ISDA® Safe, Efficient Markets

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RE: DOCKET NO. OCC-2011-0008/RIN 1557-AD43; DOCKET NO. R-1415 /RIN 7100 AD74; RIN 3064-AE21; RIN 3052-AC69; RIN 2590-AA45

MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES

Ladies and Gentlemen,

The International Swaps and Derivatives Association[1] ("**ISDA**") appreciates this opportunity to provide comments to the Prudential Regulators[2] (the "**PRs**") regarding the recently released

[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 64 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.

notice of proposed rulemaking and request for comments ("**PR Margin Proposal**")[3] concerning margin and capital requirements for non-cleared swaps and non-cleared security-based swaps and the implementation of the related statutory provisions enacted by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").

For purposes of this discussion, swap dealers, security-based swap dealers, major swap participants and major security-based swap participants are "**Swap Entities**" and a Swap Entity that is subject to regulation by a Prudential Regulator is a "**Covered Swap Entity**" or "**CSE**". Also, references to "swaps" include security-based swaps ("**SBS**") unless indicated otherwise.

EXECUTIVE SUMMARY

Our analysis of the proposed rules addresses three critical themes: providing for implementation without excessive disruption; addressing systemic risk in an appropriate manner; and developing a workable cross-border framework.

Implementation: The proposed time frame for implementation is too short given that final margin rules have not yet been issued and given the operational, regulatory and documentation challenges including the need for the global regulatory community to approve models and make timely determinations of substituted compliance. ISDA asks that the initial margin ("**IM**") requirements take effect two years after the rules become final in the US, EU and Japan and the variation margin ("**VM**") requirements be phased in over the same two year period. The implementation dates should accommodate code freezes and year-end book closings. In addition, the requirements should not impose unnecessary documentation burdens: for example, requiring new master agreements to segregate pre- and post-compliance date swaps will significantly increase the implementation and compliance demands for all market participants.

Systemic risk: The purpose of the margin rules is to reduce systemic risk, and to that end, the rules should avoid provisions that are pro-cyclical or that unnecessarily drain liquidity from the system. The proposed requirement that CSEs post and segregate IM for inter-affiliate swaps is not necessary to reduce systemic risk and will trap significant amounts of liquidity. Inter-affiliate swaps should therefore be exempt from the IM rule. Monthly recalibration of IM models, which would be mandated under the proposed rule, is potentially pro-cyclical and should be replaced with an annual review process. The $3 billion threshold for IM exchanges with financial end users is also potentially pro-cyclical (and inconsistent with non-US regulators) and should be raised to $11 billion. Finally, financial end users whose swaps activity is below the material swap exposure threshold do not raise systemic risk and should not be required to exchange VM.

Cross-border: As recently stated by the OTC Derivatives Regulators Group, divergences from international standards for margin rules should be minimized.[4] We urge consistency between the

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

3 Prudential Regulators, *Margin and Capital Requirements for Covered Swap Entities*, 79 FR 57348.

4 OTC Derivatives Regulators Group, Report to G20 Leaders, Nov. 2014, p.8.

PR rules and those of the EU and Japan and the framework proposed in the paper (the "**BCBS/IOSCO Paper**") issued in September 2013 by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions.[5] We ask the PRs to determine that substituted compliance would apply to the non-US margin rules that conform to the BCBS/IOSCO Paper. Moreover, in order to allow a cross-border market to continue, margin rules from two different jurisdictions should not simultaneously apply to the same collateral transfer: therefore, we ask that the PRs follow the BCBS/IOSCO Paper and apply US rules only to the collection of margin (and not to the posting of margin) for cross-border swaps. For further discussion on cross-border issues, please refer to ISDA's letter to the Commodity Futures Trading Commission (the "**CFTC**") which addresses the advance notice of proposed rulemaking on the cross-border application of margin requirements.

[5] "Margin requirements for non-centrally cleared derivatives", by Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions (Sep. 2013).

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CRITICAL ISSUES

A. IMPLEMENTATION

1. The IM rules should only take effect two years after finalization.

It is unlikely that the market will be able to meet the proposed deadline of December 1, 2015. It currently appears that final rules across several major jurisdictions will not be finalized until early to mid-2015. After the rules are final, it will be necessary for market participants to have sufficient time to allow for the legal, operational, risk management and technological enhancements necessary to effectively and safely implement these new regulations. In particular, CSEs will need time to build, test and receive approvals for IM models that are very new to the market. The regulators will also need time to formalize the regulatory approval processes for IM models across multiple jurisdictions. Moreover, the ability of the market to make the necessary enhancements will depend on the outcome of the substituted compliance/equivalence determinations, and this could further slow the implementation process.

Based on our members' assessment, we submit that two years from finalization of rules in the EU, US and Japan would be the minimum timescale to properly implement the rules, assuming they are fundamentally harmonized.

To supplement this suggestion, in a letter dated September 25, 2014 to the WGMR Monitoring Group of BCBS/IOSCO, ISDA provided a proposal of key benchmark implementation deliverables which market participants aim to complete by April 2017 (our estimate of the two-year time period from when we expect national rules to be finalized). We have approached these deliverables from an implementation perspective, leveraging legal, operational, and technology experts from our member firms that have engaged in related projects over many years.

2. The VM rules should be phased in during the two years after finalization.

We request a phase-in period for VM. Many parties do not currently post VM and implementation of the VM requirements as proposed in the PR Margin Proposal will require fundamental changes to existing VM arrangements. A "big bang" approach under which all market participants must be fully compliant with the VM rules as of a single compliance date is unnecessary and potentially systemically dangerous. It is unnecessary because many of the parties required to post VM will be trading in low volumes and will pose very little risk to the system. A big bang approach is potentially systemically dangerous because of the difficulties of implementing the VM requirements simultaneously for a very large population of swap users.

The difficulties of implementing VM are comparable to those for implementing IM: the market will need significant operational, risk management, technological and legal enhancements. The build-out for VM will involve a broad population of smaller participants if the PRs do not grant our request for a VM exemption for those below the material swaps exposure threshold. This broader population will have to develop systems to transfer appropriate collateral in the required timeframes and will need to negotiate and document the required margin terms with CSEs.

We therefore request the following: over the two year period after finalization of the rules in the EU, Japan and the US, phase in VM with thresholds corresponding to the IM phase-in, accommodating the code freeze and year-end book closings as requested below.

3. Implementation dates should accommodate "code freezes" and year-end book closings.

The implementation dates should avoid December or January or, for Japanese firms, the end of March. Financial institutions generally prohibit technological changes to their systems between early December and mid-January in an annual code freeze. This practice is consistent with principles of prudential bank management and long-standing best practice across the industry, and was established in conjunction with the bank supervisory process. In addition, financial institutions are generally going through year-end book-closing processes in December or January and, in Japan, at the end of March. Implementing any new procedures that will require systems changes is extremely difficult during the code freeze or at year-end.

4. A new master agreement should not be required to prevent pre-compliance date swaps from being subject to the margin rules.

The proposed margin requirements will apply to swaps executed prior to the compliance date if entered into under an eligible master netting agreement ("**EMNA**") that also applies to swaps executed after the compliance date.[6] We ask that the PRs permit parties to use a new credit support arrangement ("**CSA**") (or other contractual arrangements), in lieu of a new master agreement, to distinguish between pre- and post-compliance date swaps for purposes of application of the margin rules. Thus, for example, a single EMNA could have two CSAs: one for pre-compliance date swaps and one for post-compliance date swaps.

A new CSA (or other contractual arrangement) under an existing master agreement will suffice to segregate between pre- and post-compliance date swaps for purposes of determining applicable IM and VM. Moreover, using a single EMNA will allow firms to net pre- and post-compliance date swaps against a defaulting counterparty. Close-out netting is a critical risk reduction technique for CSEs, even if it is not recognized in the IM and VM calculation. Indeed, preventing close-out netting between pre- and post-compliance date swaps would increase systemic risk, which would be inconsistent with the purpose of the PR Margin Proposal.

In addition, we ask the PRs to clarify that use of an EMNA does not prevent use of a "master master" that establishes netting arrangements between two or more EMNAs or EMNAs and other agreements such as a master repurchase agreement. Such "master master" netting agreements reduce close-out risk and will not impact the calculation of IM or VM.

B. SYSTEMIC RISK

1. Inter-affiliate swaps should be exempt from the IM requirements.

We ask that inter-affiliate swaps be exempt from the IM requirement for the following reasons.

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[6] PR Margin Proposal at 57359 and §§_.4(d) at 57392 and __.8(b) at 57393.

Systemic risk: The proposed approach runs counter to the policy objective of reducing systemic risk. For large, global entities it is more prudent and efficient to consolidate risk management expertise and resources, rather than manage multiple risk books that may have natural offsets. The imposition of margin requirements on inter-affiliate swaps would disincentivize centralization of risk management and may result in the dispersion of expertise and resources.

