ISDA Safe, Efficient Markets

September 21, 2012

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Re: Canadian Securities Administrators (CSA) Consultation Paper 91-406 on Derivatives: OTC Central Counterparty Clearing (the CCP Consultation Paper)

The International Swaps and Derivatives Association, Inc. (**ISDA**)[1] welcomes the opportunity to respond to the Consultation Paper published by the CSA on June 20, 2012 setting

[1] Since 1985, ISDA has worked to make the global over-the-counter ("OTC") derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 800 member institutions from 56 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers.

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forth the CSA Derivatives Committee's (**Committee**) framework for centralized clearing in the Canadian over-the-counter (**OTC**) derivatives markets. We are pleased to share these comments with the CSA, in addition to our comment letters submitted to the CSA in connection with Consultation Paper 91-401 setting forth the CSA Derivatives Committee proposals regarding the regulation of OTC derivatives (the **OTC Derivatives Consultation Paper**)[2] and Consultation Paper 91-402 setting forth proposals for the reporting of OTC derivatives transactions and the operation of trade repositories[3].

ISDA is actively engaged with providing input on regulatory proposals in the United States, the United Kingdom, Europe and Asia. Our responses to the questions posed in the CCP Consultation Paper are derived in part from these efforts and from consultation with ISDA members operating in Canada and build upon our comments in the January 2011 Comment Letter. Our comments are organized as follows:

- Section I discusses the requirements and prospects for establishing a mandatory clearing requirement for derivatives.
- Sections II through VII consider CCP Consultation Paper Questions #1 - 8 and provide comments on the framework for CCP Clearing proposed by the Committee.
- Section VIII addresses certain other considerations raised by the CCP Consultation Paper. This section will consider CCP Consultation Paper Questions #9 - 12.

I. Mandatory CCP Clearing

ISDA and its members are longtime proponents of swap clearing done in a manner that promotes safety and market integrity. As such, ISDA commends the Committee for its careful consideration of these issues and welcomes further dialogue with the Committee on this letter. Given the efforts being made to increase the use of central counterparty clearing houses ("**CCP**s"), which will profoundly affect the role of the CCP in the broader financial infrastructure, effective CCP regulation, prudential supervision and oversight is critically important. If this is not achieved, CCPs will themselves become a major source of concentrated systemic risk. Thus, it is highly important that comprehensive analysis and consultation occurs on the design of the market structure and the implications for financial stability.

Information about ISDA and its activities is available on the Association's web site: www.isda.org.

[2] Letter from ISDA to the CSA dated January 14, 2011 may be found at http://www2.isda.org/regions/canada/ (**January 2011 Comment Letter**).

[3] Letter from ISDA to the CSA dated September 12, 2011 may be found at http://www2.isda.org/regions/canada/ (**September 2011 Comment Letter**).

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ISDA agrees with the Committee that the adoption of proper requirements relating to CCP clearing will be a key element in addressing the reform of financial markets in Canada to enhance the transparency of markets and the overall mitigation of risks[4]. However, we submit that there are a number of clear exceptions (both in terms of transaction types and participants) that should be incorporated into the overarching regulation enacted. These include the circumstances set out in our comments and response in Sections II through VII below.

As noted in our January 2011 Comment Letter, we urge the Committee to consider the global nature of the markets when creating regulations for OTC derivatives to ensure that such regulations do not restrict the ability of Canada market participants to continue participating in, and remaining competitive in, the global OTC derivatives market. To this end, ISDA cautions regulators against adopting duplicative, overlapping requirements and/or infrastructure where sufficient alternatives exist. For example, regulators should consider whether it is appropriate to establish a Canada-based CCP solution if an already existing CCP based abroad can adequately service Canadian market participants. Regulators should also be cautious not to introduce conflicting, unduly incremental or uncertain requirements and to avoid creating opportunities for regulatory arbitrage.

