ISDA Safe, Efficient Markets

February 5, 2014

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Re: Margin Requirements For Non-Centrally Cleared Derivatives

Ladies and Gentlemen,

The International Swaps and Derivatives Association[1] ("**ISDA**") wishes to provide comments to the Commodity Futures Trading Commission (the "**CFTC**"), the Securities and Exchange

[1] Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 62 countries. These members include a broad range of OTC 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 including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

Commission (the "**SEC**") and the prudential regulators [2] (collectively the "**Regulators**") regarding "Margin Requirements For Non-Centrally Cleared Derivatives" (the "**Release**") issued September 2013 by the Basel Committee on Banking Supervision ("**BCBS**") and the International Organization of Securities Commissions ("**IOSCO**").

Introduction

ISDA strongly supports the Release's main goals of strengthening systemic resiliency in the non-centrally cleared derivatives market by establishing margin requirements. While the Release made an important step forward by establishing a set of minimum standards to be implemented locally by national regulators, it is important for regulators and industry practitioners to now focus on the practical issues of margin requirements so that the final implementation of national regulations is globally consistent. This letter is intended to continue the constructive ongoing dialogue between regulators and industry and to focus on the practical issues and risks surrounding implementation. We hope that our comments in this letter and follow-up discussions will inform the margin rule re-proposals and aid the Regulators as they look to implement a margin framework in a manner that is consistent with the Release's objectives and the requirements of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**").

This letter indicates the areas of the Release where we believe additional rulemaking and clarification could be helpful and provides suggestions for certain provisions that have been left up to the discretion of national regulators in order to encourage globally consistent implementation.

Discussion

A. Highest Priority

I. Seek Global Harmonization and Consistency in Implementation. In order to ensure the efficient functioning of the global derivatives market and to eliminate operational risks, we strongly support a harmonized and consistent set of rules across jurisdictions. We encourage national regulators to harmonize their new rules. Otherwise, the market will become fragmented and its liquidity impaired as counterparties struggle to meet inconsistent margin requirements of various international regulators. Consistency among U.S. and non-U.S. regulators is also encouraged by Dodd-Frank. Section 752 of Dodd-Frank directs the Regulators to coordinate with foreign regulators "[i]n order to promote effective and consistent global regulation of swaps and security-based swaps".[3] Within the U.S., Sections 731 and 764 specifically require the Regulators to establish comparable margin requirements "to the maximum extent practicable".[4]

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[2] The Prudential Regulators are: the Treasury Department (Office of the Comptroller of the Currency) ("OCC"); Board of Governors of the Federal Reserve System ("Federal Reserve"); Federal Deposit Insurance Corporation ("FDIC") ; Farm Credit Administration ("FCA"); and the Federal Housing Finance Agency ("FHFA").

[3] Section 752 of Dodd-Frank.

[4] Section 731 and 764 of Dodd-Frank.

The goal of international and domestic harmonization of margin rules is best achieved by the adoption of the framework set out in the Release and by further collaboration by the national regulators in the monitoring group to be established by BCBS and IOSCO. Because many market participants will need to comply with rules in different jurisdictions, consistent international adoption of the Release will make it easier for market participants to set up appropriate margin arrangements. For margin requirements, inconsistent rules will potentially be incompatible in practice: for example, if the IM model requirements for one jurisdiction establish different levels of IM than those in another jurisdiction, then parties would face a very difficult determination as to which IM levels should apply. International adoption of the Release will also prevent regulatory arbitrage and lead to a more level playing field between competitors in different jurisdictions.

In addition, as certain jurisdictions may not be harmonized, we encourage the Regulators to draft the U.S. margin rules (the "**Margin Rules**") in a manner that does not impose unworkable requirements on entities subject to the Margin Rules that face swap counterparties in non-harmonized jurisdictions. For example, the Margin Rules should not require an entity subject to the Margin Rules to post collateral to a counterparty that is not subject to any requirements to post collateral to the entity subject to the Margin Rules or to protect the collateral it receives. While we strongly encourage the international harmonization of margin rules, market participants in non-harmonized jurisdictions should not receive a competitive advantage as a result of margin regulation.

II. Covered Entities and Qualification Thresholds for IM. The Release provides that margin must be posted only if both counterparties are "covered entities", which include financial firms and systemically important non-financial firms. The Release further provides that the definition of "covered entity", including the "financial entity" component of such definition, should be determined by the Regulators.