In addition, inter-affiliate transactions do not pose the same risk to the markets as do outward-facing swaps. Unlike transactions between unrelated parties, affiliates of CSEs share full transparency on risk positions, exposures and valuations to centrally and efficiently manage risk. CSEs already manage risk of inter-affiliate trading through VM, parent guarantees and other means, and are often required to do so, for example, because of the "source of strength" doctrine applicable to US bank holding companies.

In addition, imposing IM on inter-affiliate trades will incur significant costs and introduce other risks. CSEs and their affiliates will be required to post and segregate IM with third party custodians, trapping significant liquidity and injecting third party risk of the custodian into an inter-affiliate relationship.

Section 23A and 23B: The preamble to the PR Margin Proposal notes that in regard to inter-affiliate swaps, Sections 23A and 23B of the Federal Reserve Act may also apply.[7] The PRs cite Section 23B as support for the view that transactions between banks and affiliates must be executed on an arms' length basis. However, the need to execute swaps on an arms' length basis does not mean that IM should be required under the margin rules. The goal of the margin rules is to reduce systemic risk, which is different from the goals of Sections 23A and 23B, which seek to protect a bank affiliate within a bank holding company. Moreover, to the extent that the PRs are concerned about banks receiving adequate collateral for inter-affiliate transactions, the PRs can (and do) address this concern through Sections 23A and 23B and the implementing regulations.

Clearing exemption: In 17 CFR Sec. 50.52, the CFTC sets out a clearing exemption for inter-affiliate swaps. The same logic that justifies this exemption also justifies an inter-affiliate IM exemption.

Approach in other jurisdictions: The BCBS/IOSCO Paper did not propose IM requirements on inter-affiliate trades, instead leaving it to the discretion of national supervisors, and a BCBS/IOSCO consultative document observed that these trades "frequently serve risk management or other purposes that are different from non-centrally-cleared derivative transactions with third parties" and that the imposition of IM requirements on these trades "could tie up substantial liquidity".[8] Under the EU uncleared margin rules, an exemption for inter-affiliate trades is available if certain conditions are met.[9] The Japanese proposed margin rules

7 PR Margin Proposal at 57359, 57388.

8 BCBS/IOSCO Paper at p. 21, quotes from BCBS/IOSCO Consultative Document, Margin requirements for non-centrally-cleared derivatives**,** July 2012, p. 28.

9 Article 11(5) – (10) of Regulation (EU) No 648/2012 (4 July 2012).

("**Japanese Margin Proposal**") also provide an exception for inter-affiliate swaps.[10] As a result, the lack of an inter-affiliate exemption would result in inconsistent treatment of US and non-US swap entities.

Threshold Calculation: In addition, in the absence of a general exemption for IM, it is not clear how the initial margin threshold of $65 million will apply to inter-affiliate transactions. The $65 million threshold must be applied at a group level and assumes that the parties to the transaction are members of different groups. It is very unclear how the thresholds will be calculated at a group level if the parties to the transaction are members of the same group.

2. Model issues

a. Market participants should have flexibility in addressing non-linear dependencies and volatility sensitivities.

The proposed requirements for regulatory approval include the condition that an IM model must "include all material risks arising from the nonlinear price characteristics of option positions or positions with embedded optionality and the sensitivity of the market value of the positions to changes in the volatility of the underlying rates, prices, or other material risk factors".[11]

We submit that the rules should not initially require that an IM model capture all non-linear dependencies ("**NLDs**") or sensitivities to volatilities ("**Vega**") if the model demonstrates margin adequacy, *i.e.*, that it will make adequate determinations of necessary IM. ISDA members are currently working on approaches to include Vega in their models. The members will continue to work with the PRs to achieve a solution as expeditiously as possible. We are also working on addressing NLDs. However, because of computational challenges and a lack of standardization, NLDs pose more difficulties than Vega. NLDs require more study before the industry can accurately determine the impact of their inclusion. We will continue to work with the PRs to address NLDs.

b. The requirement to benchmark the IM model to margin of clearing organizations should be removed.

The proposed rules require that IM model calculations be benchmarked against IM amounts required by derivatives clearing organizations ("**DCOs**") for similar cleared transactions.[12] We are concerned about this requirement for reasons of policy rationale and feasibility. The models will have been chosen or developed by a CSE and approved by the relevant regulator. Having undergone rigorous development, testing and review processes, the models should not be benchmarked to DCO models which have been developed under different standards, algorithms and assumptions. For example, DCO models generally use a 5 day close-out period as opposed

[10] Financial Services Agency of Japan, draft amendments to the "Cabinet Office Ordinance on Financial Instruments Business" and "Comprehensive Guidelines for Supervision" with regard to margin requirements for non-centrally cleared derivatives, July 3, 2014. Available in Japanese at http://www.fsa.go.jp/news/26/syouken/20140703-3.html.

[11] PR Margin Proposal at 57394.

[12] PR Margin Proposal at 57394.

to the 10 day period required for uncleared swaps. DCOs also are not required to, and generally do not, hold capital against their positions. As a result, their need for IM to mitigate risk is different than that of CSEs. In addition, whereas DCOs focus or limit their services to a particular subset of plain-vanilla product types, uncleared swaps cover a much broader set of product types and therefore a DCO's model may not appropriately calculate IM for non-cleared product types.

Moreover, the proposed requirement to benchmark IM model calculations for bilateral, uncleared swaps to the IM amounts required by DCOs raises conceptual questions given that the DCO business model is diametrically different from a bilateral swaps business model. For example, the DCO is, in substance, a riskless principal (and in some jurisdictions, viewed as an agent of the clearing members/swap counterparties) in light of the member default fund contributions, the members' residual interest in the DCO, and portfolio netting. Further, a DCO obtains significant market risk diversification benefits by maintaining a balanced-book business model. On the other hand, risk mitigation associated with uncleared, bilateral swaps between a Swap Entity and one of its counterparties generally is limited by the offsetting trades and collateral under a CSA between the two parties. As such, any comparison of the cleared and uncleared swap IM models would not be informative and, therefore, the increased cost and burden associated with performing such a comparison would not be justified.

c. Market participants need flexibility to recalibrate IM models to reduce pro-cyclicality and make other appropriate adjustments.

The proposed rules require CSEs to re-calibrate the model at least monthly to "ensure that the data incorporate a period of significant financial stress"[13]. This requirement is excessive and potentially pro-cyclical. A period of market dislocation could result in an increased demand for margin and such an increased demand could create a spiral that causes counterparties to demand larger amounts of collateral, causing distressed markets to become even more illiquid. In a paper issued by the Bank of England, the authors stated that "the analysis [in the paper] suggests that model calibrations which give higher weight to recent data are more pro-cyclical".[14]

Instead of required monthly recalibration, we propose that a study be performed annually by individual CSEs (or by ISDA) and models recalibrated as appropriate based on the results of the study, subject to a review by a governance structure of the relevant CSE that (i) monitors the coverage of the model through conducting quantitative impact studies ("**QIS**") after the execution of each recalibration, (ii) determines if an update to the model is needed, and (iii) recommends a phase-in schedule for changes to the model affecting posted IM amounts. Moreover, any increase in IM requirements should be subject to the discretion of regulators, acting on a coordinated global basis, who may at a time of stress find it more prudent to phase-in, in discrete steps, a calibration increase. The margin proposal issued by the European supervisory authorities (the "**EU Margin Proposal**") states that "[c]ounterparties shall establish transparent and predictable procedures for adjusting margin requirements in response to changing market

13 PR Margin Proposal at 57394.

14 Financial Stability Paper No. 29 – May 2014, "An investigation into the pro-cyclicality of risk-based initial margin models"; by David Murphy, Michalis Vasios and Nick Vause, issued by the Bank of England.

conditions."[15] Our suggested approach – an annual review with consideration of recalibration – is consistent with this requirement for transparent and predictable procedures.

d. Risk factors should be permitted to be used in lieu of asset classification.

The PR Margin Proposal identifies seven broad risk categories (agricultural commodity, energy commodity, metal commodity, other commodity, credit, equity, and foreign exchange or interest rate) within which the IM model may reflect "offsetting exposures, diversification and other hedging benefits" for swaps that are governed by the same EMNA.[16] The rules specifically prohibit the model from offsetting across the broad risk categories.[17]

We propose parties be permitted to determine IM based on risk sensitivities of the portfolio instead of classifying swaps into different categories if they have qualifying models. Such a determination would be made by aggregating each type of risk (rates; equity; credit; and commodity) across the portfolio and then aggregating the total amount of risk.[18] Market participants may prefer use of risk sensitivities because it aligns IM closer to the portfolio's economic risk, thus providing appropriate incentives for risk management. Using risk factors to address different types of risk in the portfolio is consistent with the goal of avoiding over-modeling correlations between disparate types of risk factors. Use of risk factors would be practical, would maintain risk management incentives and produce clear and well-defined netting sets for modeling purposes.

