ISDA International Swaps and Derivatives Association, Inc.

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February 1, 2011

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

Re: RIN 3038-AD28 - Notice of Proposed Rulemaking on the Protection of Collateral of Counterparties to Uncleared Swaps (75 Fed. Reg. 75432)

Dear Mr. Stawick:

The International Swaps and Derivatives Association, Inc. ("ISDA")[1] and the Securities Industry and Financial Markets Association ("SIFMA")[2] submit these comments in response to the Notice of Proposed Rulemaking on the Protection of Collateral of Counterparties to Uncleared Swaps in which the Commodity Futures Trading Commission (the "Commission") solicited comments on its proposed rules to implement Section 724(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank", and such rules, the "Proposed Rules").

Below are comments reflecting the consensus of SIFMA and an ISDA working group comprised of firms representing both buy-side and sell-side perspectives regarding considerations relevant to the Proposed Rules.

I. General Comment

Given that the bilateral OTC derivatives markets are limited to entities that qualify as "eligible contract participants" that meet defined size or sophistication criteria and exclude retail investors, we submit that the final rules relating to the segregation of collateral of counterparties to uncleared swaps (the "Final Rules") (i) should permit bilateral contract negotiation in place of formalistic rules where appropriate (as discussed in greater detail below) and (ii) should strike a balance between the burden presented and the need to protect the interests of counterparties who are, by definition, deemed to be able to protect their own interests.

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[1] ISDA was chartered in 1985 and has over 800 member institutions from 54 countries on six continents. Our 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 ("OTC") derivatives to manage efficiently the risks inherent in their core economic activities. For more information, please visit: www.isda.org.

[2] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

II. Definitions of "Initial Margin" and "Variation Margin"

We are concerned that the definitions of "Initial Margin" and "Variation Margin" in the Proposed Rules are more appropriate to the futures markets and less readily applicable in the uncleared OTC derivatives context. We also believe that if these terms are to be used in other Commission rules that reference cleared transactions (whether futures or swaps), their use will create confusion with the equivalent concepts used in the uncleared OTC derivatives markets, which are distinguishable for the reasons noted below.

First, unlike the futures markets, market participants in the uncleared OTC derivatives markets do not "pay" variation margin to each other in settlement of changes in market value. Rather, each day during the life of a swap[3] (or portfolio of swaps), they post (and grant a security interest[4] in) varying amounts of collateral or other credit support that reflects an estimate (typically at mid-market) of the amounts that would be payable between the parties if the transaction(s) were terminated at such time.[5, 6]

Second, the rough equivalent of initial margin in the uncleared OTC derivatives context is referred to as "Independent Amount". In contrast to the futures markets, where initial margin levels are typically fixed by a clearing house or exchange, the amount of Independent Amount to be posted in respect of an uncleared swap (or a portfolio of uncleared swaps) is negotiated by the parties and may either be a fixed amount or an amount that may be adjusted over time.[7] Although Independent Amount generally is not defined by reference to a particular purpose, often it is intended to protect the Independent Amount holder against volatility that might occur during the life of a transaction or during the close-out process.

Given these distinctions, we believe that the Proposed Rules, in order to avoid confusion, should not use the terms "Initial Margin" or "Variation Margin" and should instead utilize the standard terms customarily employed in the uncleared OTC derivatives markets to refer to amounts of collateral posted by parties to uncleared swaps.[8]

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[3] As used in this letter, "swap" has the meaning ascribed in section 1a of the Commodity Exchange Act (7 U.S.C. 1a).

[4] It is worth noting that, under one of ISDA's English law-governed Credit Support Annexes, title to credit support is transferred to the Secured Party (rather than having a security interest granted to the Secured Party in such credit support). However, the large majority of collateral posted in respect of OTC derivatives transactions in the United States is governed by a New York law-governed ISDA Credit Support Annex that provides for the grant of a security interest to the Secured Party rather than a title transfer.

