Standardization, Documentation and Clearing

The transition to the new swaps regime is a transition from an environment in which relationships between transacting parties involve bilateral obligations which are contractual, to the trading of instruments with particular rights and obligations. The formalized trading environment should produce better information about pricing of the instruments, which in turn allows for the marking-to-market of positions in swaps. In a purely contractual environment a swap party which finds that a swap is disadvantageous to it could either enter into a new swap transaction to hedge the original transaction, or pay to terminate the swap (the payment would be the net present value of the remaining netted cash flows). But termination could give rise to legal disputes. Consider for example Banco Espirito Santo v Concessioniria Do Rodoanel Oeste S.A.:^2

Plaintiffs, multinational financial institutions and "hedge providers," commenced this breach of contract action when defendant decided to pay off $895 million in loans before their maturity, concomitantly triggering its right to prematurely terminate the interest rate swaps it had entered into with plaintiffs. An interest rate swap is a liquid financial derivative instrument in which two parties agree to exchange interest rate cash flows, based on a specified notional amount from a fixed rate to a floating rate or vice versa. The central dispute in this appeal is whether the interest rate swap agreements required defendant to pay plaintiffs an early termination fee, referred to in the interest swap agreements as a "Close Out Amount," for terminating the swaps prior to their maturity. Plaintiffs argue that the different punctuation of the term "Close Out Amount" in the swap agreements ("Close-out Amount" versus "Close Out Amount") creates an ambiguity as to the meaning of the term. We hold that the different punctuation of the term does not alter the manifest intention of the parties as gathered from the language employed in the agreement, which unambiguously provides that neither party owes any "Close Out Amount" upon voluntary prepayment of the loans.

Defendant Concessionaria Do Rodoanel Oeste S.A. (Rodoanel), part of a large private infrastructure company, was upgrading and operating a toll road in Sao Paolo, Brazil. In 2009, Rodoanel entered into $895 million in loans and derivative interest-rate swaps to finance the project. Rodoanel was the "borrower" and non party banks Inter-American Development Bank and Japan Bank for International Cooperation were the "Senior Lenders." Plaintiffs Banco Espirito Santo, S.A., Caiza Banco de Investimento, S.A. and Credit Agricole Corporate Investment Bank (plaintiffs), the "hedge providers," entered into separate interest rate swaps agreements with Rodoanel.

The $895 million senior loans at issue here were governed by certain agreements between Rodoanel and the senior lenders, primarily the Common Terms Agreement (Senior Lender CTA) which is governed by New York law. The senior loans imposed a floating rate of interest. To protect the senior lenders and Rodoanel from the risk of the latter defaulting on loan payments caused by sudden spikes in interest

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rates, however, the Senior Lender CTA required Rodoanel to enter into derivative interest rate swap transactions. On December 3, 2009, Rodoanel entered into three such substantively identical transactions with plaintiff, which are all large and sophisticated multinational financial institutions and "hedge providers." The practical effect of these derivative swap transactions was to convert Rodoanel's payment obligations under its loan with the senior lenders from a floating rate to a fixed rate. These interest rate swap transactions were each governed by a 2002 Master Agreement published by the International Swaps and Derivatives Association (ISDA), with one agreement between Rodoanel and each plaintiff bank. These forms are called ISDA Master Agreements, which are used in many thousands of interest rate swap transactions each year. Each ISDA Master Agreement is executed together with a schedule (ISDA Schedule,) which serves the purpose of customizing the parties' contractual arrangement by reflecting any deviations from the standard language of the Master Agreement, as well as any specific terms that have been negotiated by the parties...

The ISDA Master Agreements at issue here are governed by New York law and provide for disputes to be resolved by New York courts. Each ISDA Master Agreement executed by Rodoanel and each plaintiff bank states in its introduction that "this 2002 Master Agreement . . . includes the schedule (ISDA Schedule) and the documents and other confirming evidence . . . exchanged between the parties or otherwise effective for the purpose of confirming or evidencing th[eir] Transactions."

It appears that after the swap agreements were executed, the pertinent floating interest rate dropped precipitously, making the interest rate swap agreements very favorable to plaintiffs. Accordingly, on February 11, 2011, Rodoanel gave notice of its intention to prepay the senior loans, and on May 16, 2011 prepaid them. Section 2 of the Senior Lender CTA sets forth Rodoanel's rights and obligations with respect to prepayment of the senior loans. In particular, Section 2.8 gives Rodoanel the right to prepay the senior loans, and provides that, in such case, "[n]o prepayment penalties or premiums shall apply to any prepayments." In addition, as noted, prepayment of the senior loans caused the interest rate swaps to terminate automatically before maturity.

Upon this early termination, plaintiffs demanded that Rodoanel pay them the "Close-out Amounts." With regard to early terminated transactions, the ISDA Master Agreement defines "Close-out Amount" as having two components: (a) the cost of replacing the group of terminated transactions (including the costs of liquidating them and of obtaining new funding) and (b) the value of the remaining rights under the terminated transactions (the "market-to-market" or "MTM" amount, i.e., the net present value of expected future cash flows from the swap transaction).

Rodoanel refused to pay any "Close-out Amounts," citing the ISDA Schedule's provision that "[i]f an Additional Termination Event [prepayment] occurs, no Close Out Amount shall be payable under this Agreement" (emphasis added). Subsequently, plaintiffs commenced this breach of contract action for Rodoanel's breach of the CTA and ISDA Agreements in refusing to pay the MTM amount (the second component of the Close-out Amount). In essence, plaintiffs claim that the "Close Out Amount" term in the ISDA Schedule was only meant to include liquidation cost (the first component of the Close-out Amount) and thus Rodoanel was only relieved of the obligation to pay liquidation cost, but still had to pay the MTM.

Rodoanel answered and simultaneously moved for summary judgment dismissing the complaint, essentially relying on the four corners of the contract alone, namely the ISDA Schedule's "Close-out Amount" provision. In response, plaintiffs rely upon the unique punctuation of the term "Close-out Amount" in the ISDA Schedule, which differs from the punctuation of the same term "Close-out Amount" in the ISDA Master Agreement, where there is a hyphen and "out" is not capitalized. The differing punctuation of the same term, plaintiffs argue, creates an ambiguity of the meaning of the term, which can only be resolved by extrinsic evidence. Apparently agreeing with plaintiffs that the different punctuation creates an ambiguity, Supreme Court allowed parol evidence to aid in its interpretation and
found that plaintiffs submitted sufficient evidence to raise an issue of fact as to whether the term "Close Out Amount" in the ISDA Schedule, differs from the term "Close-out Amount" in the ISDA Master Agreement.

The fundamental rule of contract interpretation is that agreements are construed in accord with the parties' intent... and "[t]he best evidence of what parties to a written agreement intend is what they say in their writing"... Thus, a written agreement that is clear and unambiguous on its face must be enforced according to the plain meaning of its terms, and extrinsic evidence of the parties' intent may be considered only if the agreement is ambiguous...

As indicated, the central dispute in this appeal is the meaning of the term "Close Out Amount." Where the parties dispute the meaning of particular contract terms, the task of the court is to determine whether such terms are ambiguous. The existence of ambiguity is determined by examining the " entire contract and consider[ing] the relation of the parties and the circumstances under which it was executed," with the wording viewed " in the light of the obligation as a whole and the intention of the parties as manifested thereby"... "read in the context of the entire agreement"...

A contract is unambiguous if "on its face [it] is reasonably susceptible of only one meaning"... Parol evidence cannot be used to create an ambiguity where the words of the parties' agreement are otherwise clear and unambiguous... Conversely, "[a] contract is ambiguous if the provisions in controversy are reasonably or fairly susceptible of different interpretations or may have two or more different meanings"... Whether a contract is ambiguous presents a question of law for resolution by the court...