In contrast, classifying derivatives by broad risk categories raises a number of issues, including:

- It may be difficult to determine the appropriate risk category for a trade. For example, a derivative with significant exposure to both equity and foreign exchange rates needs to be classified as either "Equity" or "Rates" at trade inception. Even if the parties to the derivative agree on a particular classification, they may disagree with other market participants. As a result, a party may end up using different classifications for the same trade type if it is facing different counterparties.

- The appropriate classification may change over time. For example, for a derivative with exposure to equity and foreign exchange rates, the principal source of risk may shift over time such that the initial classification as either "Rates" or "Equity" may cease to be appropriate. The same trade type may end up being classified differently depending on when and in what market conditions it was executed. The overall view of risk becomes distorted if what was classified as a "Rates" trade becomes in essence an "Equity" trade but remains in a "Rates" silo.

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[15] Consultation Paper on the Draft regulatory technical standards (the "**Draft RTS**") on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Art. 11(15) of Regulation (EU) No 648/2012 published by the European Securities and Markets Authority, the European Banking Authority and the European Insurance and the Occupational Pensions Authority on 14 April 2014 at p. 30.

[16] PR Margin Proposal at 57375 and 57394.

[17] PR Margin Proposal at 57375 and 57394.

[18] See ISDA SIMM Risk Classification & Methodology Working Group, "ISDA SIMM: SBA – Margin" (September 15, 2014).

- Use of asset classes could impede effective portfolio hedging. For example, a trade classified as "Equity" may significantly contribute to overall foreign exchange risks in a portfolio. Simple direct FX hedges can reduce FX portfolio risk. However, a simple FX hedge would be in a separate risk category than the Equity trade and, as a result, the FX risk in the Equity trade could not be set off against the FX hedge under the PR Margin Proposal. Therefore, IM will most likely be increased by such a hedge and parties will be disincentivized from a prudent hedging action.

In the release, the PRs state that they "are aware that some swaps may be difficult to classify into one and only one asset class as some swaps may have characteristics that relate to more than one asset class. Under the proposal, the [PRs] expect that the CSE would make a determination as to which asset class best represents the swap based on a holistic view of the underlying swap".[19] The PRs seek comment on whether this approach is reasonable. We note that while the Bank for International Settlements ("**BIS**") uses asset classification in regard to over-the-counter ("**OTC**") derivatives, the BIS uses the classifications for purposes other than risk measurement and management. The BIS categorizes OTC derivatives as either: foreign exchange, interest rate, equity-linked, commodity or credit default swaps for reporting purposes, not risk measurement or risk management. Due to the concerns discussed above, we submit the goals of the PR Margin Proposal would be better met if parties are permitted to use either risk factors or asset classification.

e. One broad risk category should be used for commodities.

The release explains that the PRs' preliminary view is that one commodity asset class is too broad but the regulators seek comment on this treatment.[20] We request that there be one asset class for all commodity swaps. The majority of commodity swaps are index swaps (or options on indexes) with multiple underlying commodities of different types. Having more than one commodity asset class would make it difficult to assign such swaps to the appropriate class. As noted above, it would also be very difficult to ensure consistency amongst market participants, which could lead to disputes on margin requirements. In addition, the BCBS/IOSCO Paper, the EU Margin Proposal and the Japanese Margin Proposal all provide for a single risk category for commodity derivatives.[21] The use of a single category by the PRs would therefore promote international consistency and facilitate cross-border swaps.

f. The rules should allow the use of a model for haircuts on IM collateral as well as a standardized schedule.

Under the proposed rules, haircuts on eligible collateral for IM are to be determined according to the standardized schedule provided in the rules.[22] We propose that the PRs' margin rules allow the use of a model to determine and apply haircuts to collateral for IM. Models are subject to risk and oversight policies which require the models to be reviewed and updated on a regular

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[19] PR Margin Proposal at 57375.

[20] PR Margin Proposal at 57375.

[21] BCBS/IOSCO Paper at p. 12; EU Margin Proposal at p. 30; Japanese Margin Proposal.

[22] PR Margin Proposal at 57392.

basis. Models are more dynamic and better reflect market conditions than a static table. In times of financial market stress, a static table will not adequately reflect the prevailing market conditions. At such times, it is critical that assumptions and inputs that factor into the margin calculations are capable of being dynamically updated. Use of a haircut schedule that is not updated in a period of market turmoil will mean that certain IM collateral held will potentially be wrongly valued, placing collateral holders in a vulnerable credit position.

In addition, from a harmonization perspective, the BCBS/IOSCO Paper and the Japanese Margin Proposal allow the use of a model or standardized schedule and the EU Margin Proposal allows the use of a standardized schedule or the party's own estimates for haircuts.[23]

g. Incorporation of foreign exchange ("FX") risk of IM in the IM model should be permitted as an alternative to the proposed 8% haircut for IM.

The proposed schedule for haircuts on IM collateral includes an 8% "[a]dditional (additive) haircut on asset in which the currency of the swap obligation differs from that of the collateral asset".[24] ISDA supports CSEs being permitted to incorporate FX risk into the IM model calculations in lieu of applying the proposed 8% haircut.

In a letter to the European supervisory authorities (the "**ESAs**"), ISDA analyzed the proposed 8% cross-currency haircut.[25] In the letter, ISDA provided examples that showed the following with respect to IM:

- any additional risk introduced due to FX risk between the collateral and the derivative should be mitigated by both parties posting collateral, in the form of additional segregated IM.
- FX sensitivities at the trade level are routinely captured in the IM calculation. This methodology could be extended to capture the FX risk between the derivative portfolio and the collateral, by simulating the collateral as additional cash flows, for the calculation of the required IM.
- FX risk calculated for the purpose of the IM computation should be allowed to be netted across asset classes because the trade level market sensitivities that drive the aggregate amount of FX risk in each asset class are captured in the IM calculation.

By including the risk of the IM collateral when measuring the portfolio risk in the IM calculation, collateral will fall naturally into its respective risk category. Our proposal is that CSEs be permitted to use this approach in lieu of applying the 8% cross-currency haircut.

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23 BCBS/IOSCO Paper at p. 17; EU Margin Proposal at p. 39; Japanese Margin Proposal.

24 PR Margin Proposal at 57392 and 57396 –Table B, missing description.

25 ISDA letter to the European Securities and Markets Authority, the European Banking Authority and the European Insurance and the Occupational Pensions Authority re: Proposed Margin Requirements: Analysis of Currency Mismatch Haircut, dated 17 August 2014. Available at http://www2.isda.org/functional-areas/wgmr-implementation/.

3. The threshold for material swaps exposure should be $11 billion.

The proposed rule provides that CSEs must collect and post IM for swaps with financial end users with material swaps exposure ("**MSE**") and the proposed rule sets the threshold for MSE at $3 billion.[26] The BCBS/IOSCO Paper set this threshold at €8 billion (approximately $11 billion).[27] We recommend that the PRs set the threshold for MSE at the same level as the BCBS/IOSCO Paper.

Separate Thresholds: In the release accompanying the proposed rules, the PRs analyze the MSE threshold in relation to the $65 million bilateral threshold[28] and cite this analysis as support for the proposed MSE threshold of $3 billion. The release states that the "intent of both the Agencies and the 2013 international framework is that the IM threshold provide smaller counterparties with relief from the operational burden of measuring and tracking IM collection amounts that are expected to be below $65 million".[29] Based on the PRs' analysis, the release further states that "[i]dentifying a material swaps exposure with a gross notional amount of $3 billion is more likely to result in an outcome in which entities with a gross notional exposure below the material swaps exposure amount would be likely to have an initial margin collection amount below the proposed permitted initial margin threshold of $65 million".[30]

We view the two thresholds as distinct in their scope and purposes. The IM threshold ($65 million) is a bilateral threshold which is intended to alleviate the operational burdens related to collecting and posting small amounts of IM for all parties subject to the IM requirements. In contrast, the MSE threshold is an entity threshold meant to identify and exclude from the margin requirements those financial end users whose swaps activity is limited and who do not pose systemic risk to the financial markets. In the BCBS/IOSCO Paper, the international group of regulators defined and provided levels for the two different thresholds and did not relate the two.

