From: Christopher Young <CYoung@isda.org>
Sent: Wednesday, February 16, 2011 5:58 PM
To: SegBankruptcy <SegBankruptcy@CFTC.gov>
Cc: Mary Johannes <MJohannes@isda.org>
Subject: RIN No. 3038-AD99: Advanced Notice of Proposed Rulemaking - Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies (75 Fed. Reg. 75162)
Attach: CFTC - Follow-up collateral.pdf

Attached please find ISDA's follow-up comments on the ANPR regarding Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies.

Please let us know if you have any questions.

Regards,

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February 16, 2011

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

Re: RIN No. 3038-AD99 - Advanced Notice of Proposed Rulemaking — Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies (75 Fed. Reg. 75162)

Dear Mr. Stawick:

The International Swaps and Derivatives Association, Inc. ("ISDA") is writing further to its comment letter (the "Comment Letter") in response to the Advanced Notice of Proposed Rulemaking regarding the Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies (the "ANPR") issued by the Commodity Futures Trading Commission (the "Commission"). The purpose of this letter is to clarify and expand on certain points made in the Comment Letter in response to questions you have raised to ISDA after reviewing the Comment Letter.

ISDA, which represents participants in the privately negotiated derivatives industry, is among the world's largest global financial trade associations as measured by number of member firms. ISDA was chartered in 1985 and today has over 800 member institutions from 54 countries on six continents. Its members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the risks inherent in their core economic activities.

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

advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

I. The importance of portability for cleared swaps

In the Comment Letter, our analysis was based on what we considered to be the critical objective that the derivatives clearing organization ("DCO") be able to avoid immediate closing of the aggregate client account on the default of a futures commission merchant ("FCM") by allowing non-defaulting clients of that FCM to port their positions. From our conversations with the Commission following submission of the Comment Letter, we now understand that models for the protection of client collateral are concerned only with the protection of collateral, and were not intended to meet the objective of enhancing portability.

Nevertheless, we would like to stress just how important that objective it is. From a client's perspective, portability in the event of an FCM default is an important risk mitigation feature which helps justify the incremental costs of centralized clearing, as rehedging costs are much more significant than in the futures market. We believe that the client desire for continuance of transactions and the avoidance of systemic risk requires additional focus on the facilitation of trade portability and the re-prioritization of close-out procedures as the option of last resort. From a client point of view, the enforced close-out of positions could lead to significant losses, particularly for a financial entity hedging other rate exposures. The close-out of even a portion of a large derivative book, like that which is currently run by a GSE, for example, may create huge losses for the swap hedger, and ultimately significant costs to the taxpayer. Further, for clients that are subject to regulatory capital requirements, a reduction in the ability to port positions may lead to higher regulatory capital costs.[1]

Let us consider the potential size of a close-out of a defaulted FCM's aggregated client account. Taking our start from the Comment Letter, in which we estimated the industry-wide total IM required for customer transactions to be $833 billion (at the 99% confidence level), we make the following assumptions (highlighted in bold):

[1] On this point, please see paragraph 112(b) of the Basel Committee on Banking Supervision's Consultative Document "Capitalisation of bank exposures to central counterparties" (December 2010) (the "Basel Consultative Document").

Total client initial margin ("IM")	833,000	$mm
Large FCM clears **10%** of client IM	83,300	$mm
Net IM of that FCM's clients is **35%** of the gross IM	29,155	$mm
Equivalent risk in 10yr Note Futures	8,900,000	CBOT contracts
FCM's house IM	**400**	$mm
Equivalent risk in 10yr Note Futures	122,100	CBOT contracts

The conversion from net IM, which is considered as simple directional risk, to an equivalent CBOT futures hedge is done by dividing the IM by the IM that a CBOT future would require if it were margined using a 99% 5-day coverage, as per the OTC swaps. The margin per contract, based on a move of 42 basis points, is $3,276.

Notes:

1. The average daily trading volume in the CBOT Ten Year Note contract ("Note Contract") is about 1.1mm contracts, so that IF ALL VOLUME APPEARING WERE IN THE OPPOSITE DIRECTION, it would be feasible to close out the risk in 8 days.

2. Closing the FCM's house risk by executing 122,100 Note Contracts is entirely feasible within the assumed period. An FCM's house risk is two orders of magnitude lower than that of its client account.

3. If the market were to charge 20bps in bid/ask to hedge the client position on a net basis, this would amount to a loss of 50% of the client IM under net risk, $14,578B, which is about 18% of their IM in total. The bid/ask charge could be a multiple of this.