We suggest that the "financial entity" definition should include only those market participants that have a significant market presence in the OTC derivatives markets and that are systemically important. In particular, we urge the Regulators to confirm that corporate end-users are excluded from the scope of covered entities because the swap activities of such entities will not be systemically important and because of the economic benefits of allowing unsecured hedging by such parties. End-users may exit the OTC derivatives market if they are required to post margin, leading to a significant loss of liquidity and of economically beneficial hedging activities.

Similarly, we encourage the regulators to confirm that covered entities will not include special purpose vehicles that are of the type commonly used for securitization, financing or other bona fide risk or liquidity management purposes. Special purpose vehicles ("**SPVs**") do not have ready access to liquid collateral that can be transferred back and forth to a swap counterparty in the manner generally required for IM and VM. These SPVs typically have specialized credit support arrangements (such as a pledge of the assets of the SPV) that protect swap counterparties without use of VM or IM. SPVs would potentially be forced to exit the swap market entirely if they had to post IM and VM and such a forced departure would cause significant harm to securitization and other financial markets.

In addition, Title VII of Dodd-Frank only requires margin rules to be implemented for dealers and major swap participants ("**MSP**")[5]. As a result, the implementation that would be most consistent with both Dodd-Frank and the Release is for swaps to be subject to margin requirements only if one of the parties is a dealer or an MSP and the other party is a dealer, an MSP or a "covered entity".

The Release also provides that covered entities are only required to post IM if they have at least a certain gross notional amount of outstanding non-centrally cleared swaps (the "**Qualification Threshold**"). We encourage the Regulators to confirm that the Qualification Threshold will apply to covered entities for purposes of the IM requirement. Adopting the Qualification Threshold as proposed would promote international consistency and would ensure that IM requirements apply only to covered entities with substantial non-centrally cleared swap positions that are potentially systemically important.

It is crucial that the Regulators cooperate both globally and domestically in determining which market participants will be covered entities to avoid different outcomes with respect to different types of derivatives and to avoid disadvantaging participants subject to a more strict interpretation of covered entity. A globally harmonized margin framework and the ability to recognize equivalent and comparable regulation depends on the international consistency of this key issue.

Finally, the Release does not require credit support documentation for parties that are not covered entities. We urge that this position be reflected in the Margin Rules. If neither IM nor VM is required, there is no reason to require credit support documentation. [6] In many cases, the credit support documentation would serve no purpose because no collateral would be posted by either party. Moreover, a very significant amount of time and resources would be needed to arrange for such documentation. This would be particularly burdensome for end-users who have not historically posted margin.

III. Allow Use of Asset Classes for Determining Risk Rather Than Classifying Swaps.

The Release does not permit offsets between different asset classes for calculating IM. We encourage the Regulators to consider allowing participants to comply with this restriction by determining risk associated with the relevant broad asset class across all swaps (for example, analyzing overall equity risk in all portfolio swaps) and then adding up the risk arising from all asset classes (adding the equity risk to credit, commodity and rates risk). This will permit parties to manage their risk more efficiently, as certain swaps contain risks applicable to multiple asset

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[5] See Sections 731 and 764 of Dodd-Frank.

[6] This result is consistent with CFTC Rule 23.504(b)(3). *See* Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 77 Fed. Reg. 55904, 55910 (Sept. 11, 2012) ("Having considered these comments, the Commission is of the view that the proposed rule was not intended to require margin or related terms where such are not required pursuant to other Commission regulations or the applicable regulations adopted by prudential regulators. The proposed rule was intended to require written documentation of any credit support arrangement, whether that be a guarantee, security agreement, a margining agreement, or other collateral arrangement, but only to require written documentation of margin terms if margin requirements are imposed by Commission regulations, the regulations of prudential regulators, or are otherwise agreed between SDs, MSPs, and their counterparties.")

classes.[7] In addition, many swaps are not amenable to a straightforward swap-level classification. For purposes of IM calculations, parties should be permitted to offset risks arising between swaps and certain instruments that do not constitute swaps or security-based swaps, such as securities options. We also request that the Regulators confirm that market participants can offset risk across derivatives regulated by different Regulators, so that, for example, market participants can aggregate the equity risks in single name equity swaps (regulated by the SEC) and index equity swaps (regulated by the CFTC) or the credit risks in single name credit default swaps (regulated by the SEC) and index credit default swaps (regulated by the CFTC). In addition, the asset classes should include such instruments to ensure that they are broad enough to match the asset classes used by foreign regulators. These issues are further discussed in the ISDA SIMM White Paper. [8]

IV. Allow a Two-Year Phase-In Period. We estimate that market participants will need a minimum of two years from the time when rules are adopted to the time when market participants are required to exchange variation margin and post initial margin. Compliance with the margin requirements will entail significant time and investment related to technological and other operational requirements. For example, risk management systems must be recalibrated and models and output will need to undergo rigorous testing before implementation. In addition, the regulatory process for model approval is likely to be time-consuming, especially for the initial approvals which will occur simultaneously for many entities and with many regulators.