[5] Parties often agree that swaps will be valued for this purpose as of the close of business on the business day preceding the day of the collateral call.

[6] Such estimate is defined in ISDA documentation as the "Exposure" of the party that would be entitled to receive a payment in the event of an early termination (typically calculated at mid-market).

[7] The agreed level of Independent Amount may be specified in advance in the parties' swap master agreement or negotiated on a transaction-by-transaction basis. Parties may agree to allow for adjustments to Independent Amount levels due to, for example, changes in market volatility. In addition previously agreed levels of Independent Amount are sometimes reduced in circumstances where portfolio or other cross-margining arrangements are put in place.

[8] To the extent that the terms "Initial Margin" and "Variation Margin" are defined in other Commission rules (e.g., with respect to cleared swaps), we would recommend that the Commission clearly delineate the application of such defined terms and take account of how the concepts may vary for futures, cleared swaps and uncleared swaps.

Specifically, we propose the following definition of "Exposure Collateral" as a replacement to the Proposed Rules' definition of "Variation Margin":

> "Exposure Collateral" means money, securities or property posted by a party to secure its obligations pursuant to the terms of a swap agreement, the amount of which is based on an estimate of the net mark-to-market exposure of all transactions under the master swap agreement.

Since Independent Amount is an amount that is defined by the parties and calculated on a basis that is distinct from the Exposure Collateral calculation, we propose the following definition of "Independent Amount" as a replacement to the Proposed Rules' definition of "Initial Margin":

> "Independent Amount" means money, securities or property posted by a party to secure its obligations pursuant to the terms of a swap agreement and that is either (i) specified as an "Independent Amount" in the relevant agreement of the parties or (ii) calculated based upon terms agreed between the parties (in either case, in addition to and separately from any Exposure Collateral requirement).[9]

III. Disclosure of Segregation Costs

The Commission asks whether the Final Rules should require a swap dealer ("SD") or major swap participant ("MSP") to disclose costs associated with segregation to its counterparties at the time that such SD/MSP provides notice to such counterparty of its right to require segregation of the Independent Amount it posts. ISDA and SIFMA do not believe that mandating disclosure is necessary or desirable for two main reasons.

First, a counterparty can always, in accordance with current market practice, request the disclosures it considers necessary from its SD/MSP (as well as its desired custodian) as a condition of continued trading as and when it deems appropriate. Also, an SD/MSP will be incentivized by competitive factors and the prospect of future business to be responsive to counterparty requests for cost disclosure. As a result, a counterparty that is considering electing for segregation can reasonably expect to obtain disclosure from its SD/MSP as to whether or not, given the facts and circumstances relevant to the parties' trading relationship, there is likely to be a pricing or other form of impact on swaps with respect to which Independent Amount is segregated (as compared to swaps with respect to which Independent Amount is not segregated).

Second, mandatory disclosure by the SD/MSP is impractical because much of the material costs are within the control of a third party: the custodian. Since the custodian determines the custodial account fees and costs that it will charge in its sole discretion, disclosure by the SD/MSP of custodian costs could be rendered inaccurate or misleading as a result of factors outside the control of the SD/MSP.

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[9] In light of these proposed changes to the definitions of Initial Margin and Variation Margin, we would propose a corresponding replacement of the definition of "Margin" with the following: "Uncleared Swap Collateral" means both Exposure Collateral and Independent Amount.

