

May 22, 2014

Kevin M. O'Neill
Deputy Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Standards for Covered Clearing Agencies (File No. S7-03-14)

Dear Mr. O'Neill:

The International Swaps and Derivatives Association, Inc. (“ISDA”)¹ appreciates the opportunity to provide the Securities and Exchange Commission (the “Commission”) with comments on the proposed rulemaking referenced above (the “Proposed Rulemaking”).² Our comments focus on clearing agencies that act as central counterparties for security-based swaps, as opposed to those entities that are clearing agencies by virtue of the services they provide with respect to securities settlements or custody. We address selected aspects of the Proposed Rulemaking that are the most germane to the objectives of market safety, efficiency and the preservation of globally integrated markets.

Consistency with PFMI Standards

ISDA supports the Commission’s efforts to update its clearing agency rules to take into account the CPSS-IOSCO Principles for Financial Market Infrastructures (“PFMI Standards”) and to provide support for determinations by non-U.S. banking regulators that covered clearing agencies satisfy the requirements for QCCP status under the Basel III framework. One of the elements of the QCCP definition under the Basel framework is that the relevant regulator has “publicly indicated” that it applies to the central counterparty (“CCP”), on an ongoing basis, domestic rules and regulations that are consistent with the PFMI Standards.³ Accordingly, ISDA believes that it would be beneficial if the Commission’s rule were to recite the Commission’s

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.

² 79 Fed. Reg. 16866 (March 26, 2014).

³ See Basel Committee of Banking Supervisors, “Capital Requirements for Bank Exposures to Central Counterparties” (July 2012) (available at www.bis.org/publ/bcbs227.pdf.) page1; “Capital Requirements for Bank Exposures to Central Counterparties” (April 2014) (available at www.bis.org/publ/bcbs282.pdf.) page 2.

intent to establish standards for covered clearing agencies that are consistent with the PFMI Standards, and that the Commission's standards are to be interpreted in that context so long as no inconsistency results with the Exchange Act or other Commission regulations.⁴

Covered Clearing Agency Designation Process

ISDA agrees that the Commission should establish a process, which includes a public comment period as set forth in Proposed Rule 17Ab2-2(d), for its determinations of covered clearing agency status. ISDA recommends that a process for removal from covered status (e.g., due to a change in circumstances such that the clearing agency no longer meets the designation criteria) also be established, including a public comment period and advance notice to clearing members of at least 180 days prior to the effectiveness of such change in status.

Governance

Proposed Rule 17Ad-22(e)(2)(ii) requires a covered clearing agency to have policies and procedures reasonably designed to provide for governance arrangements that are clear and transparent, clearly prioritize safety and efficiency, support the public interest requirements of Section 17A of the Exchange Act and the objectives of owners and participants, and establish that the board and senior management have appropriate experience and skills. While ISDA supports the proposed standards and believes that a principles-based formulation is generally appropriate, ISDA believes that the proposed rule does not provide sufficient guidance in certain respects. ISDA recommends that the rule should expressly require that governance arrangements and major decisions of the board having a broad market impact be disclosed to all relevant stakeholders and the public, except to the extent that such disclosure is inconsistent with statutory and regulatory confidentiality restrictions.⁵ Furthermore, governance arrangements should provide clear processes for consideration of participants' views and involvement of participants in the covered clearing agency's decision-making process.⁶ In particular, governance arrangements should explicitly address decision-making during a crisis or emergency, and should require the covered clearing agency to obtain the views and approval of member representatives (e.g., through the risk committee or otherwise) before taking any material action in response to an emergency.

Wind-Down and Recovery Plans

The Proposed Rulemaking addresses wind-down and recovery planning under its provisions governing the covered clearing agency's risk management framework⁷ and its management of general business risks.⁸ Proposed Rule 17Ad-22(e)(3)(ii) requires that the covered clearing agency's risk management framework include plans for the recovery and orderly wind-down of the covered clearing agency necessitated by credit losses, liquidity

⁴ We note that the Commodity Futures Trading Commission has included such a statement in its regulations for Subpart C Derivatives Clearing Organizations. *See* 17 C.F.R. 39.40.