PR Analysis: The PRs' analysis of the MSE threshold implicitly assumes that each counterparty deals with only one CSE. The PR Margin Proposal includes a chart that shows that, on average, a counterparty with an $11 billion gross notional portfolio of cleared swaps has an IM requirement of $231 million.[31] The PRs interpret the results to indicate that "the initial margin collection amount on a swap portfolio with a gross notional size of $11 billion could be significantly larger that the proposed permitted IM threshold of $65 million".[32] This is true if the financial end user is counterparty to only one CSE for the full $11 billion portfolio. However, if a financial end user enters into swaps with multiple CSEs, then the $65 million IM threshold is applicable to each pairing between the financial end user and each CSE. For example, assume a financial end user enters into $2.75 billion notional with each of four different CSEs, for a total

[26] PR Margin Proposal at 57391.

[27] BCBS/IOSCO Paper at p. 8.

[28] PR Margin Proposal at 57366-8.

[29] PR Margin Proposal at 57367.

[30] PR Margin Proposal at 57368.

[31] PR Margin Proposal at 57367.

[32] PR Margin Proposal at 57367.

portfolio of $11 billion in swaps. Then, under the study's parameters, the IM requirement with each CSE would be approximately $57.8 million, below the $65 million IM threshold. In the market, it is very unusual for a financial end user to have swap relationships with only one CSE. As a result, the analysis does not appear to support a lower threshold than the one proposed by the BCBS/IOSCO Paper.

Pro-cyclicality: A lower threshold for the MSE increases the pro-cyclicality of the margin requirements. In times of stress in the financial markets, volatility rises, which results in increased demand for IM leading to increased demand and prices for eligible collateral, adding to the stress in the financial markets. The risk of pro-cyclicality will be greater with a MSE threshold of $3 billion instead of $11 billion. The number of counterparties that will be subject to the margin requirements will be greater with the lower threshold and the population on the cusp that moves above the threshold in any given period will be greater, escalating the pro-cyclicality risk. A QIS performed by ISDA in relation to the initial margin paper published by BCBS/IOSCO showed that the amount of IM required under normal market conditions would increase by a multiple of three times under stressed market conditions.[33] We request that an updated study be performed to determine the pro-cyclical effects of using a threshold of $3 billion instead of $11 billion.

Harmonization: As discussed further in this letter and prior letters to the PRs, ISDA stresses the necessity for harmonization across jurisdictions. The EU Margin Proposal set the global threshold for applicability of the margin requirements at €8 billion (approximately $11 billion) and the Japanese regulators have proposed ¥1.1 trillion (approximately $10 billion).[34] Consistency with regulators in other jurisdictions for purposes of harmonization of the margin rules is needed to keep US market participants on an even footing with their peers and competitors.

4. **Financial end users below the MSE threshold should not be required to post or collect VM.**

The PR Margin Proposal requires CSEs to exchange VM with all financial end users. We propose the elimination of this VM requirement for financial end users below the MSE threshold.

Imposing a VM requirement on smaller market participants will not address systemic risks and will make hedging by such participants more difficult and costly. Systemic risks are not implicated because a default by a smaller participant is unlikely to cause the failure of a CSE and to transmit credit problems to the markets. Yet the burden of such VM requirement is particularly significant for smaller participants: many of them do not currently post VM and implementation of the VM requirements will require fundamental changes to existing VM arrangements. Because of the difficulties of implementation, the likely result of imposing VM requirements on smaller market participants is that some would be forced out of the market

[33] ISDA, Initial Margin for Non-Centrally Cleared Swaps; Understanding the Systemic Implications, November 2012, pp. 5, 9. Available at: http://www2.isda.org/attachment/NTA5Nw==/Margin%20for%20Uncleared%20Presentation%20FINAL.pdf.

[34] EU Margin Proposal at p. 49; Japanese Margin Proposal.

because they are not able to meet VM operational and documentation requirements. This would, in many cases, increase the costs and difficulties of hedging. A mechanism should be established to permit non-systemic market participants to remain in the derivatives markets.

The MSE threshold is a good indication of whether a financial end user poses systemic risk and the threshold is already in use as a threshold for the IM requirement. We therefore propose that this threshold be used for the VM requirement for financial end users.

C. CROSS-BORDER

1. Margin rules and requirements should be consistent among different jurisdictions and within the US.

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, within the US (PRs, the CFTC and the Securities and Exchange Commission (the "**SEC**") rules) and consistent with the BCBS/IOSCO guidelines for margin. As of the date of this letter, the SEC has not yet re-proposed its rules on margin. We encourage national regulators to harmonize their margin rules. Otherwise, the market will become increasingly fragmented and its liquidity impaired as counterparties struggle to meet inconsistent margin requirements of various international and US regulators. Moreover, for margin requirements, inconsistent rules will potentially be incompatible in practice. International consistency will also prevent regulatory arbitrage and lead to a more level playing field between competitors in different jurisdictions.

In particular, there remains the possibility of differences regarding the scope of instruments covered by the US regulators and by the rules of other jurisdictions. Such differences could be detrimental to both US and non-US firms. Therefore, for global consistency purposes, we ask the PRs, the CFTC and the SEC to explore a way to phase in the collateral requirements for instruments covered by the US regulators but not covered by the rules of other major financial jurisdictions.

2. The PRs should be flexible in the assessment and determination of whether foreign rules are comparable to US rules and appropriate for safe and sound operation using an outcomes-based approach.

For cross-border swaps, under the PR Margin Proposal, the availability of substituted compliance for the PRs' margin requirements requires a joint, public comparability determination by the PRs.[35] In making the determination, the PRs will "consider whether the requirements of such foreign regulatory framework for non-cleared swaps and non-cleared security-based swaps applicable to such covered swap entities are comparable to the otherwise applicable requirements of this part and appropriate for the safe and sound operation of the covered swap entity, taking into account the risks associated with non-cleared swaps and non-cleared security-based swaps".[36] We ask that the PRs provide specific standards and conditions that will be used in the

[35] PR Margin Proposal at 57395.

[36] PR Margin Proposal at 57395.

determinations. Well-defined criteria will provide guidance to non-US regulators in determining whether their local regulation may be deemed comparable, which can facilitate harmonization of the margin rules across jurisdictions.

3. The PRs should determine, before the applicable compliance date, that substituted compliance applies to non-US margin rules that conform to the BCBS/IOSCO Paper.

The European and Japanese regulators have recently proposed margin requirements based on the BCBS/IOSCO Paper. Other jurisdictions may issue similar rules in the near future. We recommend that, with respect to jurisdictions that adopt margin requirements that conform to the BCBS/IOSCO Paper, the PRs make a substituted compliance determination. Such treatment would be a fitting recognition of the extensive consultative process by which the BCBS/IOSCO Paper was developed. In addition, we suggest that such determinations be made as soon as possible after the relevant margin rules are adopted, and before the compliance date of the PR margin rules. A timely determination will greatly facilitate the implementation of the margin rules.

4. CSEs should not be required to post margin to non-US financial end users.

The PR Margin Proposal requires CSEs to post margin to and to collect margin from financial end users (in the US and outside the US). We propose that, in cross-border transactions, posting requirements should not apply although collecting requirements will still apply.

In its discussion of cross border transactions, the BCBS/IOSCO Paper states that that the "margin requirements in a jurisdiction may be applied to legal entities established in that local jurisdiction … in relation to the initial and variation margins that they collect." In the EU Margin Proposal, the draft RTS do not directly address cross-border transactions, but the RTS require collection of margin (from non-EU counterparties by both financial counterparties and certain non-financial counterparties) rather than the posting of margin to non-EU counterparties. Under the Japanese Margin Proposal, a covered Japanese entity is only required to collect margin from a non-Japanese counterparty and is not required to post margin to a non-Japanese counterparty. Under each of these proposals, if a swap dealer in one jurisdiction enters into a swap with a counterparty located in another jurisdiction, the local rules for the swap dealer apply to <u>collection</u> of margin but not to <u>posting</u> of margin. For example, a financial counterparty in the EU has no obligation under the RTS to post margin to a US entity.

We request that PRs take the same approach that CSEs not be required to post margin to a non-US financial end user. If our proposal is adopted, if a US CSE entered into a swap with a non-US financial end user, the CSE would collect margin under the US rules but would not post margin under the US rules. For non-US counterparties that are Swap Entities or "true" end users, no comparable exemption is needed because the PR Margin Proposal does not impose a separate posting requirement for such counterparties.

Our support for this approach is based on the following. First, the margin rules are intended to protect US markets against systemic risk, and it is therefore appropriate for the PRs to regulate collateral coming into a US-regulated CSE but not necessary to require that collateral be posted to non-US entities. Second, without such an exemption, a cross-border swap between a US CSE and a non-US financial end user will be simultaneously subject to both US and non-US rules. Compliance with both rules simultaneously would be extraordinarily difficult and could be impossible if the two rules require mutually inconsistent practices. Third, if the jurisdiction of the non-US entity does not provide sufficient safeguards with respect to collateral, then CSEs will face increased risk because of the requirement to post. Finally, adopting the same cross-border approach as other jurisdictions will promote international harmonization and help create a level playing field for US and non-US firms.