Attempting to have the market absorb, or one or more dealers to take, the equivalent of 9mm Note Contracts could cause a major market disruption with significant adverse economic impact. A certain portion of the risk could be covered fairly quickly, as those clients able to reestablish risk quickly do so: however, it is a feature of major client risk hedgers that they would not be able to move so fast.

A comparison with client IM subject to fellow customer risk is in order. Taking the composition of a well-diversified futures client omnibus account for a large FCM, the largest client IM is only 1% of the total client IM in that FCM's omnibus account, the

largest five clients, 3%. On that basis, if the five largest clients were to go into default under the extreme but plausible scenario that defines the size of the DCO guarantee funds, their losses would amount to about 5% of the total gross omnibus account, with the result that fellow customers would lose about 2% of their IM. This is in contrast to 18% loss due simply to re-hedging in the example above.

This analysis underlines our concern with client account close-out, and providing for the means to allow a DCO to avoid closing out all accounts of a defaulted FCM's clients.

Of the four models described in the ANPR (referred to herein as the "Individual Segregation Model", the "LSOC Model", the "Waterfall Model" and the "Baseline Model"), while the Waterfall Model and the Baseline Model as intended by the CFTC do not appear to address client account close-out concerns at all, the Individual Segregation Model and the LSOC Model appear to be potentially more compatible with individual client portability.

In addition, we believe that more changes should perhaps be made so as to maximize the availability of porting for clients in good standing. In particular, non-defaulting clients would need an alternative means of transferring variation margin to the DCO during the period following their FCM's default and up until the client's positions are ported. This could be effected through a backup FCM, acting as a conduit in passing prefunded variation margin amounts to the DCO directly. This mechanism is critical because, under all four models (including the Individual Segregation Model and the LSOC Model) and even if there is a house-only default, the CCP may need to liquidate client positions if it is not receiving variation margin over time, as will be the case unless there is a conduit for non-defaulting clients to pay in variation margin post-FCM default. However, neither such backup FCM or portability can be guaranteed.

Below we explore portability under each of the four models in more detail:

Individual Segregation Model. While very costly, this model seems to provide the best chance for a DCO to port client accounts to other FCMs in an orderly manner. (Indeed, it was this original model that led many of us to believe we were addressing the client account close-out problem that is a potentially highly significant issue for clients in swap clearing.)

LSOC Model. This is less costly than the Individual Segregation Model from the perspective of operational and compliance costs, as discussed in the Comment Letter (although the increase compared with the Baseline Model in initial margin or guarantee fund contributions estimated in the Comment Letter for these two models was the same) and, if cleared trades are marked with a client ID—rather than rely on an end-of-day client report—then this model may increase the possibility of client portability compared with the Baseline Model. However the full detail of the LSOC Model would need to be set out and studied before this could be determined more definitively, for example it should be

clarified how any excess margin posted by a client would be treated on the FCM's default, and whether an FCM that accepts client positions from a defaulted FCM would potentially be liable to the defaulted FCM's trustee in bankruptcy for pre-funded margin provided by the defaulted FCM on behalf of such client.

Waterfall Model. For the reasons set out below, the Waterfall Model is less likely to promote portability of clients' positions compared with the Baseline Model. The Waterfall Model therefore has increased potential, compared with the Baseline Model, to expose clients to the potential close-out risk, which, as discussed, is broader than a narrowly defined "fellow customer risk".

- Since the DCO and clearing member safeguards are more exposed in the Waterfall Model to customer default risk relative to the Baseline model, the DCO and its default management group may be more incentivized to close out the client account sooner to the extent they believe it is necessary to protect the DCO.

- As noted in the comment letter submitted by LCH.Clearnet Group in response to the ANPR, if some non-defaulting clients of an FCM were able to port prior to the DCO closing out all of the defaulting FCMs positions (house and client), then the quantity of collateral available for fellow customer risk at the end of the waterfall would be reduced. On this point, it would be helpful if the Commission could clarify whether any restrictions on porting would be applied under the Waterfall Model to ensure that the collateral of all non-defaulting customers would in fact be available as a DCO default resource if necessary.

- Since customer porting would reduce available resources, the DCO may be dis-incentivized to permit it.

Baseline Model. Under this model, where there is a large buffer in the form of fellow customer risk, to the extent the client account is in good health—where for example substantial excess collateral was posted—the DCO is incentivized to help clients port their portfolios as quickly and efficiently as possible. We have focused less on the Baseline Model as the ANPR was concerned specifically with the other three models as compared with the Baseline Model.