In the instant case, the ordinary and natural meaning of the agreement's words are dispositive. Examination of the entire interest rate swap agreement supports defendant's position that the term "Close-out Amount" in the ISDA Master Agreement and "Close Out Amount" in the ISDA Schedule have the same definition. The ISDA Master Agreement provides for "early termination events," which, as the term implies, enables a party to terminate the transaction early if a termination event occurs with respect to the other party. Upon an early termination, the ISDA Master Agreement sets out the procedure to calculate the "Close-out Amount." The early termination events subject to the "Close-out Amount" were as follows: 1) illegal act; 2) force majeure; 3) tax event; 4) tax event upon merger; and 5) credit event upon merger. The prepayment of the senior loans was not included as an early termination event. The ISDA Master Agreement, however, contemplates that additional termination events may be added via the ISDA Schedule. This is because the ISDA Master Agreement includes the term "Additional Termination Event" as an early terminating event and then defines such term as "any Additional Termination Event [that] is specified in the schedule." The particular ISDA Schedules executed by the parties in this case similarly specified prepayment of the senior loan as an early termination event. But, the schedule further provides that if an early termination event, namely prepayment, "occurs, no Close Out Amount will be payable under this Agreement." Thus, unlike the early termination events listed in the ISDA Master Agreement, which are subject to "Close out Amount" computation, the additional termination events added in the Schedule are explicitly excluded from the "Close-out Amount" computation. This clear and unambiguous language appears to deal a coup de grace to the breach of contract claims advanced by plaintiffs, particularly since any deviation from the ISDA Master Agreement in the ISDA Schedule serves the purpose of customizing the parties's contractual arrangements as negotiated by the parties...

Nevertheless, plaintiffs argue that the different punctuation of the same term means that the terms have different meanings, i.e., that the "Close Out Amount" term in the ISDA Schedule was only meant to include liquidation cost (the first component of the Close-out Amount of the Master Agreement) and thus Rodoanel was only relieved of the obligation to pay liquidation cost, but still had to pay the MTM. Such construction seems unreasonable and even irrational considering that the purported alternative definition is neither defined in the Schedule nor anywhere else. Ambiguity in a written agreement only exists if
there is more than one reasonable interpretation of the language at issue. Moreover, the ISDA Schedule explicitly states that a "[t]erm [] used but not defined [therein] shall have the same meaning set out in the [CTA]." Thus, since "Close Out Amount" is not defined in the Schedule," its definition in the Master Agreement controls.

Under the circumstances, it is evident that plaintiffs' strained interpretation of the term "Close Out Amount" is an attempt to rework that term's plain meaning in the ISDA Master Agreement. At the heart of plaintiffs' attempt to narrow the definition of the term "Close Out Amount," within the context of early termination due to prepayment of the senior loan, rests upon the undoubted fact that early termination provisions are, in the commercial sense, relevant to the value of interest rate swap transactions. After all, an interest rate swap is merely a transfer of interest rate exposure and, as such, it has market value exposure.

Indeed, the reason the market-to-market value of the derivative interest rate swaps was in favor of plaintiffs at the time of termination was because they "not Rodoanel" had been benefitting from the difference between their obligation to make payments based on what turned out to be a lower floating interest rate, and their right to receive payments based on the higher fixed rate. In other words, due to the interest rate swaps, Rodoanel was paying interest at the higher fixed rate, even though floating rates were low.

If plaintiffs, who are commercially sophisticated "hedge providers," had intended that, in the event of an early termination, the party "in the money" was entitled to retain the benefits of this favorable market condition, they could easily have expressed this intent in the language of the interest rate swap agreement. For instance, the agreement could have been written in such a way that defendant's obligations under the swap agreement remained, even if the senior loan was fully satisfied, unless defendant paid the remaining market value for the swap transactions. However, because the interest rate swap agreements were "instrument[s] . . . negotiated between sophisticated, counseled business people negotiating at arm's length,"... it is untenable that the parties would have intentionally left a key meaning of their agreements to such vagaries as placement and punctuation. This is especially true given the obvious need for "commercial certainty" in these $895 million loan/hedge transactions...

Ultimately, this case serves as a reminder that, in a contract containing punctuation marks, the words and not the punctuation guide us in its interpretation... Punctuation is always subordinate to the text and is never allowed to control its meaning... Of course, punctuation in a contract may serve as a guide to resolve an ambiguity that has not been created by punctuation or the absence therein, but it cannot, by itself, create ambiguity... It is a cardinal principle of contract interpretation that mistakes in grammar, spelling or punctuation should not be permitted to alter, contravene or vitiate manifest intention of the parties as gathered from the language employed...

Finally, we reject plaintiffs' argument that the Senior Lender CTA provides them a substantive right to receive a "Close Out Amount" upon termination of the swaps due to prepayment of the senior loans. Plaintiffs argument that they were intended third-party beneficiaries of the Senior Lender CTA is refuted by the documentary evidence. For instance, Section 8.14 of the CTA agreement states, in a paragraph entitled "No Third Party Beneficiaries," that such agreement "is solely for the benefit of the Borrower and no other Person . . . shall have any rights hereunder against any Senior Lender with respect to the senior loans, the proceeds thereof or otherwise." Courts have relied upon similar language to dispose of claims of third-party beneficiary status ... Likewise, the Senior Lender CTA expressly provides in the section defining "Required Hedge Agreements, § 3.2.12, that plaintiffs' rights vis-a-vis Rodoanel and the interest rate swaps would be governed by separate contracts, further negating any claim of third-party beneficiary status. Thus, even though the practical effect of the swap may have been to provide defendant with the financial equivalent of fixed-rate financing, the terms of the loan agreements make clear that defendant had distinct obligations under the senior loan agreements and under the interest
rate swap agreements. Even construing the loan and swap agreements as parts of a single transaction, nothing in the loan agreement conflicts with the plain language of the ISDA's Schedule that "[i]f an Additional Termination Event [prepayment] occurs, no Close Out Amount shall be payable under this Agreement." For instance, the Senior Lender CTA, as stated in Schedule 9, merely requires that "[t]erms of the Required Hedges shall be a Contrato Global de Derivativos . . . form or an ISDA form (2002)." In other words, Schedule 9, by its own terms, identifies two forms of acceptable derivative contracts, but says nothing about the parties' rights to negotiate the substance of those hedges "let alone whether "Close-out Amounts" would be payable upon termination of the swaps "so long as they otherwise complied with the requirements of the hedging program set forth in the Schedule.

It is not clear to what extent the new rules about clearing will in fact address this sort of litigation risk. But the new clearing environment may facilitate the management of swap portfolios:

Pending CFTC review, trueEX, the first CFTC-regulated Designated Contract Market (DCM) for interest-rate swaps, would provide CME clearing clients with access to trueEX's proprietary PTC (Portfoio Terminations and Compactions) platform. "We are pleased to offer trueEX services to our clients as part of our ongoing efforts to provide the most efficient OTC clearing solution," said Kim Taylor, President, CME Clearing. "Our clients tell us that they need to actively manage their cleared portfolios by reducing line items and maintaining the most capital efficient state of their aggregate risk across cleared and bilateral swaps. This service is one way we can help them achieve that objective."

Sunil Hirani, CEO and founder of trueEX, added: "trueEX's PTC platform would be the first and only platform to provide clients the ability to directly and instantly facilitate automated terminations, compactions, re-balancing and back-loading of legacy bilateral trades into CME's clearinghouse, and also to help clients efficiently manage their portfolio of cleared swaps."