5. CSEs should not be required to post IM or VM for swaps with counterparties in non-netting jurisdictions.

For countries where satisfactory netting opinions cannot be obtained, market participants typically do not employ collateral as a risk mitigant. Without enforceable netting there is the risk that the administrator of an insolvent counterparty will "cherry-pick" from posted collateral to be returned in the event of insolvency, which will result in an increase in the risk in posting collateral. Therefore, if the PRs do not adopt ISDA's recommendation above that CSEs not be required to post margin to non-US financial end users, we request that CSEs not be required to post margin (IM or VM) to counterparties in jurisdictions lacking enforceable netting.

ADDITIONAL ISSUES

A. SCOPE

1. The list of financial end users is too broad.

The list of entities in the proposed definition of "financial end users" includes a wide range of entities, including securitization and investment vehicles. However, the preamble to the PR Margin Proposal states that the PRs, in defining financial end user, "now are proposing to rely, to the greatest extent possible, on the counterparty's legal status as a regulated financial entity." ISDA encourages the PRs to limit financial end users to regulated financial entities and specifically to exclude structured finance vehicles (including securitization vehicles and covered bond pools) as further discussed below. In addition, the test applicable to non-US entities (i.e., the non-US entity "would be a financial end user if it were organized under [US/state] laws") will be difficult for non-US entities to apply: for example, it will be difficult for a non-US entity to determine which Investment Company Act exemption would apply if it were organized in the US.

Structured Finance Vehicles: Structured finance transactions in which the swap counterparty is either secured by a senior claim on pledged collateral held by a special purpose vehicle ("**SPV**") or is otherwise entitled to a senior priority claim on the assets of the SPV do not pose systemic risk to the broader market. Such credit support arrangements protect swap counterparties without use of VM or IM as required under the PR Margin Proposal. Further, SPVs are established as bankruptcy-remote entities with a limited number of creditors so that a swap counterparty's position as a senior secured creditor should give the swap counterparty very strong rights with respect to the SPV's assets.

In addition, SPVs do not have ready access to liquid collateral that can be transferred back and forth to a counterparty in the manner generally required under the PR Margin Proposal. SPVs would potentially be forced to exit the derivatives market entirely if they had to post or collect IM and VM in the manner contemplated by the PRs and such a forced departure would impede structured finance transactions and cause significant harm to securitization and other financial markets.

We understand that the Structured Finance Industry Group ("**SFIG**") will submit a letter to the PRs on the proposed rules and direct the PRs to SFIG's letter in regard to treatment of swaps entered into by structured finance vehicles.

Covered Bond Issuers: The EU margin proposal provides a special set of criteria for covered bond issuers.[37] We request that the PRs also develop rules that would permit covered bond issuers to use collateral arrangements other than the requirements in the PR Margin Proposal.

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[37] EU Margin Proposal at p. 25.

2. Change in status of a swap counterparty should not affect margin requirements during the life of a swap.

The rules should specify that a party's status for purposes of the margin requirements is determined when the parties enter into the swap. If the party changes status during the life of a swap, the margin requirements for that swap should not change. A party could change status because it enters into a swap and later: exceeds (or falls below) the MSE threshold; becomes (or ceases to be) a financial end user; or is required to register as (or ceases to be) a swap dealer. For example, we request clarification that if a financial end user enters into a swap with a CSE and subsequently crosses the MSE threshold, the swap will not be subject to the IM requirement.

Our position with respect to change of status is consistent with the position taken by the CFTC and the European regulators for clearing.[38] Any other position would make it difficult to price swaps: if a change in status results in change in a margin requirements, the economics of the swap could change significantly.

We recognize that a change in status also could lead to complexities under a netting agreement. For example, if an entity exceeds the MSE threshold, older swaps ("**legacy swaps**") should not be subject to IM requirements but newer swaps will be subject to such requirements. As a result, the parties should have the option to document the legacy swaps under a different CSA than the one applicable to new swaps. If parties use different, separate CSAs for new and legacy swaps, then netting for purposes of calculating IM or VM can be limited to the new swaps. If the legacy swaps are documented under separate CSAs and are not netted with new swaps for purposes of IM or VM calculation, a legacy swap should retain the margin status that it had when the swap was executed.

In addition, if a counterparty changes status by becoming a CSE (after December 2019), there is no time lag under the proposed rules before IM and VM must be exchanged. In order to accommodate the operational and documentation requirements for IM and VM, we ask that the PRs permit a phase-in period for margin for new CSEs.

B. THRESHOLDS

1. Threshold calculations should exclude inter-affiliate and FX swaps

<u>Inter-affiliate</u>: We ask the PRs to clarify that inter-affiliate swaps are not included in the MSE calculation. The objective of the threshold is to ensure that the margin requirements only apply to market participants that pose the greatest amount of systemic risk. The volume of inter-affiliate transactions is not a good indicator of systemic risk. As noted above, BCBS/IOSCO stated in their initial consultative document on margin that these trades "frequently serve risk management or other purposes that are different from non-centrally-cleared derivative transactions with third parties" and that the imposition of initial margin requirements on these

[38] CFTC Rule 50.2, on mandatory clearing, does not require a party to submit a swap for clearing if the party was not subject to the clearing requirement at the time it executed the swap.

trades "could tie up substantial liquidity".[39] Moreover, MSE is determined on a group-wide basis and generally inter-affiliate transactions are not recognized for group-wide financial measurements. Therefore, we recommend that inter-affiliate transactions should not be included in determinations as to whether a group is required to post IM.

FX swaps: There is no requirement to deliver IM or VM for specific types of FX trades ("**Exempt FX**"), which are explicitly permitted to be excluded from the IM and VM requirements by the US Treasury. This exclusion is a recognition that Exempt FX have unique characteristics that distinguish them from other swaps. Exempt FX are also excluded from the de minimis threshold calculation for determination of swap dealer registration status. The same characteristics that justify excluding Exempt FX from the IM and VM requirements and the de minimis threshold calculation also justify excluding them from the margin threshold calculations. Including Exempt FX could have illogical results. For example, a counterparty that enters into Exempt FX trades in very large volumes and other derivatives only in small amounts would be required to post and collect IM on the non-FX derivatives, even though the risk from the non-FX exposure is minimal. In addition, due to the short dated nature of most FX, it is market practice to execute a second trade in order to close the risk of existing trades, rather than cancel or novate such trades. Therefore, the gross notional can be much larger than the net risk position on FX than for other classes. This will exacerbate the accidental capture of less risky counterparties.

2. The MSE and $65 million threshold should not include swap exposures of affiliates.

Aggregation of swap exposure across all affiliates of a financial end user overstates the risk posed by the counterparty to the financial system and will be difficult, if not impossible, to implement from a practical perspective, particularly where control is calculated using a 25% test. Calculations of the MSE and initial margin threshold amount (the "**$65 Million Threshold**") should only include the swaps that the financial end user enters into or guarantees. This calculation should not include swaps of the financial end user's affiliates unless such swaps are guaranteed by the financial end user. This approach would be the same as that taken by the CFTC and SEC in the calculation of major swap participant and major security-based swap participant ("**MSP**") status under the final rules defining Swap Entities (the "**Swap Entity Definitions**"), under which an entity is not required to include the swap exposure of its affiliates unless it has guaranteed or otherwise agreed to be responsible for those positions.[40] Further, were the rule to require aggregation of all affiliate positions, parties would need to put in place new reporting and tracking systems that would differ from the systems put in place to make MSP calculations, and which could be very expensive and time consuming to implement. Under a 25% control test, many affiliates may not be consolidated for accounting purposes and gathering the swap positions across all such entities would be enormously challenging. For example, if a

[39] Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions consultative document on "Margin requirements for non-centrally cleared derivatives" dated July 2012, p. 28.

[40] [An] entity's swap or security-based swap positions in general would be attributed to a parent, other affiliate or guarantor for purposes of the major participant analysis to the extent that the counterparties to those positions would have recourse to that other entity in connection with the position. Positions would not be attributed in the absence of recourse. 77 FR 30596, at 30689.

financial end user (such as a financing vehicle) is a subsidiary of a corporate group, then the corporate group would need to determine the swap and FX activity of every affiliate, including non-US affiliates. Such a determination will be particularly difficult because the calculation uses the US definition of "swap", which differs significantly from the equivalent definition in other jurisdictions.

3. The MSE and $65 Million Threshold should exclude any swaps executed by an investment manager acting for a financial end user if recourse to the financial end user is limited to assets provided to that investment manager.