IV. Notification of Segregation Right

A. Frequency of Notification; Confirmation/Election

The proposed required annual notification to a counterparty of its right to elect to segregate and the corresponding requirement to obtain each year not only confirmation of receipt of such notice but also a counterparty's affirmative election as to its segregation right are unnecessary and unduly burdensome.[10] These requirements are inappropriate to markets that are limited to entities that qualify as eligible contract participants. Moreover, these requirements would potentially lead to trading disruptions (e.g., the need to track and confirm receipt of notice acknowledgements and segregation elections by Chief Executive Officers or Chief Risk Officers could prevent parties from entering into swap transactions in a timely manner). Therefore, we propose that an SD/MSP should only be required to deliver a single notification of the right to segregate, and the counterparty should be deemed to have elected not to require segregation of its Independent Amount until such time as the counterparty duly notifies the SD/MSP of its election to require segregation. Such single notification should be delivered (i) with respect to new counterparties, prior to the trade date of the parties' first swap transaction entered into after the date that is six months after promulgation of the Final Rules (e.g., as part of a master agreement) and (ii) with respect to existing counterparties, within one year of promulgation of the Final Rules.[11]

In addition please note that the workload estimate of 0.3 hours (18 minutes) for each counterparty that falls under regulation 23.601 appears insufficient given the extent of the requirements included in the Proposed Rules. Specifically, the following documentation-related functions would be necessary: scheduling, drafting, issuing, tracking, receipt, validation, classification and storage. As a result, we believe that the process contemplated by the Proposed Rules would entail multiple hours of staff time per counterparty.

B. Authorized Representative

Requiring notice to and acknowledgement from a Chief Risk Officer or Chief Executive Officer of a counterparty, per the Proposed Rules, is not necessary. The parties to a swap should be able to satisfy any notice requirement contained in the Final Rules if an SD/MSP provides a written notice to a counterparty (or an investment manager that is authorized to act on behalf of a party) in accordance with notice terms mutually agreed between the parties (or, absent such terms, to a person reasonably believed to be authorized

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[10] Please note, in this regard, that although 23.601 may be read to imply that a counterparty's confirmation and election may only be required once per year, 23.601(e) does not directly limit the confirmation and election required in 23.601(d). In addition the required timing of the initial notice to be given under the Proposed Rules is ambiguous (specifically, the meaning of the terms "at the beginning of each swap" in 23.601(a) and "before confirming the terms of any such swap" in 23.601(d) are unclear). Presumably the intent is that notice of the segregation right must be given to a counterparty prior to the trade date of any new swap occurring after the date upon which the Final Rules become effective.

[11] Some SDs estimate having approximately 10,000 counterparties that would be implicated by the requirements contemplated by the Proposed Rules. Given the large number of counterparties involved, we propose that the SD/MSP should not be required to obtain confirmation of receipt of the notice or an affirmative election from such counterparties because such requirements would impose an enormous operational and administrative burden.

to accept notices on behalf of such a counterparty). Counterparties should be able to receive and direct the notice to the appropriate decision-makers.

C. Qualifications

Any notice requirements should be subject to appropriate exceptions where they are not relevant. For example, notification should not be required when (i) a counterparty is not required to post Independent Amount or (ii) the Independent Amount of a counterparty is already subject to segregation with a custodian (whether initially segregated pursuant to the Final Rules or otherwise).

V. Election to Require Segregation

We agree that the Final Rules should state that (i) a counterparty may elect to require segregation at its discretion upon delivery of written notice of such election to the SD/MSP and (ii) any such election will be applicable with respect to swaps entered into after delivery of such notice, unless otherwise agreed.

However, given that the negotiation of a custodial arrangement can require a significant amount of time,[12] and involves third parties not subject to Commission rules, we recommend that the Final Rules clarify that (i) the parties will be permitted to enter into new swaps pending completion of custodial documentation satisfactory to both parties for so long as the parties are negotiating in good faith to complete such custodial documentation and (ii) the requirement to segregate Independent Amount with respect to all swaps entered into after delivery of an election to require segregation will, unless otherwise agreed, become effective only upon the completion of custodial documentation (i.e., after completion of custodial documentation, the SD/MSP will be required to segregate Independent Amount with respect to all swaps entered into after the date of delivery of the election to segregate, even though the date of such election would have preceded the date of completion of custodial documentation).