PTC was designed with significant input from both buy-side and dealer participants to help the interest rate swap community cope with regulatory and compliance requirements of Dodd-Frank. trueEX's PTC platform would be the first automated platform to allow the buy-side instant and direct access to perform key life-cycle processes on pre-existing swaps in the CME Clearinghouse: terminations, compactions, re-balancing and back-loading. "The current process can take hours to execute, is manual, prone to operational risk and cumbersome. It can now be facilitated on the PTC platform in a manner of minutes," said Hirani. "PTC would save both buy-side and dealers significant time, facilitate margin and capital efficiencies, and reduce operational cost and risk in the pre-trade and post-trade process."3

The CFTC has adopted rules relating to standards for documentation of trading relationships between swap dealers, major swap participants, and their trading counterparties. The CFTC also requires swap dealers and major swap participants to meet standards for timely and accurate confirmation of swap transactions and for the reconciliation and compression of swap portfolios. In particular swap dealers and major swap participants must establish policies and procedures to ensure that, before entering into a swap the parties have agreed in writing to all

3 trueEX plans to provide CME Group's clearing members and customers with trueEX's portfolio termination, compaction, re-balancing and back-loading services (Apr. 10, 2013).
terms governing their trading relationship, including credit support arrangements (e.g. initial and variation margin requirements) and custodial arrangements. The parties must agree on swap valuation procedures for any time from execution to the termination, maturity, or expiration of the swap, for the purposes of complying with regulatory margin requirements and risk management requirements. Documentation must include alternative methods for determining the value of the swap (in the event of a failure of any input required for valuation of the swap) or a valuation dispute resolution process. The documentation must include a notice that, on acceptance of a swap by a derivatives clearing organization, the original swap is extinguished and is replaced by equal and opposite swaps between clearing members and the DCO. The regulations also require that all terms of the cleared swap conform to the product specifications of the cleared swap under a DCO’s rules. Swap dealers and major swap participants must carry out portfolio reconciliation for swap transactions which are not cleared by a DCO. Portfolio reconciliations may be carried out by the counterparties or by third parties. The rules require policies and procedures for termination and for portfolio compression.

In order to improve record-keeping and reporting, swap market participants will be required to have a unique identification number (legal entity identifier or LEI). The CFTC’s reporting and recordkeeping requirements went into effect on April 10, 2013, although the global LEI system is not yet in operation. In the meantime swap market participants need to obtain a CFTC Interim Compliant Identifier (CICI).

ISDA states that portfolio compression:

...reduces the overall notional size and number of outstanding contracts in credit derivative portfolios. Importantly, it does so without changing the overall risk profiles of these portfolios. This is achieved by terminating existing trades on single name reference entities and on indices and replacing them with a smaller number of new trades with substantially smaller notionals that carry the same risk profile and cashflows as the initial portfolio.

Firms participating in these cycles have eliminated approximately $74.6 trillion in CDS notional. TriOptima, provider of OTC derivatives market infrastructure services, has offered its triReduce portfolio compression services for CDS OTC derivatives since 2005. Through their cycles, participating institutions have eliminated $68 trillion in notional amounts through May 2010 in single name, index, and tranche contracts in Europe, US, Japan and emerging markets. TriOptima was recently designated by the ISDA Credit Steering Committee members as the service provider for European single name recouponing and compression cycles.

Creditex and Markit were selected by the ISDA Credit Steering Committee as the service provider for US single name compression cycles, and they also offer cycles in other CDS single name contracts. Through their cycles, which began in late 2008, participating institutions have eliminated $6.6 trillion in notional through October 2010.

4 CFTC’s Division of Market Oversight and Office of Data and Technology Issue Advisory Reminding All Swap Counterparties of April 10 Deadline to Obtain a CICI Identifier (Mar. 15, 2013) at http://www.cftc.gov/PressRoom/PressReleases/pr6535-13. See also https://www.ciciutility.org/.

The CFTC’s approach to requiring clearing of swaps has so far relied on the actions of market participants in developing swaps for clearing. This approach is shown by the CFTC’s Clearing Requirement Determination at the end of 2012. The Adopting Release\(^6\) stated:

With only limited checks on the amount of risk that a market participant could incur, great uncertainty was created among market participants. A market participant did not know the extent of its counterparty's exposure, whether its counterparty was appropriately hedged, or if its counterparty was dangerously exposed to adverse market movements. Without central clearing, a market participant bore the risk that its counterparty would not fulfill its payment obligations pursuant to a swap's terms (counterparty credit risk). As the financial crisis deepened, this risk made market participants wary of trading with each other. As a result, markets quickly became illiquid and trading volumes plummeted...

The failure to adequately collateralize the risk exposures posed by OTC derivatives, along with the contagion effects of the vast web of counterparty credit risk, led many to conclude that OTC derivatives should be centrally cleared. For instance, in 2008, the Federal Reserve Bank of New York (FRBNY) began encouraging market participants to establish a central counterparty to clear CDS. For several years prior, the FRBNY had led a targeted effort to enhance operational efficiency and performance in the OTC derivatives market by increasing automation in processing and by promoting sound back office practices, such as timely confirmation of trades and portfolio reconciliation. Beginning with CDS in 2008, the FRBNY and other primary supervisors of OTC derivatives dealers increasingly focused on central clearing as a means of mitigating counterparty credit risk and lowering systemic risk to the markets as a whole. Both regulators and market participants alike recognized that risk exposures would have been monitored, measured, and collateralized through the process of central clearing.

Recognizing the peril that the U.S. financial system faced during the financial crisis, Congress and the President came together to pass the Dodd-Frank Act in 2010. Title VII of the Dodd-Frank Act establishes a comprehensive new regulatory framework for swaps, and the requirement that swaps be cleared by DCOs is one of the cornerstones of that reform. The CEA, as amended by Title VII, now requires a swap:

1. To be cleared through a DCO if the Commission has determined that the swap, or group, category, type, or class of swap, is required to be cleared, unless an exception to the clearing requirement applies;
2. To be reported to a swap data repository (SDR) or the Commission; and
3. If the swap is subject to a clearing requirement, to be executed on a designated contract market (DCM) or swap execution facility (SEF), unless no DCM or SEF has made the swap available to trade.

Clearing is at the heart of the Dodd-Frank financial reform... Notably, Congress did not focus on just one asset class, such as CDS; rather, Congress determined that all swaps that a DCO plans to accept for clearing must be submitted to the Commission for a determination as to whether or not those swaps are required to be cleared pursuant to section 2(h)(2)(D) of the CEA.... Nations around the world have been preparing for the move to mandatory clearing. For example, the Japanese Financial Services Authority (JFSA) has proposed requiring certain financial institutions to clear yen-denominated interest rate swaps that reference LIBOR and CDS that reference the Japanese iTraxx indices by the end of 2012. After that, the requirement will be expanded to other entities engaging in these swaps. In addition, the JFSA is considering expanding its mandatory clearing coverage to include U.S. dollar- and euro-denominated interest rate swaps, as well as yen-denominated interest rate swaps referencing TIBOR. The JFSA also will consider mandating single-name CDS referencing Japanese reference entities, and index and single-name CDS on North American and European reference

\(^6\) CFTC, Clearing Requirement Determination Under Section 2(h) of the CEA 77 Fed. Reg. 74284 (Dec. 13, 2012)
entities. The Monetary Authority of Singapore (MAS) released a consultation paper addressing mandatory clearing on February 13, 2012. Based on a preliminary review MAS expects Singapore dollar interest rate swaps, U.S. dollar interest rate swaps, and Asian currency non-deliverable forwards to meet its proposed mandatory clearing criteria. Additional swaps will be considered for mandatory clearing via clearinghouse submission or upon the review of MAS.

The Securities and Futures Commission and Hong Kong Monetary Authority jointly released a consultation paper addressing mandatory clearing on October 17, 2011. This consultation plan described a phased implementation approach where clearing requirements will initially cover standardized interest rate swaps and non-deliverable forwards. Hong Kong regulators have said they will consider extending the mandatory clearing requirements in subsequent phases. In July, the Hong Kong regulators published consultation conclusions and stated that the precise mandatory clearing obligations would be set out in subsidiary legislation which they will be consulting on in the fourth quarter of 2012.

On April 18, 2012, the Australian Council of Financial Regulators published a consultation on a number of OTC derivatives, including mandatory clearing. The Council of Financial Regulators is developing advice for the government which is expected to adopt legislation by end-2012.