Institutional investors such as pension plans typically employ multiple investment managers to invest and manage separate pools of assets in separate managed accounts. Such managed accounts are generally established by each investment manager under trading documentation that limits the recourse of any swap counterparty to the assets in the account. While a single beneficial owner may have multiple managed accounts with different investment managers, each account is a separate and distinct pool of assets and the liabilities of the account are limited to the assets in the account. A requirement that the beneficial owner aggregate swap exposures across all such managed accounts would run counter to the contractual limitations on liability and to the approach taken by the CFTC and SEC in the calculation of MSP status under the Swap Entity Definitions. In the Swap Entity Definitions, the CFTC and SEC recognized that in these situations, it is appropriate to focus on where the risk actually resides and that, therefore, swap positions in managed accounts should not be aggregated with the beneficial owner's other positions.[41] This approach should also be applied to a party's calculation of the MSE and $65 Million Threshold.

4. The test for affiliates is not appropriate for purposes of the threshold calculation.

Under the proposed rules, each of the MSE and the $65 Million Threshold is calculated based on aggregate swaps activity of a counterparty and its affiliates and affiliates include any company that "controls, is controlled by or is under common control with another company".[42] Control, in turn, is defined to mean (1) ownership, control or power to vote 25% or more of a class of a company's voting securities; (2) ownership or control of 25% or more of a company's total equity; or (3) control of the election of a majority of the directors or trustees of a company.[43]

The criteria for inclusion in aggregate swaps activity of a counterparty for purposes of determining whether the counterparty has a material swaps exposure should reflect indicators of

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[41] [We] conclude that the major participant analysis that applies to the beneficial owners of those positions should focus on where the risk associated with those positions ultimately resides, given how the statutory major participant definitions focus on the risks posed by large swap or security-based swap positions. Thus, for example, if the counterparties to a swap or security based swap position within a managed account have recourse only to the assets of that account in the event of default— and lack recourse to other assets of the beneficial owners—we do not believe that it would be appropriate to attribute that position to its beneficial owner. 77 FR 30596, at 30690.

[42] PR Margin Proposal at 57389.

[43] PR Margin Proposal at 57389.

substantive control (including the ability to direct trading and hedging activity and management of the risk exposure of the affiliate) that can be observed and verified by reliable sources such as audited financial statements. The appropriate aggregation should be defined by whether an affiliate is consolidated by the ultimate parent under the accounting standards applicable to the ultimate parent of the group. This approach is consistent with accounting standards, which the PRs use as the basis for preparing regulatory reports, and will enable counterparties in different jurisdictions to apply the thresholds to groups of entities on a consistent basis. Using other measures of control could give rise to significant operational complexity because the level of ownership of affiliates that are not consolidated by the parent-investor is not always disclosed in the financial statements (whether the percentage ownership interest is disclosed often is driven by materiality of the investment). In addition, the EU approach is broadly aligned with the EU accounting definition of control for consolidation purposes.

5. CSEs should be able to rely on counterparty representations as to MSE status.

The margin rules should allow parties to rely on representations made by their counterparties as to the counterparty's status in relation to MSE. It should be the responsibility of the counterparty making the representation to immediately provide updates of any change to its status.

C. IM MODEL

1. Parties should be permitted (but not required) to include non-swap assets in the model.

Counterparties often have exposure to the same risk factors in multiple markets. Therefore, we submit that IM models would be most effective if they are allowed to capture parties' exposure with respect to risk factors across various types of assets, including assets that are not swaps. In addition, certain products may be viewed as derivatives in one jurisdiction but not in another, and parties should be permitted to include such products to achieve global consistency. For instance, if two parties have exposure to equity risk to each other, one by way of equity options, and another by way of equity swaps, the parties should be able to take this into account in the models. This type of modeling would present a more accurate reflection of the actual exposure of each counterparty with respect to certain risk factors, and would eliminate the posting of redundant margin, which would only decrease liquidity in the derivatives markets.

2. The proposed period for calibration and the holding period should be harmonized with the applicable periods in other jurisdictions.

The PRs propose a period for calibration of the IM model of at least one year and not more than five years. The EU Margin Proposal proposes a calibration period of at least three years. Further, the PRs propose that the model calculate IM based on a "holding period equal to the shorter of ten business days or the maturity" of the swap; whereas the EU Margin Proposal requires that IM be calculated using a "margin risk period of at least 10 days". We ask that the PRs harmonize the final rules with the EU proposed rules.

D. COLLATERAL REQUIREMENTS

1. Scope of eligible collateral for IM should be broader and more consistent with the BCBS/IOSCO policy framework; IM haircut requirements should also be consistent with the BCBS/IOSCO policy framework.

Eligible collateral: The proposed list of eligible collateral for IM differs from that in the BCBS/IOSCO final policy framework. The PRs' list is narrower in scope than that in the BCBS/IOSCO Paper or the list in the EMIR draft RTS or the Japanese Margin Proposal.[44] For example, bank debt is not eligible under the PR proposal, but is eligible under the BCBS/IOSCO Paper and may be eligible under EMIR and Japanese regulation. We support a broader scope, including allowance for bank debt, for IM.

IM haircut requirements: In regard to the schedule, the IM haircuts proposed by the PRs differ from those under the BCBS/IOSCO Paper, the EU Margin Proposal and the Japanese Margin Proposal. We recommend that the PRs bring the schedule more in line with the haircuts proposed by BCBS/IOSCO and the other regulators.

2. Eligible collateral should include settlement currency as agreed upon by the parties.

As proposed, eligible collateral includes "immediately available cash funds that are denominated in … [t]he currency in which payment obligations under the swap are required to be settled".[45] We ask that the PRs confirm that this includes any currency agreed upon by the parties as the settlement currency.

The revised Basel III leverage ratio framework provides that variation margin received in the form of cash may be used to reduce the leverage ratio exposure if certain conditions are met, including that the cash is "in the same currency as the currency of settlement of the derivative contract".[46] The BIS has defined "currency of settlement" as "any currency of settlement specified in the derivative contract, governing qualifying master netting agreement (MNA), or the credit support annex (CSA) to the qualifying MNA".[47] We therefore request that eligible collateral for margin purposes include the settlement currency as agreed upon by the parties.

3. Eligible collateral for VM should include non-cash collateral.

Limiting eligible collateral for VM to cash is not necessary and places undue burden on parties that do not carry large cash positions in the ordinary course of their business. Many market participants that use swaps to hedge the risk in held assets do not carry large cash positions. For example, pension funds and insurance companies generally do not hold large amounts of cash in

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44 PR Margin Proposal at 57392; BCBS/IOSCO Paper at pp. 16-7; EU Margin Proposal at pp. 32-4; Japanese Margin Proposal.

45 PR Margin Proposal, §__.6(a) at 57392.

46 Basel III leverage ratio framework and disclosure requirements, January 2014, p. 4, available at: http://www.bis.org/publ/bcbs270.pdf.

47 BIS, Frequently asked question on the Basel III leverage ratio framework, October 2014, p. 1.

their investment portfolios. Requiring VM to be posted only in cash may affect risk management strategies and disincentivize parties from managing their asset positions efficiently. Risk in non-cash assets may be mitigated by limiting the scope of eligible collateral to high quality, liquid assets. Appropriate haircuts for non-cash collateral provide protection against credit and other relevant risks.

Both the BCBS/IOSCO and the EU regulators propose that eligible collateral for VM include non-cash collateral.[48] We ask that the PR final rules permit non-cash collateral for VM and confirm that no haircut applies to cash that is posted as VM.

4. Entities that are affiliated with sovereigns should be allowed to use sovereign debt as margin.

Many sovereigns have direct or indirect ownership stakes in various market participants. It would be a severe restriction on such market participants if they were unable to post bonds issued by the government that carried a stake in such market participant. This restriction is not appropriate given that there is little wrong way risk in, for example, a bank with partial government ownership using that government's bonds as collateral.

E. INITIAL MARGIN

1. A longer period for calculation of IM should be permitted.

We support the requirement for a regular call for IM, but the business day following the relevant trade is not an operationally practicable timeline. In contrast to VM, IM generally is more difficult to calculate due to complex calculations and trade reconciliation. In particular, at the beginning of a trade, IM amounts are larger and the chance of calculation mismatch is greater. Further, the anticipated volume of call processing would make T+1 timing for IM calls difficult.

In addition, many counterparties have offices and branches in different jurisdictions and transact with counterparties located in different jurisdictions and different time zones. A proper calculation of IM required to be collected can only be made when the books of all market participants are closed, which for most global market participants will only occur on weekends. This is especially critical because IM thresholds are calculated on a group basis, so all branches and offices of a counterparty must be closed in order for the calculation to be correct. We expect that the process will become more efficient over time, but at present, IM should be required to be called for on a weekly basis. Collection of IM is subject to the time required to deliver the collateral.