ISDA welcomes the Committee's proposal to review and recognize (or exempt from recognition) foreign-based CCPs as a priority to ensure that Canada meets its G20 commitments and to develop cooperative regulation regimes with regulators outside of Canada. Given the global nature of the OTC derivatives market, such coordination is essential to effectively establish international minimum risk management standards, avoid regulatory arbitrage, and mitigate systemic risk and adverse spill-over across countries. Diverse and inconsistent requirements between different supervisors will increase costs and make it less likely that robust international standards can be developed. Although the Committee recognizes that it must support and engage in ongoing work with international bodies to set data standards and continue to develop best practices, we add that, for such efforts to be fruitful, there needs to be specific parameters and processes spelt out so that a foreign CCP is not caught by surprise and find itself unable to comply with the location requirements. As you know, a significant volume of CAD IRS is already cleared by LCH and other foreign CCPs in a well-regulated environment. As such, market participants would expect these foreign CCPs to meet the requirements for recognition to be set by Canadian legislators. We cannot over-state the importance to market participants of being able to continue to clear their transactions through foreign CCPs. Any legislation that favors recognition and use of a domestic CCP (rather than market forces driving the choice) will be counterproductive. It will result in fragmentation of trading volumes between different CCPs, thereby reducing netting benefits and increasing margining costs. The domestic CCP will in all likelihood have to charge more for its services as its clearing volumes will be lower. Ultimately, all these increased costs will be passed on to end-users in Canada.

[4] For example, as of June 2011, 50% of the IRS market was centrally cleared, a 138% increase since 2007 contributing to counterparty risk reduction. Refer: http://www2.isda.org/#web-brochure.

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ISDA supports the Committee's proposal to adopt rules for determining which derivatives will be subject to mandatory clearing using both bottom-up and top-down approaches. We agree with the Committee's assessment that a carefully balanced combination of both the top-down and bottom-up approaches to identifying products suitable for mandatory clearing, pursuant to which regulators would be required to work closely with eligible CCPs and market participants (who are the ones most subject to the risks associated with inappropriate clearing) to determine the suitability of subjecting an OTC derivatives product to the mandatory clearing regime, will provide clarity to the market and will ensure consistent risk analysis.

While regulators may consider that it is important to have the ability to directly control the scope of mandatory clearing, the top-down approach has the potential to increase systemic risk as a regulator may not be in the best position to determine the suitability of any particular product for clearing or whether eligible CCPs are sufficiently prepared to provide clearing services in respect of such products. As further referred to below, this determination relates in a large part to such risk management issues as the liquidity of the product and the valuation and margining of the product, which may be more appropriately determined in conjunction with the eligible CCPs and market participants. We would urge that, in addition to the Committee's proposed incorporation of the CPSS-IOSCO's Principles for Financial Market Infrastructures (the "**FMI Principles**") when developing Canada's CCP requirements, due regard be given to the relevant recommendations set out in the OICV-IOSCO paper of February 2012 entitled "Requirements for Mandatory Clearing" ("**OICV-IOSCO Paper**"), in particular Recommendations VIII, IX and X.[5]

Under a bottom-up approach, regulators will be required to consider the merits of any applications from eligible CCPs to expand the mandatory clearing regime to new OTC derivatives products in respect of which such eligible CCPs propose offering clearing services. However, systemic risk may also arise in a bottom-up approach because eligible CCPs may not be in a position to properly consider and address the impact that an extension of mandatory clearing to a new OTC derivative product would have on the wider OTC derivatives market (such as the effect on systemic risk, the implications for market liquidity of the OTC derivatives product and/or whether market participants are sufficiently prepared from an operational and risk

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[5] Recommendation VIII: A determining authority should consider using a top-down approach and may utilize a range of information sources in order to identify products which it considers may be suitable for mandatory clearing.

Recommendation IX: A determining authority should consult with stakeholders as part of its decision-making processes under the top-down approach to allow stakeholders to provide input on whether a product may be appropriate for a mandatory clearing obligation.

