandatory multilateral compression without these tolerances could actually increase risk by matching counterparties who never intended to face each other, or by lodging counterparties in transactions beyond their standards. Counterparties following FAS 133 hedge accounting may find their accounting arrangements frustrated. Unless "books" of swaps organized by counterparties are protected, distortion in records and accounts will result.

Not all compressions are riskless. In particular, many face risks and costs that make compulsory multilateral compression unsuitable for MSPs and end-users. Multilateral compression produces a variety of changed risk profiles, for example, in delta risk and counterparty risk, in a participant's portfolio which must then be managed during the compression exercise or risk economic loss, even within the confines of pre-agreed tolerances. In addition, multilateral compression cycles are typically managed with automated tools to support tear up and new trade creation that non-SD, non-MSP counterparties usually do not possess. Nor can the costs of these tools be justified by the benefits that multilateral compression may yield for these counterparties.

Thus far portfolio compression has not been applied to all asset classes. Portfolio compression is not easily portable across asset classes and the industry will need to develop practices for each additional asset class. We suggest that the following asset classes and products, as applicable,[17] should be specifically excluded from the scope of any Proposed Compression Requirement for the following reasons:

(a) *Foreign exchange swaps*: This market is focused on institutionalizing daily trade aggregation (*e.g.*, via the CLS Aggregation Service), which is more relevant in this context. Furthermore, as opposed to other asset classes (*e.g.*, credit and interest rate derivatives), where the tenor is measured in years, the average tenor for foreign exchange and currency derivatives is between three and six months (and for foreign exchange forward contracts, as little as three to five days). Given the short tenor of

[16] As noted elsewhere in this letter, the industry faces significant costs and time pressure in building the systems that are required for compliance with the Dodd-Frank Act. Given that existing portfolio compression systems have been developed at great cost, we question the benefits of the Compression Requirement in view of its likely costs.

[17] For these (and other similar) asset classes or products, which will result in very low compression, the benefits of the Compression Requirement would be minimal while the implementation costs would be significant.

these trades, their non-standardized, bilateral nature and the considerable preparation time associated with the compression process, there is minimal benefit to be gained from compression in this context.

(b) *Equity derivatives*: This market is broadly positional in nature and, as a result, there is little opportunity for compression and netting. In addition, as the equity OTC market is broadly hedged with physical securities and/or listed derivatives, the justification for the Proposed Compression Requirement is diminished and could in fact increase risks by disrupting hedged positions. A lack of product standardization in this area also weighs in favor of an exclusion from the compression requirement.

(c) *Commodities*: The notional amounts are comparatively low within this asset class and compression yields will only be worthwhile across a limited subset of products (primarily oil and precious metals). As an alternative to the imposition of the Proposed Compression Requirement to the entire asset class, we propose that so long as market participants and compression vendors can continue to define compression opportunities where the returns outweigh the costs, subjecting a consistently limited subset of commodity products to the Proposed Compression Requirement could be feasible.

Given the vast administrative and logistical obstacles that market participants will encounter in complying with the Proposed Compression Requirement, ISDA urges the Commission to consider a suitable phase-in period that will allow such parties to abide by the Commission's mandate within a reasonable timeframe, yet avoid disruption to the swap markets.

Application to Cleared Trades

ISDA strongly believes that the Proposed Compression Requirement should not attach to cleared trades. If, however, the Commission were to apply the Proposed Compression Requirement to cleared trades, we would encourage the Commission to provide that clearing a swap through a DCO and satisfying that DCO's compression requirements (subject to our suggestions below), if any, will be deemed to satisfy the Proposed Compression Requirement. We anticipate that cleared swaps will represent the bulk of the market. The remainder of the market will likely comprise of more illiquid swaps, and we expect there will be insufficient volume in this segment to have any material *continuous* compression benefit.

Multilateral Portfolio Compression

The Commission requires that SDs and MSPs "participate in multilateral compression exercises that are offered by those DCOs or self-regulatory organizations of which the swap dealer or major swap participant is a member." If portfolio compression is to be mandated, we believe that requiring members of a DCO or SRO participate in compression

exercises offered by the DCO or a SRO, unless carefully monitored, will create an unreasonable advantage to those organizations and inhibit legitimate competition in the market among providers of compression services. Members of a DCO or SRO could become bound to compression services marked by inadequate transparency, insufficient testing and a lack of price competition. Consequently, we propose that the Commission allow SDs and MSPs to select the compression venue, even if they do so as a group for DCO or SRO-mandated compression. To the extent that it is rational for the exercise to take place within the DCO or SRO, then this will naturally occur, but if there are alternative services or venues that provide an equal or better service, market participants should not be constrained from taking advantage of those opportunities.

