ISDA Safe, Efficient Markets

April 29, 2011

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F St., NE.
Washington DC 20549-1090

Re: RIN 3235-AL13 - Notice of Proposed Rulemaking: Clearing Agency Standards for Operation and Governance (File Number 57-8-11)

Dear Ms Murphy:

This letter contains the response of the International Swaps and Derivatives Association, Inc. ("ISDA") to the Securities and Exchange Commission's (the "Commission") notice of proposed rulemaking ("NPR") regarding the regulations to implement risk management standards for designated clearing entities consistent with the authority to adopt such regulations provided by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

ISDA is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 800 member institutions from 54 countries on six continents. These members include most of the world's 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 ("OTC") derivatives to manage efficiently the financial market risks inherent in their core economic activities.

Since its inception, ISDA has pioneered efforts to identify and reduce 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 welcomes this opportunity to share its comments with the Commission and looks forward to assisting the Commission and its staff in implementing an appropriate risk management framework for clearing agencies that offer central counterparty ("CCP") services[1] ("Clearing Agencies"), with a view to enhancing market liquidity, reducing risk and fostering financial stability.

[1] In the NPR, the Commission also refers to a category of clearing agencies that do not offer CCP services. However, for the avoidance of doubt, in this letter, "Clearing Agencies" refers only to entities that offer CCP services.

International Swaps and Derivatives Association, Inc.
1101 Pennsylvania Ave., NW
Washington, DC 20004
www.isda.org

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Background

The Commission is proposing several rules that would set the standards for the operation and governance of Clearing Agencies.

As noted above, the Dodd-Frank Act specifically gives the Commission authority to regulate security-based swaps and to adopt regulations addressing risk management standards for security-based swaps Clearing Agencies that the Commission regulates. However, in addition to considering this specific directive in formulating the proposed rules, the Commission has taken the opportunity to extend its analysis to all Clearing Agencies that the Commission regulates. Accordingly, the Commission intends that all Clearing Agencies will be subject to these proposes rules regardless of whether they offer those services for transactions in securities that are or are not security-based swaps.

ISDA commends the Commission for its careful consideration of the issues raised by proposed of regulations and applauds the majority of the Clearing Agency risk management requirements proposed in the NPR. This response focuses on aspects of particular proposals where we think there is scope for improvement. The comments reflect those made in response to a previous Commodity Futures Trading Commission ("CFTC") NPR[2] on a related topic. We strongly encourage the SEC and the CFTC to coordinate and cooperate in the development of these regulations in order to build a harmonized U.S. framework for OTC derivatives and to bring appropriate consistency to the two agencies' regulation over similar products, practices and markets.
This letter contains three parts. The first covers our comments on the proposals in relation to Clearing Membership Eligibility. The second contains our comments on the proposed Default procedures. The third covers ISDA's other comments on the NPR, including on the proposed margin requirements and settlement requirements.

1. Clearing Member ("CM") Eligibility

We acknowledge that the Commission seeks to permit fair and open access to central clearing and has thus proposed minimum capital requirements for Clearing Agency clearing members ("CMs") that are significantly less than the capital requirements that Clearing Agencies currently require CMs to meet in the security-based swap markets.

We think that broadening access to central clearing is a worthy policy position *as long as* the associated risks are addressed to ensure that the potential benefits of broader access are realized and the substantial risks of central clearing in OTC derivatives markets are not significantly exacerbated. In this context, we urge the Commission to consider the importance of the following:

[2] ISDA response to RIN 3038-AC98-Notice of Proposal Rule-making: Risk Management Requirements for Derivative Clearing Organizations ("DCOs") (76 Fed. Reg. 3698) dated March 21, 2011.

(a) "Call Risk" Management

In OTC derivatives markets CMs generally participate in numerous Clearing Agencies and product markets. Consequently, it is very important that regulators and Clearing Agencies are able to discover and manage capital "call risk" arising from the possibility that an entity is a CM in multiple Clearing Agencies. For example, it is possible that the $50 million minimum net worth under the proposed rules is used repeatedly by a CM to meet the eligibility requirements of multiple Clearing Agencies. Consequently, there is a risk of inadequacy in a CM's capital cover for all of the Clearing Agencies at which it is a member in light of the potential impact of multiple assessments from different Clearing Agencies on the same CM or affiliate group in a short time-frame. We believe this circumstance to be a significant possibility given the relatively small number of transactors in the OTC derivatives market and the high likelihood that most CMs will be members of multiple Clearing Agencies. The proposed regulations do not address this call risk. Left unmanaged it poses a serious threat to Clearing Agency risk management.