Recommendation X: A determining authority should clearly identify and disclose what steps are available to it for products identified under the top-down approach as suitable for mandatory clearing but which are not currently cleared.

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management perspective to clear such products through eligible CCPs). This risk is especially pronounced where an eligible CCP may be set to profit from an extension of its clearing services, since incentives may exist for it to take on more risk than is appropriate. We would urge that due regard be given to the relevant recommendations set out in the OICV-IOSCO Paper, in particular Recommendations IV, V and VI.[6]

Therefore, we believe it very important that any change in the scope of mandatory central clearing in Canada should be made through a carefully balanced combination of the top-down and bottom-up approach, where the regulators would be required to work closely with eligible CCPs and market participants to determine the suitability of including an OTC derivatives product in the mandatory clearing regime. Furthermore, market participants, who are the ones most subject to the risks associated with inappropriate clearing, need to be provided with an appropriate period of consultation to allow them to comment on any potential extension of the mandatory central clearing in Canada under both the top-down approach and the bottom-up approach.

Lastly, as indicated in our previous comment letter, the Committee needs to clearly define the scope of the transactions, entities, trades and markets that are intended to be covered by the regulations in order for the industry to give meaningful comments on proposed rules. The Committee will also have to outline which of its member agencies have jurisdiction and rule-making authority over the various issues outlined in the Consultation Paper. It remains unclear what would be an "OTC derivative" and a "Canadian" derivative or market, which leaves unanswered the question of which products and parties will be covered by the regulations. For example, we need to understand whether the regulations will only cover trades where both parties are acting in the domestic Canadian market or if it will be sufficient for one party to be acting through an office in Canada in order to come under the regulatory regime. Another example is whether a derivative trade by non-Canadian entities that references a Canadian asset will be covered by the CSA regulations.

[6] Recommendation IV: In assessing a mandatory clearing obligation, a determining authority should consider information from a range of sources, including trade repositories.

Recommendation V: In assessing a proposal for a new clearing obligation under the bottom-up approach, a determining authority should conduct a public consultation.

Recommendation VI: Once a determining authority has reached a decision as to whether a product should be subject to a clearing obligation under the bottom-up approach, the determining authority should make the decision publicly available.

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II. Derivatives Subject to a Mandatory Clearing Requirement

Question #1: Do you consider that product characteristics of any OTC derivative asset classes make them eligible for CCP clearing based on the factors set out herein? If so, what asset classes would you exclude, and for what reasons?

Question #2: For which asset classes do you consider CCP clearing is inappropriate or not currently feasible based on the factors described herein, and for what reasons?

Question #3: What are the costs and risks involved in moving particular derivatives or classes of derivatives transactions to CCP clearing that regulators should consider in determining if a derivative should be subject to a CCP clearing requirement?

At the outset, we note that the review of OTC derivatives in order to determine whether to impose a mandatory clearing requirement is, of course, extremely consequential. If the relevant clearing solution fails to establish an operationally sound and robust risk management framework, or captures an inappropriate category of OTC derivatives, the consequences for the CCP and for the market could be significant.

A. Product Characteristics

We would like to refer you to ISDA's submissions to the US Securities and Exchange Commission ("**SEC**") and Commodity Futures Trading Commission ("**CFTC**") on the process for determining which products should be subject to mandatory clearing, copies of which are attached in Appendix 1 to this letter. In brief, in determining whether to impose a clearing mandate on a product, the following criteria should be considered[7]:

(a) Level of systemic risk posed by the product.
(b) Product characteristics (including analysis of complexity, volatility, tail/gap risk and dependency/correlation risk in member cleared portfolios).
(c) Level of standardization of contractual terms and operational processes.
(d) Existing infrastructure framework (such as operational expertise and margining capabilities) in respect of the trading and settlement of the product.
(e) Depth and liquidity of the market for the product, bearing in mind that the market that will be captured by the proposed clearing regime (say with one party booking the transaction in Canada) may be markedly different from the global market for that product.