Finally, in the European Union, specific clearing determinations have yet to be made. However, the European Markets Infrastructure Regulation (EMIR) provides that contracts become subject to the clearing obligation through either a "bottom up" approach or a "top down" approach. The "bottom up" approach is where a national authority authorizes a central counterparty (CCP) to clear certain classes of OTC derivatives. The "top down" approach is where the European Securities and Markets Authority (ESMA) identifies classes of OTC derivatives which should be subject to the clearing obligation but for which no CCP is authorized to clear. Based on this framework, ESMA has the authority to make clearing determinations for classes of OTC derivative contracts.

With the adoption of these final rules, the Commission is taking a critical step toward meeting the G-20 commitment and fulfilling the requirements of the Dodd-Frank Act. The Commission has consulted with authorities from around the globe to ensure that our efforts are as coordinated as possible.

The Commission promulgated Sec. 39.5 of its regulations to implement procedural aspects of section 2(h) of the CEA. Regulation 39.5 establishes procedures for: (1) Determining the eligibility of a DCO to clear swaps; (2) the submission of swaps by a DCO to the Commission for a clearing requirement determination; (3) Commission initiated reviews of swaps; and (4) the staying of a clearing requirement. The determinations and rules adopted in this release implement the clearing requirement under section 2(h) of the CEA for certain swaps and require that those swaps must be submitted for clearing to Commission-registered DCOs. Under section 2(h)(1)(A), "it shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a [DCO] that is registered under [the CEA] or a [DCO] that is exempt from registration under [the CEA] if the swap is required to be cleared.' A clearing requirement determination may be initiated by a swap submission. Section 2(h)(2)(B)(i) of the CEA requires a DCO to "submit to the Commission each swap, or any group, category, type or class of swaps that it plans to accept for clearing, and provide notice to its members of the submission." In addition under section 2(h)(2)(B)(ii) of the CEA, "[a]ny swap or group, category, type, or class of swaps listed for clearing by a [DCO] as of the date of enactment shall be considered submitted to the Commission."

F. Submissions from DCOs

On February 1, 2012, Commission staff sent a letter requesting that DCOs submit all swaps that they were accepting for clearing as of that date, pursuant to Sec. 39.5 of the Commission's regulations. The Commission received submissions relating to CDS and interest rate swaps from: The International Derivatives Clearinghouse Group (IDCH) on February 17, 2012; the CME Group (CME), ICE Clear
Credit, and ICE Clear Europe, each dated February 22, 2012; and a submission from LCH.Clearnet Limited (LCH) on February 24, 2012

The clearing requirement determinations and rules adopted in this release cover certain CDS and interest rate swaps currently being cleared by a DCO. The Commission intends subsequently to consider other swaps submitted by DCOs, such as agricultural, energy, and equity indices.

As stated in the NPRM, the decision to focus on CDS and interest rate swaps in the initial clearing requirement determinations is a function of both the market importance of these swaps and the fact that they already are widely cleared. In order to move the largest number of swaps to required clearing in its initial determinations, the Commission believes that it is prudent to focus on those swaps that have the highest market shares and, accordingly, the biggest market impact. Further, for these swaps there is already a blueprint for clearing and appropriate risk management. CDS and interest rate swaps fit these considerations and therefore are well suited for required clearing consideration.

Notably, market participants recommended that the Commission take this approach, and comments received on the NPRM supported this approach as well. In addition, interest rate swaps account for about $500 trillion of the $650 trillion global OTC swaps market, in notional dollars--the highest market share of any class of swaps. LCH claims to clear about $302 trillion of those--meaning that, in notional terms, LCH clears approximately 60% of the interest rate swap market. While CDS indices do not have as prominent a market share as interest rate swaps, CDS indices are capable of having a sizeable market impact, as they did during the 2008 financial crisis. Overall, the CDS marketplace has almost $29 trillion in notional outstanding across both single and multi-name products. CDS on standardized indices accounts for about $10 trillion of the global OTC market in notional dollar amount outstanding. Since March 2009, the ICE Clear Credit and ICE Clear Europe have combined to clear over $30 trillion in gross notional for all CDS. Because of the market shares and market impacts of these swaps, and because these swaps are currently being cleared, the Commission decided to review CDS and interest rate swaps in its initial clearing requirement determinations. The Commission recognizes that while this is an appropriate basis for the initial determinations, swap clearing is likely to evolve and clearing requirement determinations made at later times may be based on a variety of other factors beyond the extent to which the swaps in question are already being cleared.

None of the 33 comments received expressed outright opposition to the Commission's clearing requirement proposal. Indeed, 22 of the comment letters strongly supported the Commission's proposal and urged the Commission to finalize its proposal promptly. These comments also supported the Commission's analysis under the five-factor statutory test, and agreed with the Commission's conclusion that swaps within the four proposed classes of interest rate swaps and the two proposed classes of CDS were appropriate for required clearing. All three DCOs clearing the swaps subject to the final rules expressed strong support for the proposal and agreed with the overall approach taken by the Commission.

Submission of Swaps Required To Be Cleared and Failures to Clear

CME sought clarification that market participants do not have to clear those swaps that fall within a class of swaps under Sec. 50.4, but for which no DCO provides clearing or for which the DCO provides clearing to only a limited number of market participants. Other commenters expressed similar concerns about not requiring clearing where no DCO offers customer clearing. Freddie Mac requested clarification regarding the legal status of a swap that is submitted for clearing to a DCO, but fails to clear.

The Commission confirms that if no DCO clears a swap that falls within a class of swaps under Sec. 50.4, then the clearing requirement does not apply to that swap. In essence, it is a two-step process to determine whether the clearing requirement applies to a particular swap. First, a market participant must determine whether its swap falls within one of the classes under Sec. 50.4. Then, if the swap falls within one of the classes, the market participant must determine if any of the eligible DCOs clear that swap. The second step requires market participants to determine if all the product specifications required under the
DCO's rules are met. If no eligible DCO will accept the swap for clearing because there is a different product specification, then the swap is not required to be cleared. Market participants need not submit swaps to a DCO if they know that the DCO does not clear that particular swap.

In response to Freddie Mac's request for clarification, if counterparties submit their swap to a DCO for clearing and the swap fails to clear because it contains a term or terms that prevent any eligible DCO from clearing the swap, then the swap is not subject to the Commission's clearing requirement. On the other hand, if the swap fails to clear because one or both of the counterparties have not met the DCO's or their clearing members' credit requirements, then the swap remains subject to the clearing requirement and must be cleared as soon as technologically practicable after the counterparties learn of the credit issue. The Commission notes that section 739 of the Dodd-Frank Act amended section 22(a)(4)(B) of the CEA to provide that, regarding contract enforcement between two eligible counterparties, "[n]o agreement, contract, or transaction between eligible contract participants or persons reasonably believed to be eligible contract participants shall be void, voidable, or unenforceable * * * under this section or any other provision of Federal or State law, based solely on the failure of the agreement, contract, or transaction * * * to be cleared in accordance with section 2(h)(1)." Accordingly, a swap that fails to clear because of credit issues may not be voided by either eligible counterparty solely for the failure of the swap to be cleared in accordance with section 2(h)(1), but the basis for the failure to clear must be addressed by the counterparties and they must promptly resubmit the swap for clearing.

With regard to clearing that is not available to all market participants, the Commission will not require a swap to be cleared unless clearing is generally available to all types of market participants.

iii. Customer Segregation for Swaps

Under section 2(h)(2)(D)(ii)(V) of the CEA, in making a clearing requirement determination, the Commission must take into account the existence of reasonable legal certainty in the event of the insolvency of the relevant DCO or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property. Several commenters raised general concerns about customer segregation for cleared swaps.

Vanguard recommended that the Commission should not implement mandatory clearing for any swaps until the Commission's final swap customer segregation rules under the legally segregated, operationally commingled (LSOC) model are fully operational and capable of being tested for at least three months prior to mandatory clearing. In response to these comments, the Commission observes that the compliance date for LSOC was November 13, 2012. The Commission worked with market participants to ensure that compliance by that date was accomplished ... the compliance schedule for this first clearing requirement will commence on March 11, 2013. Accordingly, as requested by SIFMA AMG, parties in the first compliance category will have more than 3 months of experience under the LSOC rules prior to required clearing taking effect. Those parties in the second and third categories will have over 6 and 9 months of testing prior to required clearing, respectively. During this time, the Commission will continue to work with market participants to resolve matters that require clarification regarding LSOC.