⁵ We note that the Commodity Futures Trading Commission has included such a statement in its regulations for Subpart C Derivatives Clearing Organizations. *See* 17 C.F.R. 39.32.

⁶ *See* PFMI Standards ¶ 3.2.18.

⁷ Proposed Rule 17Ad-22(e)(3)(ii).

⁸ Proposed Rule 17Ad-22(e)(15)(ii).

shortfalls, losses from general business risk, or any other losses. Proposed Rule 17Ad-22(e)(15)(ii) requires that policies and procedures related to general business risks include the holding of liquid net assets funded by equity equal to the greater of (x) six months of current operating expenses or (y) an amount determined by the board of directors to be sufficient to ensure a recovery or orderly wind-down of critical operations and services, as contemplated by the plans established under the risk management provisions. Discussion in the preamble to the Proposed Rulemaking helpfully draws attention to the importance of wind-down and recovery plans having a sound legal basis.⁹ However, apart from a preamble statement of the Commission's expectation that covered clearing agencies would review existing standards relating to recovery and orderly wind-down and revise such practices in a manner consistent with the findings of such review, the Proposed Rulemaking provides little guidance with regard to the content of such plans or stakeholder consultation procedures with respect to their adoption.

ISDA notes that the issues surrounding resolution and recovery of central counterparties are novel and complex, and raise, among other considerations, questions regarding effects on incentives, disparate impact on various stakeholders, and intricate interplay with capital and accounting rules. As a result, ISDA believes that new clearing agency rules, policies and procedures addressing recovery and resolution (that go beyond existing, capped assessment powers) would be appropriate subject matter for detailed Commission review and public comment. In order to provide a meaningful basis for such review and comment, the Commission should articulate principles-based standards against which orderly wind-down and recovery plans could be assessed. ISDA suggests that such standards should include: limited and predictable liabilities of clearing participants; non-disruption of expectations regarding close-out netting sets; consistency with accounting criteria for the netting of cleared exposures for financial statement and regulatory capital purposes; a requirement that loss allocation rules not place any non-defaulting clearing member or customer of a clearing member in a worse position than under a liquidation in insolvency of the covered clearing agency; due consideration of effects on incentives for participation in the default management process and clearing agency moral hazard risks; and transparency in relation to the default management process, loss allocations and the decision-making process governing wind-down and recovery.¹⁰ We note that recovery tools such as forced allocation, initial margin haircutting of non-defaulting clearing members, invoicing back or partial non-voluntary tear-ups would not meet these standards and should be avoided. We believe that pro-rata reduction in a covered clearing agency's payment obligations should be considered as a loss allocation measure of last resort, i.e., only after all the resources in the waterfall have been exhausted. As a loss allocation method, pro-rata reduction of the covered clearing agency's payment obligations is transparent and predictable and creates incentives for surviving participants to actively engage in the default management process and to bid aggressively in the auction process.

⁹ 79 Fed. Reg. 16878.

¹⁰ Further detail regarding appropriate standards for this purpose is set out in the response letter of ISDA, the Institute of International Finance Inc. and The Clearing House, dated October 11, 2013, to the CPSS-IOSCO Consultative Report: Recovery of Financial Market Infrastructures, page 3, under the heading "*Key Principles to ensure an effective and viable recovery framework*" (available at: <http://www2.isda.org/attachment/NjAxNA==/Industry%20Response%20to%20CPSS109%201%20of%202.pdf>). This response letter also discusses the accounting criteria to net cleared derivatives. *Id.* at 3-4.