[7] Also, as we detailed in our January 2011 Comment Letter, the five factors outlined in Section 723 of the Dodd-Frank Act are a good starting point for regulators to take into consideration when identifying contracts appropriate for mandatory clearing in order to best achieve the goals of mandatory clearing and to mitigate adverse effects.

(f) Availability of fair, reliable and generally accepted pricing sources for the product.
(g) Availability of eligible CCPs and the robustness of their risk management systems for the product.
(h) Where only one CCP exists that can clear the product, competition and market issues. This is because allowing a de facto regulatory driven monopoly in clearing a product may distort market incentives.
(i) Degree of certainty as to the legal treatment in the event of insolvency of any CCP or its clearing members.
(j) Costs of submitting the product for clearing which will be passed on to market participants.
(k) Costs for market participants and end users resulting from a potential fragmentation of the OTC derivatives market with respect to such types of products and from inefficient use of regulatory capital as a result of such fragmentation.
(l) Anticipated positive effects on the OTC derivatives market if the product becomes subject to mandatory clearing.
(m) Projected harmful effects on CCPs if the product becomes subject to mandatory clearing.
(n) International regulatory approach towards the product.

In determining the product characteristics of any OTC derivative asset class that makes them amenable to central clearing, we consider that the "sufficient liquidity" requirement ought to be applied very conservatively. We repeat the importance of this, as a CCP must calculate net margin each day and price availability is required to do this. In addition, since this requirement applies for the whole life of the trade price availability must be guaranteed in all market conditions, including stressed markets.

Moreover, further study is necessary to determine if there is sufficient liquidity with respect to each derivative asset class. Certain parameters for liquidity for each product are a minimum number of market makers, frequency of trading (daily) and depth of market (daily trading must be in sizes that are not insignificant). Some products may meet these requirements, or not, depending on tenor. For example, 5-year fixed income swaps may be traded daily in significant sizes but the same swap with a 30-year term may not trade frequently enough to be considered liquid. In addition to having multiple market makers for each cleared product, it is important for a Canadian CCP to be able to manage the risk and collateral around those products in a way that accurately reflects the Canadian markets, and that those market makers who are members of the CCP be required to provide daily valuations to the CCP.

When considering clearability, it is also practical to recognize that the margin model of leading OTC derivatives CCPs employs historical market data to compute initial margin[8]. Where historical data is not available, it will be necessary to perform analysis to verify that the proxies

[8] There should also be minimum standards set for the period of data used and that these calculations are validated with respect to stressed market conditions.

adopted provide a conservative representation of the underlying risk including adverse market conditions.

As stated in our January 2011 Comment Letter, the Committee should also consider the costs of establishing regionally-based CCPs, which may or may not be further bifurcated by asset class, as well as the availability of international CCPs to adequately meet the needs of Canadian market participants. In this regard, it should be noted that if clearing of Canadian dollar-denominated interest rate derivatives increases at international CCPs, this is likely to reduce the viability of centrally clearing in Canada.

Finally, the product that is to be subject to mandatory clearing must be clearly specified. There needs to be clarity on whether that product is subject to the mandate if it is embedded in, or part of a structured derivative transaction. We would submit that it should not be subject to the mandate as the CCP would not be able to clear the transaction as a whole, and requiring clearable portions of the transaction to be cleared would adversely affect the risk profile and economics of the transaction as a whole.[9]

B. Asset Classes Inappropriate or Not Feasible for CCP Clearing

As mentioned above, we submit that there are a number of clear exceptions (both in terms of transaction types and participants) that should be should be incorporated into the overarching regulation enacted. One such example, albeit not the only transaction types that should be exempted, are foreign exchange spots, forwards and swaps. 68% of foreign exchange forwards and swaps are up to 7 days, with another 30.8% being more than 7 days and up to 1 month, thus leaving a mere balance of 1.2% that are more than one month[10]. Hence, these transactions pose settlement risk rather than counterparty credit risk and settlement risk is already dealt with through CLS Bank. Thus, these transactions should not be subject to a clearing or trade execution mandate. This is in line with the proposed reforms in the US and EU and Asian markets like Singapore and Hong Kong.