The CDS cleared by CME, ICE Clear Credit, and ICE Clear Europe that were submitted to the Commission are standardized contracts providing credit protection on an untranched basis, meaning that settlement is not limited to a specific range of losses upon the occurrence of credit events among the reference entities included within an index. Besides single-name CDS, untranched CDS on indices are the only type of CDS being cleared by these DCOs. Other swaps, such as credit index tranches, options, and first- or Nth-to-default baskets on these indices, are not currently cleared.

CME and ICE Clear Credit each clear CDS on indices administered by Markit. The Markit CDX family of indices is the standard North American credit default swap family of indices, with the primary corporate indices being the CDX North American Investment Grade (consisting of 125 investment grade corporate reference entities) (CDX.NA.IG) and the CDX North American High Yield (consisting of 100
high yield corporate reference entities) (CDX.NA.HY). The standard currency for CDS on these indices is the U.S. dollar.

CME offers the CDX.NA.IG at the 3-, 5-, 7- and 10-year tenors for Series 9 and each subsequent series, to the extent that those contracts that have not reached their termination date. CME also offers the CDX.NA.HY at the 5-year tenor for Series 11, and each subsequent series. ICE Clear Credit offers the CDX.NA.IG Series 8, and each subsequent series of that index that is still outstanding, at the 3-, 5-, 7- and 10-year tenors. ICE Clear Credit also offers the CDX.NA.IG. Series 8 to Series 10, at the 7-year tenor. For the high yield index, ICE Clear Credit clears all series from the current series through the CDX.NA.HY Series 9 at the 5-year tenor. Each of these cleared CDX.NA contracts is denominated in U.S. dollars.

ICE Clear Europe made a submission covering the index CDS that it clears. As with CME’s and ICE Clear Credit’s submissions, the contracts that ICE Clear Europe clears are based on Markit indices with corporate reference entities, though in this case, the entities are based in Europe. ICE Clear Europe clears euro-denominated contracts referencing the three primary indices: iTraxx Europe (covering 125 European investment grade corporate reference entities); the iTraxx Europe Crossover (covering 50 European high yield reference entities); and the iTraxx Europe High Volatility (a 30-entity subset of the European investment grade index).

For the iTraxx Europe and Crossover, ICE Clear Europe clears outstanding contracts in the Series 7 and 8, respectively, through the current series. For the High Volatility index, ICE Clear Europe clears outstanding contracts in the Series 9 through the current series. In terms of tenors, ICE Clear Europe clears the 5-year tenor for all swaps, as well as the 10-year tenor for the iTraxx Europe index.

Based upon those portions of the CME, ICE Clear Credit, and ICE Clear Europe swap submissions relating to the CDS contracts discussed above, as well as the analysis conducted by the Commission pursuant to Sec. 39.5(b) and set forth below, the Commission has reviewed the following classes of swaps for purposes of the clearing requirement determination.

ii. Identification of CDS Specifications

Under Sec. 39.5, the decision of the Commission to require that a group, category, type, or class of swaps be required to be cleared is informed by a number of factors. As an initial matter, the Commission has looked to the DCOs’ submissions with regard to the swaps they currently clear. After analyzing the key attributes of the swaps submitted, the Commission proposed establishing two classes of CDS to be subject to the clearing requirement and, pursuant to this final rulemaking, is finalizing those classes as proposed. The first class is based on the untranched indices covering North American corporate credits, the CDX.NA.IG and the CDX.NA.HY. The second class is based on the untranched indices covering European corporate credits, the iTraxx Europe, the iTraxx Europe Crossover, and the iTraxx Europe High Volatility. Given the different markets that the CDS indices cover, the different standard currencies, and other logistical differences in how the CDS markets and documentation work, the Commission believes this is an appropriate basis for creating these two classes.

The Commission believes that indices based on other types of entities would be viewed as a separate class and would be subject to a separate determination by the Commission. For example, given the differences that exist with regard to volumes and risk management of indices based on sovereign issuers, as opposed to corporate issuers, it is likely that such CDS would represent their own class of swaps. Similarly, to the extent indices from other regions were submitted by a DCO, it is likely that the Commission would take the view that they are part of their own class of swaps as well.

The Commission believes it appropriate to define the classes of swaps as untranched CDS contracts referencing Markit's broad-based corporate indices. These corporate indices have the most net notional
outstanding, the most trading volumes, and the best available pricing. The risk management frameworks for the corporate index swaps are the most well-established, and have the most available data in terms of CDS spreads and corporate default studies for analysis of the underlying constituents of the indices. Agreements based on these indices also are widely accepted and use standardized terms. Both of the CDS classes presented herein assume that the relevant CDS agreement will use the standardized terms established by Markit/ISDA with regard to the specific index and be denominated in a currency that is accepted for clearing by DCOs. To the extent that a CDS agreement on an index listed within the classification is not accepted for clearing by any DCO because it uses non-standard terms or is denominated in a currency that makes it ineligible for clearing, that CDS is not subject to the requirement that it be cleared, notwithstanding that the CDS is based on such index. Also as proposed, this clearing determination is limited to only those series of the referenced indices that are currently being cleared. Further, to the extent that any swap on a CDS index is of a tenor such that it is scheduled to terminate prior to July 1, 2013, such a swap is not part of this clearing determination. Given the implementation periods provided for under Sec. 50.25, discussed below in Section IV, the Commission does not want to create a situation where certain market participants will be required to clear a contract based upon their status under the implementation provisions, but other parties will never be required to clear that same contract before its scheduled termination. Similarly, the classes only include those tenors of contracts which are currently being cleared.... Section 2(h)(2)(D)(i) of the CEA requires the Commission to review whether a submission under section 2(h)(2)(B) is consistent with section 5b(c)(2) of the CEA (DCO core principles). Section 2(h)(2)(D)(ii) of the CEA also requires the Commission to consider five factors in a determination based on swap submission: (1) The existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data; (2) the availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded; (3) the effect on the mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the DCO available to clear the contract; (4) the effect on competition, including appropriate fees and charges applied to clearing; and (5) the existence of reasonable legal certainty in the event of the insolvency of the relevant DCO or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property... Section 2(h)(2)(D)(i) of the CEA requires the Commission to review whether a submission is consistent with the core principles for DCOs. Each of the DCO submissions relating to CDS provided data to support the Commission's analysis of the five factors under section 2(h)(2)(D) of the CEA. The Commission also was able to call upon independent analysis conducted with regard to the CDS market, as well as its knowledge and reviews of the registered DCOs' operations and risk management processes, covering topics such as product selection criteria, pricing sources, participant eligibility, and other relevant rules..... The swaps submitted by CME, ICE Clear Credit, and ICE Clear Europe pursuant to Sec. 39.5(b) are currently being cleared by those organizations. As discussed above, the risk management, rules, and operations used by each DCO to clear these swaps are subject to review by the Commission's risk management, legal, and examinations staff on an on-going basis. Additionally, each of the DCOs has established procedures to review any new swaps it may consider offering for clearing. Before the indices referenced herein were accepted for clearing by any of the DCOs, they were subject to review by the risk management functions of those organizations. Such analysis generally focuses on the DCO's ability to risk manage positions in the prospective swaps and on any specific operational issues that may arise from the clearing of such swaps. In the case of the former, this involves ensuring that adequate pricing data is available, both historically and on a "going forward"
basis, such that a marginging methodology could be established, back-tested, and used on an on-going basis. Operational issues may include analysis of additional contract terms for new swaps that may require different settlement procedures. Each of the contracts submitted by CME, ICE Clear Credit, and ICE Clear Europe and discussed herein has undergone an internal review process by the respective DCO and found to be within their product eligibility standards.