We think that prudent management of call risk requires:

(i) daily reporting from the CM of their capital cover for the potentially numerous Clearing Agency assessments that it could be subject to from each Clearing Agency at which the CM is a member;

(ii) the CM to conduct regular stress tests at an 'extreme but plausible' market level in relation to the potentially numerous Clearing Agency assessments that it could be subject to, and to provide the results to the Clearing Agencies it is a CM at; and

(iii) each Clearing Agency to monitor and assess, on a daily basis, the ability of a CM and its related affiliates to meet these potential assessment exposures and share this daily analysis with other Clearing Agencies and the relevant prudential regulator(s).

Unless regulators and Clearing Agencies are able and willing to monitor a CM's assessment liability across all the Clearing Agencies at which it is a member and to ensure that such total liability is not excessive, we think that a far larger minimum capital requirement (e.g., $1 billion) remains appropriate.[3] At this significantly larger minimum capital requirement size, there would be less of a need for this ongoing regulatory scrutiny to address call risk across Clearing Agencies as much larger CMs are able to absorb these potential assessment costs whereas small CMs are more leveraged entities in the sense that the sum of their potential Clearing Agency assessment liabilities will be a larger number relative to their capital base.

(b) Minimum Standards of Risk Management Capability

In addition, we urge the Commission to be more specific in its participation requirements to ensure that CMs have adequate risk management capability. An

[3] For example, existing Clearing Agencies for interest rate products have generally set minimum capital requirements between $1 billion and $5 billion depending on the type of clearing member and other criteria.

appropriate risk management framework for a CM may be broadly categorized into following main components:

(i) Board and senior management oversight;

(ii) Organizational structure: the structure should conform to the overall strategy and risk policy set by the Board of Directors. Individuals who are allowed to take risk on behalf of the CM must have a strong understanding of the organization's risk profile, the products that they are allowed to trade, and the approved limits. The risk management function should be independent, reporting directly to senior management or Board of Directors; and

(iii) Strong systems and procedures for controlling, monitoring and reporting risk, including transactions between an institution and its affiliates. Such systems will include segregation of client assets and a credit limit process.

We strongly support the Commission's proposal to require CMs to have written risk management policies and procedures. In this context, we would also like to emphasize the importance of practical experience by CMs in risk management in addition to written policies and procedures.

(c) Prohibition on Unaffiliated Credit Facility Funding Arrangements for CM Financial Resources

We think that a credit facility funding arrangement from an unaffiliated entity should not be available to satisfy CM financial resource requirements. Although a CM may have a contractual right to access additional funds, it will still have to seek funds from a financial institution at a time of stress where a credit provider may be, despite the contract, unable or unwilling to provide funds. In addition, given the likely correlation between financial institutions, such funding resources are insufficiently reliable. Finally, a Clearing Agency has no rights to monitor and request information from the non-member financial institution providing the credit support to the CM.

(d) Require Clearing Agencies to require CMs to hold capital proportional to risk

We strongly agree with the SEC's proposal that Clearing Agencies should "scale" a CM's participation depending on the CM's amount of capital. Accordingly, we applaud proposed Rule 17Ad-22(b)(7) that requires a Clearing Agency to establish and enforce written policies and procedures designed to, amongst other things, make any net capital requirements of CMs scalable so that the capital requirements are proportional to the risks posed by the CM's activities to the Clearing Agency. We emphasized the importance of an equivalent regulation in our response to the CFTC and again urge the agencies to work together to build a harmonized framework in this context[4].

[4] CFTC proposed rule §39.12(a)(2)(ii) states: "Capital requirements shall be scalable so that they are proportional to the risks posed by CMs."; see also page 5 of ISDA response to RIN 3038-AC98-Notice of Proposal Rule-making: Risk Management Requirements for Derivative Clearing Organizations ("DCOs") (76 Fed. Reg. 3698) dated March 21, 2011.