As another example, we think that there is an insufficient degree of standardization in documentation for equity derivatives at least in the near term. ISDA has recently developed and published new documentation architecture for equity derivatives to facilitate standardization. Even with this, it remains to be seen how much of the product will become standardized. The reason for this is that equity derivatives contain many unique risk allocation provisions which need to be bilaterally negotiated between two counterparties (for example, there are many different events which can occur to the underlying reference asset during the duration of the

[9] We would like to refer you to ISDA's submissions to the US Securities and Exchange Commission and Commodity Futures Trading Commission on proposed rules for product definitions, where we detail which products should be classified as "swaps," copies of which are attached in Appendix 2 to this letter.

[10] Bank for International Settlements' Triennial Central Bank Survey December 2010.

trade (e.g. bankruptcy of the issuer, de-listing, merger or tender offer) under which the counterparties may elect to adjust the trade or terminate). The ability to negotiate and tailor such provisions allows flexibility as to pricing. If market participants are forced to standardize such provisions in order to enable central clearing, this may lead to higher prices and lower liquidity as dealers will have less flexibility to manage or hedge their risk. As a further example, we think that many commodity derivatives are not sufficiently liquid in the near term for CCP clearing. In particular, many energy derivatives, such as contracts for some grades of crude oil, are relatively illiquid. The reason for this is that each grade of crude oil has unique physical characteristics which may or may not be interchangeable with other grades. The result is often unique contractual provisions that need to be bilaterally negotiated between two counterparties. We recommend that regulators provide notice and accept public comments as to whether a contract is appropriate for central clearing, on a contract by contract basis, in order to make the appropriate determination for each contract.

In addition, we would urge that you carefully consider whether the imposition of mandatory clearing in respect of any products, and the timing of such imposition, will negatively impact the ability of market participants to risk manage their businesses efficiently and/or result in increased systemic risk to the OTC derivatives market.

If the market in a certain type of product spans across several jurisdictions, it would be counterproductive to the risk management of such product for each jurisdiction to impose its own mandatory clearing obligation on this product as this may result in the break-up of netting sets among market participants (which such market participants rely on to manage their counterparty credit risk) and a fragmentation of the market in such type of product across each jurisdiction. This may hinder the ability of the market to effectively and efficiently manage its risk in respect of such product.

This may also lead to a reduction in the liquidity of a product, which may in turn result in a reduction in the market efficiency in respect of such product, with the knock-on effect that the costs of such products may increase. These increased costs will inevitably be borne by end users of such transactions in Canada thereby reducing the ability of end users to use derivatives efficiently to manage risk in their businesses and further damaging the liquidity of the Canadian OTC derivatives markets. Given the recognised importance of the OTC derivatives market for the economic development of Canada, this may have an unintended and damaging effect on the continued growth and development of the Canadian economy.

ISDA urges the Committee to consider the existence of mandatory clearing obligations with respect to the proposed products in other jurisdictions and the level of clearing that already takes place for these products (even without the clearing mandate) as well as the size of the Canadian-booked share of the global market to ensure that mandating clearing of these products would in fact result in systemic risk reduction. Moreover, the range of derivative classes that are prescribed to be subject to mandatory CCP clearing should be consistent with the approach taken in the United States and European Union.

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C. Costs Considerations

The implementation costs of building a Canadian OTC derivatives CCP, including its technological and regulatory infrastructure, are substantial[11]. For example, the Hong Kong Exchanges and Clearing ("HKEx") is initially investing HK$180 million on an information technology system and hiring staff for its new CCP clearing division, which will be run independently of HKEx's other CCPs for derivatives and equities[12].There are also substantial on-going costs of operating an OTC CCP. It is has been estimated that the running cost at the Japanese OTC CPP alone are over US$40 million annually, although this figure is still under debate within the industry.