VI. Choice of Custodian

We agree that the choice of the custodian should be mutually agreed between the parties as implied by the Proposed Rules and request that this point be expressly set forth in the Final Rules. In addition an SD/MSP should be required, upon counterparty request, to propose at least one creditworthy non-affiliated custodian that the SD/MSP is willing to use, as an option. Related to this point, the Final Rules should clarify that affiliates of either the SD/MSP or the counterparty would qualify as acceptable custodians if the parties mutually agree to use such custodian.

VII. Form of Custodian Agreement

Per the comment letter submitted by ISDA on October 8, 2010, ISDA and SIFMA maintain that, upon a counterparty's request, SDs/MSPs should be permitted to make available different segregation arrangements (including segregation with a third-party custodian pursuant to a bilateral agreement between the SD/MSP and the third party custodian (the "Bilateral Approach")

[12] Please note that, in an effort to reduce negotiation time for tri-party custodial arrangements, ISDA is currently developing a set of standardized provisions. However, even such standardized provisions would include various elections that would need to be negotiated between the parties.

and segregation with a third-party custodian pursuant to a tri-party agreement among the SD/MSP, counterparty and third-party custodian (the "Tri-party Approach")) from which a counterparty would be able to select based on the cost-benefit considerations that the counterparty deems important.[13] In this regard ISDA, SIFMA and the Managed Funds Association previously published a white paper (the "White Paper")[14] describing the various approaches that may be used to segregate Independent Amount posted by a counterparty for the benefit of an SD/MSP in respect of uncleared derivative transactions.

Given the approaches to segregation that are possible and the advantages and disadvantages associated with each (as described in the White Paper), we continue to maintain that the Final Rules should permit SDs/MSPs to offer both tri-party and bilateral segregation arrangements to a counterparty, and a counterparty should be allowed to choose from among those options based on its own risk-reward assessment.

VIII. Control of Independent Amount[15] – Statement Under Oath or Penalty of Perjury

We do not agree that a statement by a party that it is entitled to exclusive control (or the return) of the Independent Amount segregated with a custodian should be made under oath or penalty of perjury. The imposition of such standards would be highly unusual for commercial contracts and related security arrangements of this nature. Similarly, we do not agree that such a statement should be required to be made based on personal knowledge. It is not appropriate to impose personal civil or criminal liability on an individual in connection with a statement made on behalf of a legal entity pursuant to a private contract in these circumstances.

IX. Investment of Segregated Collateral

The parameters applicable to the investment of collateral that is segregated pursuant to a tri-party custodial agreement should be left to the agreement of the parties and should not be subject to Commission Rule 1.25. Commission Rule 1.25 is designed to protect clients with respect to the investment of collateral or margin where the investment decision is outside of the client's control. When collateral is segregated pursuant to a tri-party custodial agreement to which the counterparty is a party, the counterparty is able to specifically agree, with both the SD/MSP and the custodian, the types of investments that will be permitted for its Independent Amount as part of the negotiation of this custodial arrangement. Therefore, a counterparty is able to protect itself by contract, and the parameters of Commission Rule 1.25 are unnecessary.

On the other hand, if the Final Rules permit bilateral segregation agreements between an SD/MSP and a custodian, then the counterparty would not be a party to such contract and, therefore, may not be able to direct the investment of Independent Amount. To the extent that the counterparty is not able to direct investment of Independent Amount, the Commission's application of parameters similar to Commission Rule 1.25 would be appropriate for such bilateral segregation arrangements, provided that the parties are able to mutually agree to waive any such parameters if they so choose.

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[13] The comment letter submitted by ISDA on October 8, 2010 is available at http://www.isda.org/speeches/pdf/ISDA-Comment-IA-Seg.pdf.

[14] The White Paper is available at http://www.isda.org/c_and_a/pdf/Independent-Amount-WhitePaper-Final.pdf.

[15] In addressing control of Independent Amount, the Commission should take into account issues relating to perfection by "control" under the Uniform Commercial Code when drafting the Final Rules.