Dealers and MSPs and their counterparties will be required to make changes to their credit support and custodial arrangements. Significant amounts of time will be needed for the negotiation and documentation of credit support agreements and custodial arrangements. It is our members' experience that even in the current environment it frequently takes six months or more to negotiate and establish a tri-party custodial arrangement for derivatives trading, and that related technology build-outs usually take at least nine months. Following adoption of a margin rule, this time period is likely to increase as custodians respond to a very significant volume of document requests. The limited number of custodians will exacerbate this challenge. Compliance with the proposed rules will be particularly time-consuming for swaps between dealers and non-dealers. We would welcome the opportunity to discuss further details of our timing estimates with the Regulators.

In light of the above, we request that either (i) the requirements do not become effective until two years from the date on which final rules are adopted in all of U.S., Europe and Japan or; (ii) in the first quarter of 2014, regulators in the U.S., Europe and Japan inform the market that the Release framework, as proposed, will become effective in December 2015. This will allow market participants to begin developing systems and preparing for compliance with the rules prior to their effective date. In addition, delaying the implementation of IM for some time after the effective date of the VM requirements would reduce the burden on the markets by allowing a

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[7] We note that the Notice of Proposed Rulemaking issued by Prudential Regulators on April 12, 2011 (the "**NPR**") would permit parties to calculate risk within four asset classes: "The proposed rule permits a covered swap entity to use an internal initial margin model that reflects offsetting exposures, diversification, and other hedging benefits within four broad risk categories (commodity, credit, equity, foreign exchange/interest rates) when calculating initial margin for a particular counterparty if the relevant swaps or security-based swaps are executed under the same qualifying master netting agreement." 76 Fed. Reg. 27564, 27579 (May 11, 2011).

[8] ISDA, "Standard Initial Margin Model for Non-Cleared Derivatives" (December 2013).

step-by-step implementation and will permit participants to prepare for margin requirements on an incremental basis. We would welcome the opportunity to discuss the implementation timetable with the Regulators to ensure that the transition to the requirement to post IM and exchange VM is smooth and does not cause any market disruption or a loss in liquidity.

V. **Margin for Inter-Affiliate Trades.** The Release leaves the issue of inter-affiliate margin requirements to the local regulators. Inter-affiliate trades are used for internal hedging and risk management and do not increase systemic risk or threaten the safety and soundness of entities under common control. Transactions between affiliates do not create risk for the consolidated entity because a gain for one entity is an equal and offsetting loss for the other. Inter-affiliate trades "simply represent an allocation of risk within a corporate group."[9] In our view, inter-affiliate transactions do not present systemic risk, and we believe it is not appropriate to impose margin requirements on inter-affiliate transactions.

If, notwithstanding our argument above, the Regulators determine that margin is required for inter-affiliate swaps, we recommend that only VM be required. The significant additional costs and complexities of IM simply are not justified by transactions that do not give rise to broad systemic risks.

B. Additional Comments

I. **Use of Single Currency To Calculate Thresholds.** The Release uses the Euro for all of its calculations, including the thresholds. However, if regulators in different jurisdictions use different currencies for the threshold calculations, the thresholds will constantly change as a result of currency fluctuations. This may cause significant swings in the amount of margin that must be posted for reasons unrelated to the risk profile of the actual transactions, which will introduce unnecessary volatility and complexity into the IM framework. Furthermore, a long-term move in exchange rates could cause the thresholds in different jurisdictions to materially diverge, creating significant disparities in thresholds between jurisdictions. In order to ensure consistency and predictability of threshold calculations for swap market participants on a global basis, we recommend that all thresholds worldwide be denominated in a single currency.