2. Collection of IM is subject to the time required to deliver the collateral.

The PRs' proposal requires counterparties to collect IM within the business day following the execution of a new contract. We note, however, that actual delivery of IM is subject to the time required to arrange delivery of the relevant asset. For example, for parties in the US, delivery of Asian securities will require more time than transfers of US dollars. Subject to the discussion on

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48 BCBS/IOSCO Paper at pp.16-7; EU Margin Proposal at pp. 32-3.

how frequently calls for IM must be made (see above), we ask the PRs to clarify that IM must be called for on a regular basis and delivered promptly after the call.

F. VARIATION MARGIN

1. The frequency and timing of calls for VM should be flexible.

Frequency: The PR proposal requires VM to be collected at least daily, which requires daily calls for collateral. We request that some flexibility be built into the requirement for daily calls for VM in markets for which daily VM calls would pose significant operational hurdles. Such a flexible standard would be consistent with the BCBS/IOSCO proposal, which provides that parties "must exchange … the full amount of variation margin … on a regular basis (e.g. daily)."[49] This flexibility is particularly critical for parties outside the US. Under the proposed rules, non-US parties (subject to some exceptions) entering into swaps with US CSEs will have to call for VM on a daily basis and it may simply not be possible to arrange this by the time the margin rules are implemented. We therefore propose that the rule provide that VM will be called for on a regular basis, subject to regulatory review. Under such a flexible regime, parties would have the option to call for VM on a daily basis and we would expect that many parties will do so.

Timing: The proposed rules state that "[o]n and after the date on which a covered swap entity enters into a non-cleared swap or non-cleared security-based swap with a swap entity or financial end user", the CSE shall collect or post VM as applicable.[50] It is not clear when the requirement to collect or post first applies. It is not possible to determine and call for the VM amount on the date of swap execution, because the required VM amounts are not known until after the close of business. We therefore ask the PRs to clarify that CSEs have flexibility to determine how quickly the call for VM must be made after the date a swap is executed.

2. Collection of VM should be subject to the time required to deliver the VM.

The PR proposal requires counterparties to collect variation margins at least once per business day, starting "on and after the date on which a covered swap entity enters into a non-cleared swap or security-based swap with a swap entity or financial end user".[51] However, the delivery of collateral constituting VM is subject to the time required to settle the transfer of the assets. For example, delivery may be delayed if parties are in different time zones. Therefore, we request the PRs clarify that the timing requirements for VM are with respect to calls for collateral rather than actual delivery, and that actual delivery of VM will be subject to the time required to deliver the relevant asset.

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[49] BCBS/IOSCO Paper para. 2.1 at p. 9.

[50] PR Margin Proposal at 57392.

[51] PR Margin Proposal at 57392.

3. The PRs should reconsider netting restrictions for VM posting to non-netting counterparties.

Under Sec. _.4(d) of the proposed rules, a CSE may comply with the VM requirements on a net basis if the relevant swaps are subject to an EMNA. EMNAs must provide the CSE with a legally enforceable right to close-out and net transactions, including in insolvency.

A CSE cannot enter into such an agreement with "non-netting" counterparties, such as certain US pension funds and insurance companies, because the insolvency laws applicable to such non-netting counterparties do not clearly allow the enforcement of close-out and netting rights. As a result, under the proposed rules, a CSE will need to post VM to a non-netting counterparty on a gross basis and will generally have to post larger amounts of VM than it would if netting applied. Such a CSE will therefore be exposed to greater risks with respect to the posted collateral: in an insolvency of the non-netting counterparty, the CSE will be a creditor for the posted VM (which will be generally increased by the lack of netting) and the CSE may be restricted in its ability to set off the debt of the counterparty against the obligation to repay the VM. This increased risk to the CSE may, in turn, contribute to greater risk to the market if a non-netting counterparty defaults.

We therefore ask the PRs to reconsider the netting restrictions on VM posting to non-netting counterparties.

G. IMPLEMENTATION TIMING

1. During the phase-in period, financial end users should not be subject to IM requirements if they fall below the applicable thresholds.

Under §__.1(e) of the PR Margin Proposal, once a CSE and its counterpart exceed an IM threshold, the parties remain subject to the IM requirements thereafter.

During the phase-in period, only entities whose swap volume currently exceeds the applicable threshold should be subject to the margin requirements. If the swap activity of either party to a swap declines below the applicable threshold, that party should cease being subject to the IM requirements until such time as it exceeds the applicable threshold. The rules should provide for two-way application of the margin requirements during the phase-in period.

H. SEGREGATION

1. The segregation requirements should not exclude custodians that are affiliates of either counterparty.

Under the PR Margin Proposal, IM that is posted or collected by a CSE must be segregated with a third party custodian that is not affiliated with either counterparty.

We support allowing segregation of collateral with affiliated custodians. The requirement for non-affiliated custodians is not justified by risk concerns. The custodians are separate entities and, for US custodians, custodial property is not part of the custodian's assets if the custodian becomes insolvent. Many of the largest custodians are affiliates of swap dealers. Swap dealers facing other swap dealers will therefore need to use a custodian that is not affiliated with either party, which will increase the documentation burden. Moreover, because there are limited numbers of large custodians, requiring use of non-affiliates may cause issues with total custodial capacity. If a custodian uses a sub-custodian, it is not clear if the rules require the sub-custodian also to be a third party that is not affiliated with either counterparty. Such an extension of the requirement would place a burden on custodians to track and monitor sub-custodians and their affiliations.

2. Segregation requirements should not apply to margin that is not required to be posted under the margin rules.

The PR Margin Proposal, at §__.7(a), requires that a CSE that "posts any collateral other than variation margin" with respect to an uncleared swap must require that such collateral be segregated with a third party custodian.[52]

The final rules should provide that collateral that is not required does not have to be segregated. The policy rationale for the margin rules does not justify such segregation because the margin rules do not require such collateral to be posted at all. Moreover, Section 4s(l) of the Commodity Exchange Act, adopted as part of the Dodd-Frank Act, provides for optional rights of segregation of collateral under certain circumstances, and there is no indication of any Congressional intent to expand segregation requirements beyond that required by Section 4s(l) for margin that is not required under the margin rules.

3. Other segregation structures bear additional consideration.

We strongly support the creation of a regime for the protection of margin. However, because some entities lack the ability to create certain types of security interests, flexibility is required. Structures other than the one proposed merit further consideration by the PRs so long as they achieve the goal of significantly mitigating counterparty risks. For instance, title transfer and charge-back of margin is a structure that is commonly used in the market and provides protection to counterparties. Other options include segregation on the books of the CSE or segregation with an affiliate if such collateral is insulated from the insolvency of the CSE or affiliate or is subject to a customer collateral protection regime. In addition, some parties, such as trustees of pension schemes, may not be able to create financial collateral arrangements with respect to IM. Other entities may be limited by the nature of their assets. For these reasons, the margin rules should permit more flexible segregation arrangements, so long as they sufficiently mitigate counterparty risk.

4. Appropriate rehypothecation should be permitted.

The proposed rules prohibit the rehypothecation or re-use of IM.[53] We believe that a model for rehypothecation that would meet the requirements of the BCBS/IOSCO Paper could be developed for use by counterparties. We do not believe it is necessary to forestall a development of such models by prohibiting the rehypothecation of IM. The margin rules should instead

[52] PR Margin Proposal, §__.7(a) at 57393.

[53] PR Margin Proposal at 57393.

provide that rehypothecation would be acceptable if the relevant model were to meet the BCBS/IOSCO Paper requirements with appropriate modifications as agreed by the PRs. In addition, we note that other regulators may permit rehypothecation, and if so, a prohibition would create a competitive disadvantage for market participants subject to the PRs' rules. ISDA members would be happy to work with the PRs to design a feasible system for rehypothecation.

Rehypothecation is particularly important for intermediated "prime brokerage" transactions which provide liquidity and price advantages for swap customers. In a prime brokerage transaction, a customer enters into a trade with an "executing dealer" which then "gives up" the derivative to a credit intermediating dealer (a "prime broker"). As a result of the "giving up" of the derivative, the customer enters into the derivative with the prime broker rather than the executing dealer. Contemporaneously, the prime broker (which has a credit line for the customer) enters into a substantially equal and opposite derivative with the executing dealer (which does not have a credit line for the customer). As principal to both the customer and the executing dealer, the prime broker must pass any IM it receives from one party to satisfy the demand for IM from the other party; without such transfer, the economics of the transaction will fail. Since the customer and the executing broker are the ultimate recipients of all IM, an appropriate rehypothecation regime that requires the customer and the executing broker to segregate that IM can be established. Without the ability to rehypothecate IM between the customer and the executing broker, prime brokerage transactions will not be economically viable and customers will lose the liquidity and pricing provided by intermediated access to the executing dealer.