ISDA acknowledges that the sequencing and application of any recovery mechanisms may rightly vary by product type and the nature of the covered clearing agency's participants. Indeed, as mentioned in prior discussions with the Commission, any recovery or resolution mechanism must consider, for example, how such mechanism would apply to retail participants. In this regard, we are advancing further technical analysis to evaluate how recovery and resolution mechanisms would apply to varying types of clearing participants and cleared product types.

Additional specific recommendations follow from the principles-based standards described above. First, the Commission's rule should state explicitly that covered clearing agencies' wind-down and recovery plans must define the criteria (quantitative and qualitative) that will trigger the implementation of each type of plan.¹¹ Second, with regard to Proposed Rule 17Ad-22(e)(13),¹² the Commission's rule should explicitly require that replenishment of resources through compulsory means (e.g., assessments on clearing members) be subject to a well-defined cap. Third, ISDA recommends that the Commission commit itself to a study of security-based swap clearing agency insolvency, with the goal of identifying uncertainties, proposing solutions and fostering public discussion.

Qualifying Liquid Resources

Proposed Rule 17Ad-22(a)(15) defines "qualifying liquid resources" to include assets that are readily available and convertible into cash through prearranged funding arrangements without material adverse change ("MAC") provisions, such as certain committed funding arrangements and other prearranged funding arrangements determined to be highly reliable even in extreme but plausible market conditions by the board of directors of the covered clearing agency following a review conducted not less than annually. ISDA believes that, in the case of U.S. Treasury securities, prearranged and highly reliable funding arrangements may be demonstrated in a number of ways, including through non-committed repurchase agreement facilities with major bank-dealers. A covered clearing agency relying on such a facility would need to ensure that it is structured appropriately to be reliable, taking into account the fact that a facility may be used in a clearing member default scenario amidst extreme market circumstances. In particular, covered clearing agencies' procedures for making draws on uncommitted repurchase facilities should specifically contemplate the timing of close-out arrangements for defaulted clearing members and should provide for draws on such facilities to be made by specified times during business day mornings to ensure that dealer banks have sufficient time to facilitate liquidation of the U.S. Treasury securities. This approach, we believe, would be fully consistent with the PFMI Standards and would recognize the strong liquidity profile of U.S. Treasury securities.

We believe that this position is consistent with the Commission's own guidance in the Proposed Rulemaking. In the preamble to the Proposed Rulemaking, the Commission indicates that it "preliminarily believes that it would be appropriate to provide covered clearing agencies

¹¹ See PFMI Standards ¶ 2.4.4.

¹² Proposed Rule 17Ad-22(e)(13) addresses, among other matters, the allocation of credit losses the covered clearing agency may face if its collateral and other resources are insufficient to fully cover its credit exposures and the covered clearing agency's process to replenish any financial resources it may use following a default or other event in which use of such resources is contemplated.

with the flexibility to use highly reliable funding arrangements *in addition to* committed arrangements for purposes of using assets other than cash to meet the proposed requirements” of the rulemaking.¹³ In other words, the Commission specifically contemplates that non-committed facilities would, in some instances, qualify as a liquidity resource “in addition to” committed facilities. In addition, the Commission “preliminarily believes that limiting the funding arrangements that are included within the definition of qualifying liquid resources to committed funding arrangements may not be necessary or appropriate in determining liquidity requirements for a covered clearing agency operating in the U.S. securities markets and expanding the concept of qualifying liquid resources to include other highly reliable funding arrangements is necessary and appropriate to ensure the proper functioning of covered clearing agencies as required by the Exchange Act.”¹⁴

The text of the Commission’s proposed rules, however, appears to be in tension with the guidance in the preamble. Proposed Rule 240.17Ad-22(a)(15) defines “qualifying liquidity resources” as including, in relevant part, “other prearranged funding arrangements” in addition to “committed arrangements,” but only where such arrangements have no “material adverse change [MAC] provisions.” By definition, a non-committed facility is uncommitted, meaning that the concept of a MAC provision is inapplicable since there is no firm commitment in the first place. The inclusion of a MAC clause in the Proposed Rulemaking also introduces a liquidity standard that is not in the PFMIs, which will lead to confusion and inconsistency as covered clearing agencies attempt to apply a standard that is inapplicable in other clearinghouse risk regulatory regimes. Accordingly, we recommend that the Commission remove the reference to MAC clauses in Proposed Rule 240.17Ad-22(a)(15) but otherwise finalize the rule as proposed, including the explanatory comments in the preamble.