The Commission received submissions from three registered DCOs eligible to clear interest rate swaps: LCH.Clearnet Limited (LCH), the clearing division of the Chicago Mercantile Exchange Inc. (CME), and International Derivatives Clearinghouse, LLC (IDCH).\95\ On August 14, 2012, LCH acquired IDCH and changed the name of IDCH to LCH.Clearnet LLC (LCH.LLC). LCH.LLC has submitted a request to the CFTC for approval of changes to its DCO rules that would result in LCH.LLC clearing the same interest rate swaps that LCH clears. As noted in the NPRM, IDCH had no cleared swap positions. Accordingly, the change in ownership of IDCH would not change the Commission's proposal in terms of swap class assessments or volume and liquidity considerations. The proposed clearing requirement rule is not DCO specific. Upon approval of LCH.LLC's application for its DCO rule changes, LCH.LLC would become a U.S.-domiciled DCO capable of accepting the full range of interest rate swap products contemplated in the proposal.

<table>
<thead>
<tr>
<th>Swap Classes ..........</th>
<th>LCH</th>
<th>CME</th>
</tr>
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<tbody>
<tr>
<td>Fixed-to-floating, basis, forward rate agreements (FRAs), overnight index swaps (OIS).</td>
<td>USD, EUR, GBP, JPY, AUD, CAD, CHF, SEK, CZK, DKK, HKD, HUF, NOK, NZD, PLN, SGD, ZAR.</td>
<td>USD, EUR, GBP, JPY, CAD, and CHF.</td>
</tr>
<tr>
<td>USD–LIBOR, CAD–BA, CHF–LIBOR, GBP–LIBOR, JPY–LIBOR, and EURIBOR.</td>
<td>USD, EUR, and GBP out to 50 years, and CAD, JPY, and CHF out to 30 years.</td>
<td></td>
</tr>
<tr>
<td>For Fixed-to-floating and basis: USD, EUR, and GBP out to 50 years, AUD, CAD, CHF, SEK and JPY out to 30 years and the remaining nine currencies out to 10 years.</td>
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The NPRM described how interest rate swaps present a wide range of variable product classes and product specifications within each class. Notwithstanding the large variety of contracts, there are commonalities that make it possible to categorize interest rate swaps for clearing, pricing, and risk purposes. Firstly, the vast majority of interest rate swaps use the ISDA definitions and contract conventions that allow market participants to agree quickly on common terms for each transaction. In fact, the DCOs clearing interest rate swaps all use ISDA definitions in their product specifications. Secondly, counterparties enter into swaps to achieve particular economic results. While the results desired may differ in small ways depending on each counterparty's specific circumstances and goals, there are certain common swap conventions that are used to identify and achieve commonly desired economic results when entering into interest rate swaps. For example, a party that is trying to hedge variable interest rate risk may enter into a fixed rate to floating rate swap, or a party that is seeking to fix interest rates for periods in the future may enter into a forward rate agreement. The IRS submissions identified commonly known classes of swaps that they clear including: fixed rate to floating rate swaps, that are sometimes referred to as plain vanilla swaps (fixed-to-floating swaps); floating rate to floating rate swaps, also referred to as basis swaps (basis swaps); overnight index swaps (OIS); and forward rate agreements (FRAs). These class terms are also being used in industry efforts to develop a taxonomy for interest rate swaps.
Furthermore, within these general classes, certain specifications are essential for defining the economic result and the value of the swap. Each of the IRS submissions naturally used these common specifications when identifying the swaps that the DCO clears. Within each of those specifications, there are common terms used by the DCOs and markets, which allows for further classification of the full range of interest rate swaps that are executed. Accordingly, as described in the NPRM, while there are a wide variety of interest rate swaps when taking into account all possible contract specifications, certain specifications are commonly used by the DCOs and market participants. This allows for the identification of classes of swaps and primary specifications within each class.

The DCOs also risk manage and set margins for interest rate swaps on a portfolio basis rather than on a transaction- or product-specific basis. In other words, the DCOs analyze the cumulative risk of a party's portfolio. By looking at risk on a portfolio basis, the DCOs effectively take into account how swaps with different attributes, such as underlying currency, stated termination dates, underlying floating rate indexes, swap classes, etc., are correlated and thus can offset risk across attributes. This is possible because, although individual transactions may have unique contract terms, given the commonalities of transactions as discussed above, swap portfolios can be risk managed on a cumulative value basis taking into account correlations among the cleared swaps. Consequently, DCOs can be expected to fairly rapidly, and efficiently manage the risk of portfolios of interest rate swaps within and across classes in a default scenario through a small number of large hedging transactions that hedge large numbers of similarly correlated positions held by the defaulting party. As such, liquidity for specific, individual swaps is not the focus of DCOs from a risk management perspective. Rather, liquidity is viewed as a function of whether a portfolio of swaps has common specifications that are determinative of the economics of the swaps in the portfolio such that a DCO can price and risk manage the portfolio through block hedging and auctions in a default situation.

iv. Interest Rate Swap Classification for Clearing Requirement Determinations

Section 2(h)(2)(A) of the CEA provides that the Commission “shall review each swap, or any group, category, type, or class of swaps to make a determination as to whether” any thereof shall be required to be cleared. In reviewing the IRS submissions, the Commission considered in the NPRM whether its clearing requirement determination should address individual swaps, or categories, types, classes, or other groups of swaps.

Based on the market conventions as discussed above, and the DCO recommendations in the IRS submissions, the Commission proposed a clearing requirement for four classes of interest rate swaps: Fixed-to-floating swaps, basis swaps, OIS, and FRAs. At the time the IRS submissions were submitted to the Commission, LCH offered all four classes for clearing, as did IDCH, and CME offered one of them for clearing. Subsequent to the publication of the NPRM, CME has added clearing of OIS, and has stated publicly that it intends to add clearing of basis swaps and FRAs in the near future. In addition, upon launch of LCH.LLC, it is expected that LCH.LLC will begin clearing the same swaps cleared by LCH that are included in the swap classes designated by the Commission.

These four classes represent a substantial portion of the interest rate swap market...

**Margin/Collateral**

Central clearing of derivatives involves holding collateral with a central counterparty. A DCO will require initial and variation margin. In addition, a counterparty to a cleared OTC derivative needs to gain access to a DCO through a Futures Commission Merchant (FCM), which
is a member of the DCO, so the counterparty will have a futures account client agreement with the FCM. This agreement may require the counterparty to deliver margin in addition to the DCO-required margin. The CFTC has adopted rules relating to a “legal segregation with operational commingling” model (LSOC Model) whereby FCMs and DCOs must segregate collateral posted by cleared swap customers. At the same time FCMs and DCOs are allowed for operational purposes, to commingle the collateral deposited by all cleared swap customers in one account “separate from any account holding FCM or DCO property or holding property belonging to non-cleared swaps customers.”

We have noted that policy makers have suggested that non-centrally cleared swaps should be subject to higher margin requirements than centrally cleared swaps. In February 2013 the Basel Committee and IOSCO published a Second Consultative Document on Margin Requirements for Non-centrally Cleared Derivatives. The document states:

Margin requirements for non-centrally cleared derivatives have two main benefits:
Reduction of systemic risk. Only standardised derivatives are suitable for central clearing. A substantial fraction of derivatives are not standardised and will not be able to be cleared. These non-centrally cleared derivatives, which total hundreds of trillions of dollars of notional amounts, will pose the same type of systemic contagion and spillover risks that materialised in the recent financial crisis. Margin requirements for non-centrally cleared derivatives would be expected to reduce contagion and spillover effects by ensuring that collateral are available to offset losses caused by the default of derivatives counterparty. Margin requirements can also have broader macroprudential benefits, by reducing the financial system’s vulnerability to potentially de-stabilising procyclicality and limiting the build-up of uncollateralised exposures within the financial system.
Promotion of central clearing
In many jurisdictions central clearing will be mandatory for most standardised derivatives. But clearing imposes costs, in part because CCPs require margin to be posted. Margin requirements on non-centrally cleared derivatives, by reflecting the generally higher risk associated with these derivatives, will promote central clearing, making the G20’s original 2009 reform programme more effective. This could, in turn, contribute to the reduction of systemic risk. The effectiveness of margin requirements could be undermined if the requirements were not consistent internationally. Activity could move to locations with lower margin requirements, raising two concerns
• The effectiveness of the margin requirements could be undermined (ie regulatory arbitrage).
• Financial institutions that operate in the low-margin locations could gain a competitive advantage (ie unlevel playing field).