2. Default Procedures

(a) Default Management Tests

The Commission's proposals do not appear to require a Clearing Agency to conduct and document a test of its default management plan. Given the importance of robust default management we think that default management tests should be undertaken more frequently and at least on a semi-annual basis.

(b) Require CMs to Participate in Default Management

The NPR proposals in relation to default management do not explicitly require that entities who become CMs must have the ability to participate in the Clearing Agency default management process including the ability to bid for the portfolios of other CMs of the Clearing Agency.[5] We urge the Commission to make such an explicit requirement as it is critically important that Clearing Agency risk management should begin with stringent requirements to become a CM in terms of default risk management capacity (in addition to other important entry criteria such as, for example, financial resources). If a Clearing Agency admitted a CM (or a group of CMs) that was unable to participate fully in default management, there could be significant negative repercussions for the Clearing Agency and for the market. In particular, the unexpected failure of one or more CMs to participate in default management at a moment of severe stress for the Clearing Agency would reduce available resources and liquidity, place heightened burdens on other CMs, and reduce the likelihood that the Clearing Agencies risk management process would be effective.

(c) Prohibit CMs Outsourcing Default Management

As an additional and related point, default management is too critical for CMs to outsource to unaffiliated third parties. Such outsourcing arrangements may not be sufficiently reliable in times of stress and should not be depended on, particularly in light of the systemic risk issues that may arise if the default management obligations of multiple CMs across multiple Clearing Agencies are outsourced to a handful of entities. In addition, there could be conflict of interest issues, since the unaffiliated third party would not have "skin in the game." As a result, through the actions of the unaffiliated third party a CM could be assigned an unsuitable part of a defaulting CM's propriety portfolio and/or at a sub-optimal valuation and/or wrongly accept customer positions from the defaulting CM. This conflict of interest concern is exacerbated where the entity to whom the default management obligations are outsourced to is a "competing" CM in the same Clearing Agency.

(d) Liquidation Time

The Commission requests feedback on how much flexibility Clearing Agencies should have regarding the time it takes to manage a default and perform and liquidation of positions.

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[5] This applies even when CM portfolios include very complex and illiquid products.

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In response, we consider that rather than setting prescriptive time periods, the required Liquidation Time should be the actual time it takes a Clearing Agency to liquidate a portfolio of swaps. This will depend in part on the characteristics of the relevant security-based swap and the market that it trades in (e.g., liquidity levels) and also the default procedures surrounding the liquidation of such swaps and how well-established they are (e.g., a Clearing Agency may have detailed default plans that have been put through several practical tests that demonstrate the relevant portfolio of swaps can be liquidated in a very short time). Using the execution platform of a swap as a proxy for such considerations and applying prescribed categorical liquidation times based on such proxies not only gives rise to inappropriate margin levels, but also disincentivizes Clearing Agencies from practicing the appropriate default management "drills" to reduce the liquidation time of portfolios of security-based swaps. Instead of such platform-related prescribed periods, the rule should provide for the margin levels to reflect the actual liquidation time of the relevant portfolio of security-based swaps and should further provide that in determining such time period, the Clearing Agencies should take into account such factors as the characteristics of the relevant swap and the market it trades in, and the liquidation times derived from the default management plan and practice testing run by the Clearing Agency. Regulators should have view of, and sign off on the default management plan.

Clearing Agencies should continually monitor the risk associated with concentration in participants' positions. If a Clearing Agency determines that a participant's cleared portfolio is so large that it could not be liquidated within the liquidation period assumed in the Clearing Agencies default management plan, then the Clearing Agency should have discretion to include an extra charge for concentration risk in the initial margin requirements of such participant.