Segregation and Portability of Positions

Proposed Rule 17Ad-22 (e)(14) requires policies and procedures to enable, when the covered clearing agency provides central counterparty services for security-based swaps or engages in other “more complex risk profile” activities, the segregation and portability of positions of a participant’s customer and related collateral and to protect such positions and related collateral from the default or insolvency of that participant. The proposed rule is silent, however, on the issue of protections from “fellow customer risk” (i.e., protecting the positions and related collateral of a participant’s customer from losses associated with the positions of other customers of that participant).¹⁵ Clearing agencies, however, are subject to the statutory prohibition under Exchange Act Section 3E(e) against use of deposited property as belonging to “any person other than the swaps customer” of the depositing broker, dealer, or security-based swap dealer.¹⁶ ISDA recommends that the Commission make explicit that the procedures of a

¹³ 79 Fed. Reg. 16,890 (emphasis added).

¹⁴ *Id.*

¹⁵ As the Commission notes, fellow customer risk “is of particular concern because customers may have limited ability to monitor or to manage the risk of their fellow customers.” 79 Fed. Reg. 16905.

¹⁶ Section 3E(e) states: “It shall be unlawful for any person, including any clearing agency and any depository institution, that has received any money, securities, or property for deposit in a separate account or accounts as provided in subsection (b) to hold, dispose of, or use any such money, securities, or property as belonging to the depositing broker, dealer, or security-based swap dealer or any person other than the swaps customer of the broker, dealer, or security-based swap dealer.” The corresponding prohibition with respect to cleared swap collateral is set

covered clearing agency must give effect to Section 3E(e), and that the covered clearing agency should publicly disclose the manner in which its procedures do so. Furthermore, the Commission should undertake to develop (in a subsequent rulemaking) more detailed rules that require a customer-by-customer accounting of the collateral value held by the covered clearing agency with respect to security-based swap positions and impose corresponding limitations on the value of collateral that the covered clearing agency may apply toward losses on other customers' positions carried by the participant.

Disclosure

Proposed Rule 17Ad-22 (e)(23) calls for a covered clearing agency to maintain clear and comprehensive rules and procedures that provide for various public disclosures and furnishing sufficient information to enable participants to identify and evaluate risks, fees, and other material costs they incur by participating in the covered clearing agency. In order to ensure that clearing participants have sufficient information to conduct diligence and assess the risks of exposure to a covered clearing agency, and to maintain consistency with evolving international standards, ISDA recommends that the Commission provide guidance that it will interpret and administer Rule 17Ad-22 (e)(23) as being consistent with the CPSS-IOSCO Disclosure Framework for Financial Market Infrastructures.¹⁷

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Thank you for your consideration of these comments. Please contact me or ISDA staff if you have any questions or concerns.

Sincerely,



Stephen O'Connor, Chairman

out, in substantially identical language, in Section 4d(f)(6) of the Commodity Exchange Act. CFTC Regulations Part 22 implement the segregation requirements for cleared swap customer collateral. *See* 17 C.F.R. Part 22.

¹⁷ CPSS-IOSCO Principles for Financial Market Infrastructures: Disclosure Framework and Assessment Methodology (December 2012) (available at <http://www.bis.org/publ/cpss106.pdf>). *See also* CPSS-IOSCO Public Quantitative Disclosure Standards for Central Counterparties - Consultative Report (October 2013) (available at <http://www.bis.org/publ/cpss114.pdf>).