X. Disclosure re: Non-Segregated Collateral

Based on the language of Section 724(c) of Dodd-Frank, the Proposed Rules provide that an SD/MSP must, with respect to each counterparty that does not elect segregation of Independent Amount, report quarterly (no later than the 15th business day of each calendar quarter) whether its back office "procedures" related to collateral have complied with the agreement of the parties during the previous quarter.

Imposing this quarterly reporting requirement without appropriate exceptions will create costly burdens that in most cases add little to no value. Therefore, we propose that, at a minimum, a counterparty should be permitted to waive receipt of such quarterly disclosure. Furthermore, such disclosure should not be required where an SD/MSP is permitted to freely sell, pledge, rehypothecate, assign, invest, use, commingle or otherwise dispose of, or otherwise use in its business any Independent Amount that it holds, as such disclosure would be meaningless in this circumstance.[16] An SD/MSP should only be required to issue disclosures as to its back office procedures if it has agreed not to use (or otherwise rehypothecate) any Independent Amount that it holds.

Furthermore, requiring a statement specifically from a Chief Compliance Officer of an SD/MSP is excessively burdensome and should not be required. A duly authorized statement on behalf of a party should be sufficient to satisfy the Final Rules.

XI. Harmonization with SEC Customer Protection Rules

The Commission should make certain that any capital rules that it promulgates for SDs/MSPs provide that the segregation of Independent Amount will not result in any increase in regulatory capital charges, decrease in capital charge benefit or other adverse effect on capital charges for the SD/MSP. Similarly, the Commission should coordinate with the Securities Exchange Commission ("SEC") to ensure that segregation of Independent Amount will not result in regulatory capital implications for SDs/MSPs that are also broker-dealers under the capital rules applicable to U.S. broker-dealers[17].

It is also important that the Commission coordinate with the SEC to ensure that the customer protection rules applicable to broker-dealers do not apply in respect of Independent Amount that is segregated, whether in accordance with the Final Rules or otherwise.

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[16] Per the ISDA Margin Survey 2010 (available at http://www.isda.org/c_and_a/pdf/ISDA-Margin-Survey-2010.pdf), market participants in the uncleared OTC derivatives markets regularly agree to permit use (or "rehypothecation") of the collateral they post, including collateral the consists of Independent Amount. According to the survey, 44% of all respondents (89 ISDA member firms) and 93% of large dealers (Bank of America Merrill Lynch, Barclays, BNP Paribas, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan Chase, Morgan Stanley, Société Générale, The Royal Bank of Scotland, UBS, Wachovia and Wells Fargo) reported rehypothecation of collateral. Respondents as a whole reported rehypothecation of 33 percent of collateral received, while the large dealers reported rehypothecation of 82 percent of collateral received.

[17] For these purposes, references to "broker-dealers" should be read to include OTC derivatives dealers, as such term is defined in Rule 3b-12 promulgated under the Securities Exchange Act of 1934, as amended.

XII. Effective Date

The Commission asks for comments regarding the appropriate timing of effectiveness of the Final Rules. Specifically, the Commission asks whether an effective date of six months following promulgation of the Final Rules would be sufficient. ISDA and SIFMA believe that an effective date of six months following promulgation of the Final Rules is appropriate for new counterparties of an SD/MSP if the above comments are accepted. However, we believe that an effective date of one year following promulgation of the Final Rules would be appropriate with respect to existing counterparties of an SD/MSP given the large number of counterparties that are likely to be implicated by the Final Rules.[18]

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We appreciate the ability to provide its comments on the Proposed Rules and looks forward to working with the Commission as you continue the rulemaking process. Please feel free to contact us or our staff at your convenience with any questions.

Sincerely,

Robert Pickel
Executive Vice Chairman

Kenneth E. Bentsen, Jr.
Executive Vice President
Public Policy and Advocacy

[18] See footnote 9 above.