5. Enforceability requirements for custodial agreements should be clarified

The proposed rules require that an IM custodial agreement must be enforceable, "including in the event of bankruptcy … ."[54]

The phrase "including in the event of bankruptcy" is not clear in this context. "Bankruptcy" could refer to the bankruptcy of the custodian; or of the CSE; or of the counterparty. It appears to us that the best interpretation would be to focus on the bankruptcy of the custodian. The custodial arrangement is intended to protect the IM and, if the custodian's bankruptcy resulted in a loss of IM, then the IM would be exposed to the credit risk of the custodian.

This interpretation is supported by the difficulties of any other interpretation. One possible interpretation is that the custodial agreement is generally enforceable notwithstanding the bankruptcy of any party. However, it would not be possible (at least under US law) to meet the requirement if interpreted in this way. The enforceability of any agreement (under US law) is subject to the bankruptcy of a party unless there is a specific exemption, such as the safe harbors under the Bankruptcy Code that protect netting. There is no general exemption for custody agreements. Another possible interpretation would be that the custodial agreement permits the counterparty to recover the IM notwithstanding the bankruptcy of the CSE. However, this interpretation also raises difficult issues under US law. The swap safe harbors in the Bankruptcy Code (and in other insolvency statutes such as the Federal Deposit Insurance Act)

[54] Sec. _.7(c)(2) of the PR Margin Proposal at 57393.

do not include provisions specifically requiring a custodian to disregard the insolvency of its customer.

We therefore suggest that "in the event of bankruptcy" be replaced with a requirement that IM held by the custodian should not become property of the custodian if the custodian becomes bankrupt.

I. CROSS BORDER

1. US rules should not apply to non-US CSEs solely because of an affiliation with a US entity.

Under the PR Margin Proposal, a US CSE would not qualify as a foreign covered swap entity if the US CSE has a US parent. Similarly, a swap will fail to qualify as a "foreign non-cleared swap or non-cleared security-based swap" if the counterparty is a CSE that is controlled by a US entity. As a result, swaps involving non-US CSEs that are subsidiaries of US parents will be subject to US requirements even if they enter into a swap with a non-US counterparty (except in limited circumstances in which substituted compliance applies).

Extending US jurisdiction to non-guaranteed subsidiaries of US entities is not consistent with the approach taken by other regulators, including the CFTC and the European regulators. Extending US jurisdiction to such non-guaranteed subsidiaries would place the subsidiaries at a significant disadvantage to non-US owned firms. Moreover, in the absence of a guarantee, such extraterritorial jurisdiction is not justified by risks to US parents.

2. The definitions of non-cleared swap and non-cleared SBS should exclude swaps and SBS that are cleared through non-US clearing organizations.

The proposed definitions of non-cleared swap and non-cleared SBS refer to swaps that are not cleared through clearing organizations registered with the CFTC and SEC, respectively. This means that swaps and SBS cleared through non-US clearing organizations would be treated as non-cleared swaps and SBS and therefore would be subject to the PRs' margin requirements in addition to the margin requirements of the non-US clearing organization. We ask the PRs to revise the definitions to also exclude swaps and SBS that are cleared through non-US clearing organizations.

J. DOCUMENTATION

1. Documentation requirements related to valuation are overly burdensome.

Proposed rule §__.10(a)(2) requires that trading documentation specify "(i) [t]he methods, procedures, rules, and inputs for determining the value of each non-cleared swap or non-cleared security-based swap for purposes of calculating variation margin requirements; and (ii) [t]he procedures by which any disputes concerning the valuation of non-cleared swaps or non-cleared security-based swaps, or the valuation of assets collected or posted as initial margin or variation margin, may be resolved".

This rule should be removed or simplified because the issue is already addressed under regulations applicable to derivatives. CFTC Rules 23.504(b)(4)(i) and (ii) require swap trading relationship documentation to include "methods, procedures, rules and inputs" for swap valuation and a valuation dispute resolution process. Also, CFTC Rule 23.431(d)(3) requires disclosure of "the methodology and assumptions used to prepare the daily mark". Given these rules, it is duplicative and unnecessary for the PRs to impose additional documentation requirements related to valuation.

2. The definition of eligible master netting agreement, and specifically the definition of a walkaway clause, is too broad.

The proposed definition of "eligible master netting agreement" requires that the agreement "does not contain a walkaway clause", which includes "a provision that … suspends or conditions payment to a defaulter". Such a prohibition would effectively ban section 2(a)(iii) of the ISDA Master Agreement, which provides that each party's obligations is subject to the condition precedent that no event of default occurred with respect to the other party. The final definition should exclude the phrase "or suspends or conditions". The definition would then be consistent with that proposed by the CFTC in its margin rules.[55]

In the absence of provisions as set forth in section 2(a)(iii), in the event of default by a counterparty to a swap, the non-defaulting party will be obligated to meet its payment obligations under the swap to the defaulting counterparty. The risk of such one sided payment obligations is exacerbated by the potential for stays preventing early termination if an event of default occurs. Certain of the PRs have encouraged a resolution protocol that includes a stay in the event of default.[56] Banning section 2(a)(iii) could impose severe risks on the counterparty to an entity subject to the stay.

K. OTHER ISSUES

1. The minimum transfer amount ("MTA") should apply to VM and IM separately.

Under the PR proposal, the minimum transfer amount ($650,000) applies to the total amount of IM and VM.

We request that the minimum transfer amount of $650,000 apply separately to IM posted by each party and to VM. These amounts will be calculated separately, potentially with different frequencies, and will be subject to different reconciliation and netting requirements. As result, the processes for determining and settling IM and VM will be separate. It will therefore pose significant operational difficulties for the minimum transfer amount to be calculated for both IM and VM together. In addition, IM or VM with a value of less than $650,000 will not pose systemic issues that need to be of concern to the regulators. As a result, we propose a minimum

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[55] CFTC proposed rules, Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants §23.151, 79 FR 59898 at 59926.

[56] Joint Press Release, Federal Reserve Board and FDIC Welcome ISDA Announcement; available at: http://www.federalreserve.gov/newsevents/press/bcreg/20141011a.htm.

transfer amount of $650,000 for IM posted by each party and the same, but separate, minimum transfer amount for VM.

2. Exclude amended trades, novations and new trades resulting from portfolio compressions from scope of the margin rules.

The margin requirements will only apply to non-cleared swaps entered into on or after the applicable compliance date.[57] We request that the PRs extend this to (1) swaps entered into prior to the applicable compliance date ("**Legacy Swaps**") that are amended in a non-material manner; (2) novations; and (3) new derivatives that result from the portfolio compression of Legacy Derivatives.

The margin rules should exclude Legacy Swaps that are subject to non-material amendments. So long as such amendment does not create any new significant exposure under the Legacy Swap, the act of amending the derivative (or the occurrence of a life-cycle event) should not bring it within the scope of the margin rules.

A novation of a Legacy Swap that has all the same material terms as the Legacy Swap (except the new counterparty) should be excluded from the margin requirements. Such a novation is a continuation of the Legacy Swap, and should be exempt from the margin requirements on the same grounds that Legacy Swaps are exempt. In particular, novations of Legacy Swaps from one affiliate to another within the same group as part of a group restructuring should be excluded from margin requirements. A novation of a Legacy Swap within a group should not be viewed as execution of a new swap and should not trigger application of margin requirements. If a general exclusion for novated Legacy Swaps is not provided, we ask that there be an exclusion for novated swaps between affiliates resulting from organizational restructuring or regulatory requirements, including the requirements of the "push-out" rule.[58]

Portfolio compression is designed to reduce complexity in the derivatives market and has been generally encouraged by regulators. However, if the result of portfolio compression of Legacy Swaps would cause the resulting trades to be subject to margin requirements, it would severely reduce the incentives of market participants to run portfolio compression. In addition, excluding such new trades would be consistent with the margin rules since the exposure with respect to the new derivatives would be no different than that under the Legacy Swaps, which are excluded from the margin requirements.

3. Until the SEC has issued regulations governing security-based swaps, such swaps should not be subject to margin requirements.

Under the proposed rules, security-based swap dealers ("**SBSDs**") are subject to the margin requirements. The SEC has not finalized its rules on registration of SBSDs so currently no SBSDs are required to register. The SEC has adopted very limited regulation in regard to security-based swaps and implementation of rules that have been adopted is delayed. Compliance with margin requirements with respect to SBSDs and security-based swaps should

[57] PR Margin Proposal at 57388-9.

[58] Dodd-Frank Act, §716.

not be made effective until the SEC has finalized and implemented further regulation governing security-based swaps.

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ISDA appreciates the opportunity to comment on the proposed margin and capital requirements. As the Prudential Regulators progress in their on-going effort to refine the proposed rules and harmonize the proposed approach with those of other regulators, we would welcome the opportunity to assist in that process. Please feel free to contact me or my staff at your convenience.

Sincerely,

Stephen O'Connor
Chairman
ISDA

Cc: Commodity Futures Trading Commission