However, the more sizable and on-going cost of moving contracts to CCPs relates to the initial margin, plus guarantee fund contributions, that depend on the amount of contracts cleared. Globally, the direct incremental initial margin and guarantee fund contributions are expected to be large – up to about US$150 billion according to the analysis provided by the IMF[13]. A 2010 JP Morgan report estimated that the total capital cost of all the recently introduced regulatory measures across 16 global banks would amount to about $221 billion[14].

In addition, the fragmentation of multiple CCPs on product and geographic lines means a clearing member ("**CM**") will have to manage their OTC derivatives books on a CCP-by-CCP basis. Such management would be necessary in order to control the amount of collateral the CM will have to provide to each CCP, and their consequent exposure to each CCP. For example, given that the US is characterized by fixed rate mortgages and Europe by pension plan asset-liability management, it is possible that swap dealer participants will be receiving fixed in rates at a US CCP, and paying fixed at an EU CCP. In that case, what was before a balanced rate book becomes very directional at each CCP, motivating collateral and exposure management and the provision of higher rate markets for US cleared swaps relative to EU cleared swaps, thus fragmenting the liquidity of the market as it is today.

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[11] By way of comparison, on March 30, 2011 U.S. Congressman Barney Frank, Ranking Member of the Full Committee, released the following statement regarding "…a yet-to-be-released study by the Government Accountability Office stating that it will cost up to USD$2.9 billion over five years to implement the Wall Street Reform and Consumer Protection Act." Refer: http://democrats.financialservices.house.gov/press/PRArticle.aspx?NewsID=1410

[12] FX Week 05 Jan 2011. Refer: http://www.fxweek.com/fx-week/news/1935100/hong-kong-lawmakers-enforce-mandatory-ccp-2012.

[13] International Monetary Fund (2010) Global Financial Stability Report, available at http://www.imf.org/external/pubs/ft/gfsr/2010/01/pdf/chap3.pdf.

[14] JP Morgan (2010) "Global Banks—Too Big to Fail?" Morgan Europe Equity Research, February 17.

Furthermore, an additional cost for some market participants is the loss of the netting benefits they already obtain on their bilateral contracts within their own derivatives books. For example, a dealer may be getting substantial netting benefits from standardized contracts that are CCP-eligible and non-standard contracts that cannot be centrally cleared, but that are all transacted under the same master agreement. Some dealers argue that the multilateral netting benefits within the CCPs will not be large enough to offset these potential increased collateral needs.

III. Clearing Timeframes

Question #4: Does a deferred submission, be it measured in minutes, hours or days, engender significant counterparty or other risks that would make the imposition of a strict timeframe for submission to a CCP, and the acceptance by the CCP necessary?

ISDA generally supports the timeframe for submission to a CCP proposed by the Committee for most scenarios as set out under Section 5.1 of the CCP Consultation Paper. We recommend further consideration of trades across jurisdictions with significant time zone differences and the high level of trading activity that often occurs late in the business day (i.e., "close of business on the day of execution" could be too tight a timeframe in those cases) before setting a specific timeframe requirement.

We note that the CCP Consultation Paper does not mention whether there will be a transition period when a clearing eligible product becomes subject to the mandatory clearing requirement. We recommend an extended period between a CCP being given permission to clear a product and clearing becoming mandatory on that product, as well as an implementation of timelines for mandatory clearing that follows the introduction of the same in the EU and US. Further, ISDA would recommend transparency during any such period. This will provide important notice and information for affected parties on the relevant margin and default fund calculations, what pricing requirements will be set by the CCP, and how default management will operate.