Furthermore, despite the proposed definition of "multilateral portfolio compression exercise," we note that there can be several approaches to multilateral compression, including (i) full termination of existing swaps and replacement with new swaps and (ii) full and partial (*i.e.*, reduction of notional value) termination of existing swaps.[18] A multilateral portfolio compression exercise can also achieve other results, including reduction of counterparty risk, reduction of the number of outstanding swaps and reduction of outstanding notional values, all of which are consistent with the overall goals of the Dodd-Frank Act. In order to accommodate these different outcomes and methodologies used by providers of multilateral compression services, we would instead ask the Commission to consider defining "multilateral portfolio compression exercise" as follows: "an exercise in which multiple swap counterparties wholly or partially terminate some or all of the swaps submitted by the counterparties for inclusion in the portfolio compression and, depending on the methodology employed, replace the terminated swaps with other swaps whose combined notional value (or some other measures of risk) is less than the combined notional value (or some other measure of risk) of the terminated swaps in the compression exercise."

Requirement to Bilaterally Terminate or Net Certain Swaps

We do not consider the Commission's proposal to require SDs and MSPs to terminate bilaterally all fully offsetting swaps between them by close of business on the business day following execution to be appropriate. Offsetting swaps are a marginal inefficiency but they are not deep pockets of risk. The Commission's proposed termination rule would be extremely difficult and expensive to systemically implement (at the outset, specific new processes will have to be established to locate single offsetting trades) and generally would require the Commission to develop more fully-defined criteria (for instance, we are unclear as to how perfect an offset need be in order to require termination (perfect offsets are not common)).

We believe that the Commission's proposals to prescribe periodic bilateral netting of swaps not covered by multilateral or cleared compression processes will have limited

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[18] Under the latter methodology, swaps are not replaced with a smaller number of swaps; rather, existing swaps are either fully or partially terminated.

returns in the majority of cases, especially in the case of trades with end-users, who engage in trades that are typically more bespoke in nature. This could be an onerous task, particularly for those end-users. ISDA would support a less prescriptive requirement for general recordkeeping and the annual identification of *material* netting opportunities which could be executed bilaterally.

Application to Financial Entities

Lastly, the NPR requests comment as to whether "financial entities" (as defined in the Dodd-Frank Act) should be required to comply with the Proposed Compression Requirement. For the reasons detailed above, we believe that it will be difficult enough for SDs and MSPs to comply with the Proposed Compression Requirement. On this same basis, ISDA believes that it would be quite impossible for a broader subset of market participants to comply with the Proposed Compression Requirement.

D. Extraterritorial Application

It bears mention that to the extent confirmation, reconciliation and compression practices imposed on SDs and MSPs registered in the United States are different from those imposed on equivalent entities in other jurisdictions, those practices should (a) apply to U.S. counterparty business only and (b) be applied in very careful measure, particularly with respect to potentially incompatible rules between U.S. and non-U.S. jurisdictions. International coordination is imperative to avoid regulation that results in competitive disadvantages for certain market participants, or creates unintended impediments to, or potential fragmentation of, the global derivatives markets.

E. Cost of Adoption

SDs and MSPs will incur substantial initial one-time costs to develop, test and implement new procedures and technology that are required in order to be compliant with the Proposed Regulations. For instance, some firms do not currently use an electronic platform or vendor services to reconcile their portfolios. To comply with the Proposed Reconciliation Requirement promptly, those firms will need to expend significant time and resources. Even those firms that do utilize electronic platforms or vendor services to reconcile their portfolios will need to make significant adjustments to comply with the Proposed Reconciliation Requirement.

As a result, we respectfully submit that the Commission's estimate of the cost of compliance with the Proposed Regulations is too low. The Commission pegs the upfront cost for technological improvements at $2,400 for each SD and MSP, whereas at this juncture we believe that initial compliance with the Proposed Regulations will cost each such entity approximately $5-10 million. Annual portfolio reconciliation expenses for a party with a large portfolio may rival and perhaps even exceed this upfront cost. Accordingly, we at a minimum urge the Commission to implement the Proposed

Regulations in a phased manner, thereby permitting market participants the time to appropriately surmount the challenges it presents.

Similarly, in considering the annual cost of compliance with the Proposed Regulations, our estimates suggest that a figure many multiples greater than the Commission's estimate would be more realistic.[19]

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ISDA appreciates the opportunity to provide its comments on the Notice of Proposed Rulemaking and looks forward to working with the Commission as the rulemaking process continues. Please feel free to contact me or ISDA's staff at your convenience.

Sincerely,

Robert Pickel

Executive Vice Chairman

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[19] The Commission estimates that the annual burden associated with the Proposed Regulations is approximately 1,282.5 hours, at an annual cost of $1,282,250 for each SD and MSP (*see* p. 81527 of the NPR). Given the Commission's cost assumption of $100 per hour, it would seem that the Commission's analysis would in fact lead to an annual cost of $128,250 for each SD and MSP, further illustrating the discrepancy between the Commission's cost estimates and our own.