Margin and capital
Both capital and margin perform important risk mitigation functions but are distinct in a number of ways. First, margin is “defaulter - pay”. In the event of a counterparty default, margin protects the surviving party by absorbing losses using the collateral provided by the defaulting entity. In contrast, capital adds loss absorbency to the system, because it is “survivor - pay”, using capital to meet such losses consumes the surviving entity’s own financial resources. Second, margin is more “targeted” and dynamic, with each

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portfolio having its own designated margin for absorbing the potential losses in relation to that particular portfolio, and with such margin being adjusted over time to reflect changes in the risk of that portfolio. In contrast, capital is shared collectively by all the entity’s activities and may thus be more easily depleted at a time of stress, and is difficult to rapidly adjust to reflect changing risk exposures. Capital requirements against each exposure are not designed to be sufficient to cover the loss on the default of the counterparty but rather the probability weighted loss given such default. For these reasons, margin can be seen as offering enhanced protection against counterparty credit risk where it is effectively implemented. In order for margin to act as an effective risk mitigant, that margin must be (i) accessible at the time of need and (ii) in a form that can be liquidated rapidly in a period of financial stress at a predictable price.

Impact of margin requirements on liquidity
The potential benefits of margin requirements must be weighed against the liquidity impact that would result from derivative counterparties’ need to provide liquid, high-quality collateral to meet those requirements, including potential changes to market functioning as a result of an increasing demand for such collateral in the aggregate. Financial institutions may need to obtain and deploy additional liquidity resources to meet margin requirements that exceed current practices. Moreover, the liquidity impact of margin requirements cannot be considered in isolation. Rather, it is important to recognise ongoing and parallel regulatory initiatives that will also have significant liquidity impacts; examples of such initiatives include the BCBS’s Liquidity Coverage Ratio (LCR), Net Stable Funding Ratio (NSFR) and global mandates for central clearing of standardised derivatives.

As discussed in the initial proposal released in July, the BCBS and IOSCO conducted a QIS in order to gauge the impact of the margin proposals. In particular, the QIS assessed the amount of margin required on non-centrally cleared derivatives as well as the amount of available collateral that could be used to satisfy these requirements. The results of the QIS as well as comments that were received on the initial proposal were carefully considered in arriving at the margin framework that is described in this document. The overall liquidity burden resulting from initial margin requirements, as well as the availability of eligible collateral to satisfy such requirements, in particular, have been carefully assessed in designing the margin framework. The use of permitted initial margin thresholds... the eligibility of a broad range of eligible collateral... as well as the triggers that provide for a gradual phase-in of the requirements... have been included as key elements of the margin framework to directly address the liquidity demands associated with the requirements.

Key principles and requirements
... this paper presents the BCBS’s and IOSCO’s near-final policy for margin requirements for non-centrally cleared derivatives, as articulated through key principles addressing eight (8) main elements:
1. Appropriate margining practices should be in place with respect to all derivative transactions that are not cleared by CCPs.
2. All financial firms and systemically-important non-financial entities (“covered entities”) that engage in non-centrally cleared derivatives must exchange initial and variation margin as appropriate to the counterparty risks posed by such transactions.
3. The methodologies for calculating initial and variation margin that must serve as the baseline for margin that is collected from a counterparty should (i) be consistent across entities covered by the requirements and reflect the potential future exposure (initial margin) and current exposure (variation margin) associated with the portfolio of non-centrally cleared derivatives at issue and (ii) ensure that all counterparty risk exposures are covered fully with a high degree of confidence.
4. To ensure that assets collected as collateral for initial and variation margin purposes can be liquidated in a reasonable amount of time to generate proceeds that could sufficiently protect collecting entities...
covered by the requirements from losses on non-centrally cleared derivatives in the event of a counterparty default, these assets should be highly liquid and should, after accounting for an appropriate haircut, be able to hold their value in a time of financial stress.

5. Initial margin should be exchanged by both parties, without netting of amounts collected by each party (ie on a gross basis), and held in such a way as to ensure that (i) the margin collected is immediately available to the collecting party in the event of the counterparty’s default; and (ii) the collected margin must be subject to arrangements that fully protect the posting party in the event that the collecting party enters bankruptcy to the extent possible under applicable law.

6. Transactions between a firm and its affiliates should be subject to appropriate regulation in a manner consistent with each jurisdiction’s legal and regulatory framework.

7. Regulatory regimes should interact so as to result in sufficiently consistent and non-duplicative regulatory margin requirements for non-centrally cleared derivatives across jurisdictions.

8. Margin requirements should be phased-in over an appropriate period of time to ensure that the transition costs associated with the new framework can be appropriately managed. Regulators should undertake a coordinated review of the margin standards once the requirements are in place and functioning to assess the overall efficacy of the standards and to ensure harmonisation across national jurisdictions as well as across related regulatory initiatives....

The BCBS and IOSCO have focused on two principal questions:

• Whether the margin requirements should apply to all parties to non-centrally cleared derivatives, only to financial firms, or only to key market participants; and

• Whether the margin requirements should require a bilateral exchange of margin between all entities covered by the requirements, or only the unilateral collection of margin by certain types of firms (eg key market participants).

....The BCBS and IOSCO believe that the margin requirements need not apply to non-centrally cleared derivatives to which non-financial entities that are not systemically-important are a party, given that (i) such transactions are viewed as posing little or no systemic risk and (ii) such transactions are exempt from central clearing mandates under most national regimes. Similarly, the BCBS and IOSCO support not applying the margin requirements in a way that would require sovereigns, central banks, multilateral development banks, or the Bank for International Settlements, to either collect or post margin. Both of these views are reflected by the exclusion of such transactions from the scope of margin requirements. As a result, a transaction between a covered entity and one of the aforementioned entities is not covered by the requirements set out in this document...

With respect to other non-centrally cleared derivatives, the BCBS and IOSCO support margin requirements that, in principle, would involve the mandatory exchange of both initial and variation margins among parties to non-centrally cleared derivatives (“universal two-way margin”). In the case of variation margin, the BCBS and IOSCO recognise that regular and timely exchange of variation margin represents the settlement of the running profit/loss of a derivative and has no net liquidity costs as variation margin represents a transfer of resources from one party to another. The BCBS and IOSCO also recognise that the regular and timely exchange of variation margin is a widely adopted best practice that promotes effective and sound risk management.

In the case of initial margin, the BCBS and IOSCO recognise that initial margin requirements will have a measurable impact on market liquidity, as assets that are provided for collateral purposes cannot be readily deployed for other uses over the life of the non-centrally cleared derivative contract. It is also recognised that such requirements will represent a significant change in market practice and will present certain operational and logistical challenges that will need to be managed as the new requirements come into effect...

These operational and logistical challenges will be dealt with as the requirements are implemented in a
manner consistent with the phase-in timeline ... Following the end of the phase-in period, there will be a minimum level of non-centrally cleared OTC derivative activity (€8 billion of gross notional outstanding amount) necessary for covered entities to be subject to initial margin requirements described in this paper

One tool that has received broad support that can be used to manage the liquidity impact associated with initial margin requirements is to provide for an initial margin threshold (threshold) that would specify an amount under which a firm would have the option of not collecting initial margin. In cases where the initial margin requirement for the portfolio exceeded the threshold, the firm would be obligated to collect initial margin from its counterparty in an amount that is at least as large as the difference between the initial margin requirement and the threshold. For example, if the threshold amount were 10 and the initial margin requirement for a particular non-centrally cleared derivative portfolio was 15, then a firm would be obligated to collect at least 5 from its counterparty in initial margin (15 - 10=5), or more if it so chose pursuant to its risk management guidelines and principles. Such an approach, if applied in a manner consistent with sound risk management practices, can help ameliorate the costs associated with the universal two-way margin regime.