IV. Exemptions from CCP Clearing

Question #5: The Committee asks whether an exemption from mandatory CCP clearing for intra-group transactions is appropriate, including a description of the risks that they could pose to the marketplace and the costs of migrating such transactions to a CCP.

In addition to product type exemptions discussed in Section II, we submit that intra-group transactions should not be subject to a clearing or trade execution mandate. Intra-group transactions are used for aggregating risks within a group structure so that they can be centrally risk managed more efficiently. Requiring intra-group transactions to be cleared may limit the

efficiency of the intra-group risk-management process. Intra-group transactions simply represent an allocation of risk within a corporate group - they do not increase systemic risk or threaten the safety and soundness of entities under common control. Also, from an operational standpoint, applying a clearing requirement to intra-group transactions would be counterproductive as it is highly likely that one or more of the entities transacting are not group clearing members. In a typical situation, clearing an intra-group trade between entities A and B would generate additional transactions between A and the group CM and B and the group CM, resulting in a significant overhead, additional operational risk, and no clear benefit in enhanced financial stability.

Further, we submit that it is not appropriate to impose margin requirements on intra-group transactions. Margin is necessary as a risk matter to protect against the risk that such entity cannot meet its contractual obligations. There is no need to require margin for transactions between affiliates because any gains or losses do not create risk for the larger entity. Any gain on one entity is an equal and offsetting loss on the other resulting in a neutral position across the corporate group. There is a significant cost in locking up collateral for such intra-group trades (where the credit exposure is intra-group) but this will not result in any net benefit to counterparties.

V. Governance

Question #6: Is it appropriate to ensure that Canadian market participants have meaningful input into operational decisions of a CCP operating in Canada?

Question #7: Do the Committee's proposals relating to corporate governance of a CCP address potential issues relating to conflicts of interest that may arise in the operation of a CCP? If not, what other measures would address such conflicts of interest?

ISDA agrees with the Committee's proposal to incorporate the FMI Principles when developing requirements applicable to CCPs recognized in Canada. ISDA believes that requiring the CCPs to comply with CPSS-IOSCO standards,[15] would ensure that Canada's CCP meet or exceeds international benchmarks for CCP management.

Canadian regulation should require that a CCP legally separates its OTC derivative clearing activities from its other businesses. This prevents the commingling of default and guarantee funds across products. There may be limited circumstances where a combined entity should prevail, including where the entity covers both OTC and listed products with hedging properties. This will ensure that a CCP's OTC derivatives clearing activities are independently managed and there is no conflict of interest or exposure to these activities from its other

[15] CPSS-IOSCO consultative report, 'Principles for Financial Market Infrastructures' March 2011

businesses and that the CCP has dedicated resources to manage its OTC clearing activities, which is particularly important in the event of a default.

At the operational level, best practice CCP risk management starts with stringent requirements to become a clearing member ("CM") in terms of sufficient financial resources, robust operational capacity, and business expertise. We suggest that any CCP solution adopt CM requirements that are clear, publicly disclosed, objectively determined, and commensurate with risks inherent in the cleared products and the obligations of CMs to the CCP. In addition to the requirement that CCPs must adopt corporate governance policies to ensure that an appropriate proportion of board members reflects its diverse stakeholders, the Committee should aim to establish a "level playing field" among market participants that emphasizes that clearing membership should not be discriminatory and should include requirements, particularly financial, that reflect or are commensurate with the risk profile of the CM.

CCPs typically seek to ensure that their CMs are creditworthy by establishing a set of financial requirements for membership. Usually CMs are required to meet, both initially and on an ongoing basis, minimum capital requirements, often stated as the larger of a fixed amount and a variable amount that depends on some measure of the scale and riskiness of the CM's positions with the CCP and in other financial markets. In most cases, membership is restricted to regulated entities that meet regulatory minimum capital requirements. CMs that carry client accounts are often required to meet capital standards that are more stringent than regulatory minimum requirements. Clearing membership should be non-discriminatory: foreign market participants should be allowed to be CMs if they meet the publicly stated CM criteria.