(e) Clearing Agency Resolution Plan

Finally, a plan for the mitigation of Clearing Agency stress and the procedure for resolving a failing Clearing Agency were not proposed in this NPR. However, as in its prior comments[6], ISDA wishes to emphasize that it is imperative that a comprehensive plan to address Clearing Agency stress is agreed ex ante. Such a plan might include consideration of whether an alternative Clearing Agency is able to clear a particular product and also the requirement for some level of interoperability across Clearing Agencies (including compatible operational systems and procedures) so that non-defaulting portfolios can be ported relatively seamlessly to another Clearing Agency rather than forcing the unwind of large portfolios over the course of a relatively short period - a process which could result in further market dislocation. A credible Clearing Agency (or Systemically Important Clearing Agency as the case may be) resolution plan is vital for financial stability, particularly given that a Clearing Agency or Systemically Important Clearing Agency may be the principal venue for clearing a product. In the absence of adequate continuity planning, Clearing Agency stress might preclude the functioning of the market for that product, while Systemically Important Clearing Agency stress might preclude the functioning of the entire financial system.

[6] Please see ISDA response to RIN 3038-AC98, AD02 - Notice of Proposed Rulemaking Financial Resources Requirements for Derivatives Clearing Organizations (75 Fed. Reg. 63113) dated December 10, 2011 and ISDA response to RIN 3038-AC98-Notice of Proposal Rule-making: Risk Management Requirements for Derivative Clearing Organizations ("DCOs") (76 Fed. Reg. 3698) dated March 21, 2011.

3. Other comments

(a) Margin requirements

Appropriateness of 99% confidence level: The appropriateness of the confidence level of 99% for the purposes of the initial margin calculation depends on the level of mutualization. Currently, there is mutualization for CMs in the Clearing Agency default fund and mutulization for clients in omnibus client accounts. Understood in this context, a 99% confidence level is appropriate. If the current levels of mutualization are removed, for example by a requirement to have individualized client accounts instead of an omnibus account, then an appropriate confidence level ought to be higher than 99%, since the funds available to a Clearing Agency to manage a client account default will be reduced.

Client positions: While requiring Clearing Agencies to maintain comprehensive, robust, and prudent risk frameworks, we urge the Commission to enact regulations which will require Clearing Agencies to adopt risk methodologies that minimize the size of the default fund contributions associated with client positions. We believe this change is highly desirable to enable Clearing Agencies to better guaranty the portability of client portfolios – if substantial default fund contributions are associated with client accounts, we believe it may be difficult to find a replacement CM willing to accept a large client's portfolio (and the responsibility for funding the default fund amounts associated with that portfolio), particularly when distressed market conditions may be otherwise incentivizing CMs to maximize their own liquidity. We note that by reducing the impact that the customer account risk has on the default fund size the risk to the Clearing Agency is increased. This increased risk can be addressed by increasing the risk margin of the customer account, which would require distinguishing between the initial/risk margin applicable to House and Client accounts.

Spread Margins: We note that the Commission proposed rules allow Clearing Agencies significant discretion when establishing margin practices. We urge the Commission to limit the discretion of a Clearing Agency in this – particularly when a Clearing Agency seeks to reduce initial margin requirements for related positions. This should be prohibited unless the Clearing Agency can demonstrate a robust correlation in stressed market conditions and agrees to periodic public disclosure of its methodology and results.

(b) Settlement requirements

The Commission settlement finality proposals seem sensible. However, while settlement finality is desirable in a bankruptcy context, we seek greater clarification from the Commission on how this will be compatible with the correction of errors and the fact that title transfer of initial margin may not occur when it is posted to a Clearing Agency.

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Conclusion

The public policy rationale for the Dodd-Frank Act is to reduce risk, increase transparency and promote financial market stability by, inter alia, imposing risk management regulations for Clearing Agencies. ISDA believes that the Commission's NPR provides a strong and thorough set of regulations that should, assuming the concerns set out above are addressed, facilitate prudent Clearing Agency risk management and protect the integrity of the U.S. clearing system. Finally, we urge the CFTC and SEC to coordinate and cooperate on these and other regulations to build a harmonized framework to regulate OTC derivatives. A harmonized framework will increase transparency, reduce regulatory arbitrage and further strengthen confidence in U.S. markets.

ISDA appreciates the opportunity to provide these comments. Should you require further information, please do not hesitate to contact me or my staff.

Sincerely,

Robert G. Pickel

Robert Pickel
Executive Vice Chairman