This February 2013 moderated the requirements the Basel Committee and IOSCO had initially proposed and delayed the implementation date in response to comments from market participants. But ISDA was not satisfied, in particular arguing against the proposed Initial Margin requirement:

The level of IM proposed by the Paper is extremely high and would severely reduce the use of uncleared OTC derivatives. In addition, the funds need ed by market participants to acquire sufficient collateral to post IM for these uncleared OTC derivatives will reduce their overall business activities and this will damage the real economy by draining liquidity from Covered Entities... that enter into uncleared OTC derivatives. Non-Covered Entities will also suffer the impact due to the indirect cost of IM imposed on hedging transactions. Proposed IM requirements will also reduce liquidity and access to OTC derivatives that cannot be centrally cleared, which will severely impair market participants’ ability to hedge their related risks...

Requiring IM will impose significant operational hurdles because many parties do not currently post IM. In addition, it will generate significant numbers of disputes, especially if value-at-risk (“VaR”) models are used, and it will be time-consuming to develop methods to resolve such disputes. Also, each jurisdiction will need to harmonize its margin and capital rules to ensure a consistent and clear regulatory approach. Finally, some jurisdictions may not currently have legal frameworks that appropriately support IM...

In lieu of IM, which could destabilize the global markets, particularly during times of stress, systemic risk can effectively be mitigated by a three pillar approach: VM requirements, appropriate capital requirements (consistent with the tenets of Basel III), and mandatory clearing of liquid, standardized OTC derivatives. Non-centrally cleared OTC derivatives are already subject to, or will under Basel III become subject to, seven risk mitigants that we set forth in our discussion below. Ensuring a coherent and non-duplicative risk mitigating framework is therefore key in achieving the Paper’s main goals....

The application of the proposed measures comes at a very high price in terms of their impact on market and collateral liquidity. Despite the envisioned use of thresholds (aimed at alleviating such demands on collateral, but of limited impact for financial counterparties), the proposed measures are likely to lead to substantial increases in additional collateral, leading to major disruptions in the market for collateral, exerting enormous pressure on market liquidity with the potential for significant economic dislocation.
Collateral plays a significant role in the provision of secured financing to financial institutions. As such, secured funding is a major source of liquidity to the global financial system. Removing collateral amounts in the contemplated quantities from the market—segregation and no-hypothecation implies precisely this— is tantamount to at least an equal amount of drainage to the global liquidity, and perhaps more (if the pledged collateral had been re-hypothecated). It is such drainage of the global liquidity that could have potentially significant (and unintended) economic implications... the use of secured funding continues to remain below pre-Lehman level primarily because the re-use of collateral has been reduced. In this context, further reductions in available collateral caused by the contemplated proposals could result, through the secured finance channel, in significant economic dislocation.

The associated cost of using non-cleared OTC derivatives could discourage users, forcing them to abandon non-cleared OTC derivatives and instead employ imperfect hedges using only clearable risk-hedging tools, and confronting them with unwanted basis risk. Users might also find that their transactions do not qualify for hedge accounting treatment, which would introduce significant volatility to their income statements. There are also certain specific risks for which the appropriate hedge is not yet and may not in the future be available in cleared form. As a result, users may decide to forego their hedging strategy and remain exposed to the risks they previously wished to manage away. They may also prefer to not take the underlying risks at all, which could have dampening effects on economic growth. For example, single name credit default swaps on borrowers that are not widely traded will not be cleared, and are often used by lenders. If their use is hindered, banks will be restricted from making loans and underwriting issuances of corporate bonds. Investors also use custom OTC derivatives tailored to match their investment or risk-management needs... which will not be clearable and which will become far more expensive for customers, prohibitively for some...

The Paper...assumes that a large part of the OTC derivatives market will be centrally cleared by 2015 and thus not subject to the IM requirements. For instance, Appendix C Section 1(b) of the Paper assumes that "interest rate and equity derivatives are expected to exhibit the largest decline" in non-centrally cleared derivatives products. This assumption appears to result from the QIS guidance that “all equity options should be considered clearable" and "all single name equity swaps should be considered clearable”. However, there is no central clearing counterparty currently offering clearing for equity swaps, which may never become clearable due to bespoke financing characteristics, so this assumption is not warranted. While the amount of centrally cleared OTC derivatives will undoubtedly increase by 2015, many OTC derivatives will not be clearable. We estimate the non-cleared OTC derivatives market will consist of the following:

a) Several larger, relatively broad market segments, including the majority of interest rate swaptions and options (caps, collars, floors), cross-currency swaps, single-name credit default swaps and various types of equity and commodity swaps, will likely remain non-cleared, as they do not fit the eligibility requirements of Central Counter Parties (CCPs).

b) A number of individual sectors (both small and large) of many otherwise clearable OTC derivative product classes will likely remain non-cleared due to a lack of liquidity (and associated lack of valuation/pricing depth) in certain transactions. The lack of liquidity in these areas results from the economic terms (currency denominations, maturities, underlying reference rates, etc.) of such transactions, which are traded less than others.

c) Transactions involving corporations and other non-financial end-users in jurisdictions around the world where such market participants are exempt from clearing requirements will also remain non-cleared...

The IM requirement proposed by the Paper will depend on central clearing being fully implemented in all relevant jurisdictions. At present, the clearing mandate for OTC derivatives (other than futures and options generally, as well as CDS indices and IRS in the US and Japan) has not been implemented in any
jurisdiction. It is not yet clear how efficiently the market for centrally cleared OTC derivatives will function and how quickly central counterparties are able to clear all of the products the Paper assumes they will. It is unclear how market participants will be able to comply with IM requirements if the regulations governing centrally cleared OTC derivatives are not yet promulgated in their jurisdiction, which would significantly increase the OTC derivatives subject to the intentionally harsher IM regime.

The OTC derivatives market has never operated on the basis of a bilateral IM posting requirement. Therefore market participants as well as regulators will need to spend significant time and expend significant effort before a bilateral IM standard is feasible from an operational, regulatory and legal perspective.

Unlike transfers of VM, most market participants do not currently have the operational capabilities to post IM on a bilateral basis, and to the extent such infrastructure is in place, it would need to be significantly overhauled to account for the vast increase in scale the Paper proposes. Many parties in the OTC derivatives markets are also not accustomed to third party custody of any margin, and custodians would need to significantly enhance their operational capabilities to handle the increased IM requirements.

We note that non-centrally cleared OTC derivatives are already subject to, or will under Basel III become subject to, the following seven risk mitigants:

a) A market participant's firm’s own Core Equity Tier 1 (CET 1) Regulatory Capital,
b) Transparency through trade repositories,
c) Daily VM subject to an agreed threshold,
d) Basel 1 Counterparty Credit Risk charges,
e) Basel 2 and Basel 2.5 market risk charges,
f) Basel III Credit Valuation Adjustment (CVA) charges, and
g) Basel III Liquidity Coverage Ratio (LCR) which includes a specific add-on for changes to the mark to market value of OTC derivative portfolios.

We appreciate that the IM requirement proposed in the Paper practically eliminates counterparty credit risk, but it does so at a very heavy cost...

Mandatory clearing of liquid, standardized OTC derivatives will shift a large volume of OTC derivative activity towards centralized clearing, further reducing systemic risk. To the extent that punitive IM levels are motivated by a desire to encourage clearing, this is an ill-conceived measure. Punitive IM would directly harm those critical markets and financial services vital to the real economy such as housing and corporate financing, without necessarily in creasing the likelihood of clearing. Instead, mandatory clearing requirements could achieve this more effectively for swaps for which clearing is appropriate...⁹

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⁹See http://www.bis.org/publ/bcbs242/isda.pdf.