II. Further observations on the Waterfall Model

The analysis of costs of the Waterfall Model in the Comment Letter was based on our understanding that the deferral of access to that tranche of capital comprising client IM would entail (a) a deferral in the decision to close out the trades of those clients and therefore (b) an increased likelihood of porting transactions to a non-defaulting FCM following crystallization of the defaulting client's losses. As noted above, we now understand neither (a) nor (b) are implied by the Waterfall Model, but that the DCO would

have discretion to close out the clients' positions upon the FCM's default. As a result of our changed understanding, we have some further observations on the Waterfall Model.

While the total pool of capital available in an FCM default is not changed by a simple re-ordering of the waterfall (compared with the Baseline Model), we believe that this development[2], with increases in client margins, may threaten the capital of the DCO and other clearing members.

The increased risk to which the DCO and clearing members would be exposed represents a real wealth transfer from the clearing infrastructure (DCOs and clearing members), upon which systemic safety is to depend, to clients. Compensation to the clearing members in the form of increased ticket costs would be ineffective as there is no link between one FCM introducing client risk and another FCM raising their ticket costs: no equilibrium model in this context provides risk compensation.

This reordering of collateral may also render FCMs (and other clearing members) more directly vulnerable to poor business management practices of competitor FCMs.

- Historically, such seizure of guarantee funds was a last resort; now, in this new scenario, the rules may encourage a "race to the bottom" in risk management standards by FCMs if clients were to choose the lowest cost FCMs (i.e. those with less dollars spent on risk management efforts), because it would be unlikely that clients of a poorly risk-managed FCM would be subject to mutualization of risk upon a default of their FCM given that client mutualization is the last step in the waterfall. The level of support provided by FCMs themselves (and other clearing members) to DCOs will increase in a manner that has never been contemplated and accordingly may be viewed by some as skewing the risk-reward tradeoffs for the industry.

- In addition, the enhanced probability of loss of guarantee fund contributions, and the inability to assess how the business practices of competitors may contribute to this risk, may force FCMs to reconsider participating in the OTC clearing market, and at a minimum will impact available lending resources. Regulatory capital held against default fund contributions will likely be higher given the increased probability of their usage. This is evidenced in the Basel Consultative Document, which proposes a risk sensitive approach which would capitalize default fund contributions at 100% if they are required to meet the "hypothetical capital" requirements of a CCP.

In order to prevent this type of "race to the bottom" and potential concerns among FCMs with respect to other clearing members, it will be even more important for DCOs to be vigilant with respect their policies and procedures regarding risk management, including

[2] The only caveat to this statement would be if a new buffer were created from a commensurate increase in IM.

capital requirements and criteria regarding members, as well as calculations and methodologies used in connection with the various margin requirements imposed by such DCOs.

III. Further information on operational costs of the Waterfall Model

In response to your request for further information on the average ongoing annual operational and compliance cost per FCM reported in the Comment Letter for the Waterfall Model ($16.1 million), we have obtained further information from some of the submitting firms and sought to enhance consistency of approach for submissions of this cost. As noted in the Comment Letter, there are various challenges in arriving at a consistent set of assumptions and categories for the various costs involved in this type of analysis, and it remains the case that these estimates could be substantially improved by a more detailed study than has been possible in the time available. However, based on our further work, we are able to report a lower average cost per FCM for ongoing annual operational and compliance costs for the Waterfall Model of $2.8 million, with a median cost of $0.7 million.

As noted in the Comment Letter, ISDA strongly encourages the Commission to undertake a full and thorough study of all of the models with input from a broad set of market participants to develop the most accurate assessment possible of the costs to the industry of implementing the Individual Segregation Model, the LSOC Model or the Waterfall Model and to delay issuance of proposed or final rules until such a study can be completed.

IV. Conclusion

We summarize with reiteration of the major themes:

- Segregation of client collateral can already be achieved within the context of bilateral uncleared contracts: what was desired in the client clearing context was client portability.

- Fellow customer risk, properly conceived, includes the cost incurred by non-defaulting clients as the result of a DCO closing out their positions following a client and FCM default.

- The close-out of a client account for swaps clearing potentially poses systemic risk, as currently conceived. More changes should be made so as to maximize the availability of porting for clients in good standing following an FCM default, in particular non-defaulting clients would need an alternative means of transferring variation margin to the DCO following their FCM's default and up until their positions are ported.

ISDA looks forward to working with the Commission as you continue the rulemaking process. Please feel free to contact me or my staff at your convenience.

Sincerely,

Robert Pickel
Executive Vice Chairman