II. **Permit Participants to Determine Consolidation.** Under the Release, the thresholds apply on a consolidated basis, though the Release does not state how consolidation will be determined. We believe that it is crucial that consolidation is applied consistently across all jurisdictions to ensure consistency of threshold calculations. This is especially important due to the multinational nature of many market participants. If various jurisdictions apply different standards for consolidation, it may result in two counterparties calculating exposure on a consolidated basis with respect to two different sets of entities. In addition, accounting standards differ between jurisdictions, so it may not be possible to adopt a uniform consolidation approach that would be consistent for all jurisdictions. Therefore, the Margin Rules should allow a market participant to determine how consolidation will apply to itself and to its affiliates, based on appropriate accounting standards and subject to regulatory review. The Margin Rules should

[9] See CFTC and SEC joint proposed rule, "Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", 75 Fed. Reg. 244 at 80183.

require such a consolidation determination to be consistent across all entities within a corporate group, regardless of where such entities are located. This would ensure consistent treatment for a corporate group across different jurisdictions.

III. Exclusions from Threshold Calculations. We recommend that physically-settled FX swaps and forwards, trades with non-covered entities and inter-affiliate swaps be excluded from threshold calculations. If a market participant is not required to post IM with respect to certain trades, such trades should not be used in determining its obligation to post IM or the amount of IM required to be posted. For example, if physically-settled FX is exempt from the IM requirement because of its risk profile and the language of Dodd-Frank, then it would not be appropriate to use the notional amount of physically settled FX in determining a firm's IM thresholds.

IV. Apply Minimum Transfer Amount Separately for IM and VM. The Release provides that margin transfers between parties may be subject to a minimum of up to EUR 500,000. We request that the Regulators clarify that (1) counterparties may elect such a minimum transfer amount, or such smaller amount as they may negotiate; and (2) this minimum amount applies to IM and VM separately, as requiring one minimum transfer amount may cause significant settlement complications, because different assets can be posted as IM and VM.

In addition, many market participants have swaps denominated in different currencies, and therefore deliver margin in different currencies as well. We request the Regulators to permit counterparties to establish separate minimum transfer amount 'buckets" for each currency so that parties do not need to calculate transfer amounts between multiple currencies. The parties could elect to decrease the minimum transfer amounts with respect to the individual currency buckets to account for the many currencies used in non-centrally cleared derivatives.

V. Standardized IM Models Should be Encouraged and an Expedited Approval Process Should Apply to Standardized Models. Standardized, widely-used IM models will reduce disputes and increase efficiency. ISDA members are currently developing a standard initial margin model ("**SIMM**") to ensure that counterparties have the option of at least one third party model developed in accordance with industry standards. A streamlined process should be developed to expedite the approval of the use of the SIMM or other standardized models by market participants. This will permit a faster spread of models and ease regulatory burdens that could otherwise require Regulators to approve models for each market participant on an individual basis. The widespread use of standard models among market participants will provide greater certainty to the market and may, as discussed below, assist the market in developing a mechanism to resolve IM disputes. The SIMM is further discussed in the ISDA SIMM White Paper. [10]

In addition, we encourage the Regulators to allow market participants to delegate their obligation to run a model to a counterparty or to a third party, subject to robust dispute resolution standards. It is an accepted practice in the swap market for a counterparty to agree that a dealer will make determinations for a swap in the dealer's capacity as "calculation agent", and it would make sense to allow this approach for margin model calculations.

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[10] ISDA, "Standard Initial Margin Model for Non-Cleared Derivatives" (December 2013).

VI. Allow Use of Industry Model for IM Disputes. Without an established, tested dispute resolution process in place prior to the imposition of IM requirements, parties will have no way to resolve disputes over levels of IM in an efficient and timely manner. This is particularly crucial with respect to cross-border transactions, where the two parties are subject to different regulation and may have fundamentally conflicting margin requirements. While we urge regulators to harmonize rules, in practice it may not be possible to achieve complete uniformity, and therefore a robust dispute resolution mechanism for the calculation of IM is necessary to resolve cross-border disputes as to the amount of IM to be posted. In particular, if parties use proprietary models, a dispute mechanism needs to be developed that would permit parties to resolve disputes without disclosing confidential information. In conjunction with its development of the SIMM and following discussions with the Regulators, ISDA will propose a dispute resolution process for use with the SIMM and adapt the current dispute resolution mechanism to accommodate the new margin requirements. ISDA will regularly update the Regulators on these developments.

VII. Allow Flexibility for IM Timing Requirements. The Release provides that counterparties should deliver IM on a regular basis to prevent large discrete calls for additional IM due to "cliff edge" triggers. ISDA supports this position, as significant delays in posting IM could exacerbate market instability in times of stress. In addition, Regulators may wish to consider allowing IM to be delivered on a different schedule and at a different frequency to VM. VM is generally easier to calculate than IM at the outset of a swap because an at-the-market swap will typically have an initial market value of zero. The calculation of IM requirements with respect to new trades requires more complex calculations and trade reconciliation, which necessitates more flexibility in delivery times for IM. It would be beneficial if parties were permitted to consider practical concerns and risks in determining how frequently IM should be exchanged, so long as "cliff edge" triggers are avoided.

VIII. Eligible Collateral. The Release proposed various requirements with respect to the collateral that can be posted as margin. The implementation of these requirements raises the following issues.

A. Permissible Collateral. We encourage the Regulators to develop a consistent list of permissible collateral across all jurisdictions, which may be the list proposed in the Release. While the Release noted that this list was illustrative, it is important for the selected list to be consistent worldwide. Consistency will improve the efficiency of the derivatives market by permitting participants in all jurisdictions to have a uniform set of eligible collateral requirements. Further, it is equally important that the text of the definitions used by the regulators is consistent across jurisdictions in order to meet the goal of cross-border harmonization. ISDA would welcome the opportunity to assist the Regulators in developing a consistent taxonomy of eligible collateral across jurisdictions.

B. Allow Use of a Model for Calculation of Haircuts. We support the Release's proposal to permit use of a model to determine haircuts and we request that the Regulators permit use of the SIMM and other models to determine haircuts. To this end, it would be beneficial for the SIMM and other models to make determinations on a holistic basis so that

calculations can reflect offsets between (i) IM requirements and (ii) posted IM and VM. This will permit a more effective determination of counterparty risk because it will take into account the aggregate risk of both derivatives positions and collateral.

C. Clarify the Cross-Currency Haircut. The Release provides that collateral denominated in a difference currency than the underlying transaction should be subject to an additional 8% haircut. We welcome the opportunity for further discussion with the Regulators to ensure that the provisions of this haircut are clear. In particular, we believe it is important to clarify how this haircut will apply to cross-currency swaps, or other swaps that have multi-currency exposure. In addition, we would like to work with the regulators to understand how this haircut will apply to model-based IM calculations.

IX. Treatment of IM and Rehypothecation. The Release describes in detail a limited right to rehypothecate IM, subject to a significant number of conditions. However, it is not clear how rehypothecation can be achieved efficiently within the confines of the conditions provided in the Release. ISDA would welcome the opportunity to work with the Regulators in the implementation of the rehypothecation framework to ensure that rehypothecation can be efficiently utilized by market participants while preserving full protection for pledgors and secured parties.

The Release requires IM to be held so that the IM is immediately available to the secured party upon its counterparty's default but is also protected in the event of the secured party's insolvency. The Release does not require IM to be held in any specific manner. We request confirmation that counterparties will be permitted to choose their own method of holding margin so long as it complies with this standard. In particular, we request confirmation that segregation on the books of the secured party is sufficient protection for the granting party if the collateral is protected, by treatment as "customer property" or otherwise, in the event of the secured party's insolvency. For example, for non-cash collateral in the U.S., appropriate segregation on the books of the dealer and its subcustodians would protect the pledgor in the event of the secured party's insolvency and thus should be permissible. Dodd-Frank requires dealers to offer customers the option of segregation of their IM at a third party custodian. Such a statutory provision implies that the parties are not required to use a third party custodian if they agree otherwise.

Finally, credit support arrangements using transfers of title (in lieu of pledges of a security interest) are very common and raise potential issues. In particular, it is not clear how a secured party can segregate collateral which has been transferred to it outright and to which it has full title, since holding such collateral for the benefit of the pledgor/transferor might be inconsistent with the legal effect of a title transfer. If market participants that use title transfers are required to segregate margin or are subject to other restrictions on its use, there is a risk that such title transfers could be legally recharacterized as pledges or other grants of security. This could have significant repercussions on foreign jurisdictions where title transfers are prevalent, and regulators across the world will need to consider this issue in harmonizing global margin rules. We would welcome the opportunity to work with the Regulators on the issues raised by transfers of title.

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ISDA appreciates the opportunity to provide this letter to the Regulators. We would welcome the opportunity to assist the Regulators in their efforts to implement the Release and draft the Margin Rules. Please feel free to contact me or my staff at your convenience.

Sincerely,

Robert Pickel
Chief Executive Officer
ISDA

cc:

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John C. Lawton, Commodity Futures Trading Commission
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