In addition to financial requirements, leading CCPs establish standards of operational reliability for CMs. CCPs typically impose tight deadlines for the submission of trade data and for completing various settlement obligations. The failure of a CM to meet these tight deadlines could significantly increase the CCP's risk exposures to that CM and possibly to other CMs as well. Compliance with operational deadlines is closely monitored on a day-to-day basis. Furthermore, in recent years many CCPs have been paying greater attention to the backup systems that CMs would have available if their primary operating systems were disrupted.

VI. Participant Access

Question #8: The Committee seeks public comment on the relevance of developing rules allowing for access to CCPs regardless of trading venue. Is this of concern in the Canadian marketplace at this time or in the future?

ISDA supports the Committee's proposal to adopt regulations that require CCPs to develop access policies that facilitate fair and open access to the CCP from multiple trading venues and which do not unreasonably prohibit or limit access to its services regardless of how the derivatives transaction is executed. Some examples illustrating why trading venue should not be a factor in whether a CCP accepts a trade for clearing include: (i) the CCP prohibits clearing of

derivatives transacted on a trading venue preferred by Canadian participants; (ii) the CCP accepts trades from only one particular trading venue and that trading venue does not accept trades from Canadian participants; and (iii) the CCP gives preferential pricing to a particular trading venue and that trading venue is not accessible to, or preferred by, Canadian participants.

We believe that market participants who wish to transact and clear a particular derivative transaction should be allowed to decide whether or not to trade on an organized trading platform. While increased use of trading platforms will bring benefits for particular derivative product types that are suitable for such venues, we believe that mandatory or incentivized use of such platforms where such products are not suitable to their use will not reduce risk and will negatively affect market participants and markets in general. As the G20 recognized, it is not always appropriate for derivatives trading to take place on organized trading platforms even if the transactions have become relatively standardized. There are many differing models for negotiating and executing a derivative transaction and market participants should retain a choice between these different models to reflect their particular needs.

VII. Reporting

Question #9: The Committee asks for comment on the type of information that a CCP should provide and that should be made publicly available.

While ISDA supports the Committee's objectives of improving market transparency, we caution the Committee against mandating duplicative efforts. The rationale for imposing a reporting mandate is to improve transparency particularly to regulators, thus enhancing their ability to assess systemic risk and conduct resolution activities in a worst case scenario. We agree that in addition to transactions booked in Canada, a Canadian regulator would be interested for example in transactions booked in overseas branches of a Canadian-incorporated bank. Nevertheless, we submit that it would still be appropriate to impose a reporting mandate only for transactions booked in Canada and for the Canadian regulators to co-ordinate with other global regulators to ensure that they have access to relevant data required to be reported elsewhere. We believe that this would be more efficient and would reduce the risk of double-counting of reported transactions.

ISDA agrees that risk management must be at the core of the CCP's operations and believes transparency of CCP risk management practices is essential to reduce systemic risk to ensure the safety of both the CCP and the CM, as it may be of particular relevance to the CM's own contingency plans. Accordingly, in incorporating the FMI Principles, the Committee should ensure compliance with Principle 23, which highlights the need for transparency in the CCP"s management of risk. Examples of areas where transparency should be mandated include:

- Organisational requirements: risk, default management, advisory committee documents describing committee roles & responsibilities, scope of decision-

making authority, composition and nomination process, allocation of fiduciary responsibilities and frequency of meetings;

- Clearing member requirements and ongoing monitoring: documentation of credit rating methodology and framework and ongoing review process for individual clearing members, as well as, composition and exposure to of CCP member base;

- Initial margin and guaranty fund methodology: standard reporting - regulatory capital calculations;

- Composition/value of initial margin and guaranty fund; and

- Default procedures.

VIII. Further Questions for Public Comment

Question #10: Generally, the Committee has endeavoured to follow international recommendations in the development of the recommendations for Canada in this paper. Are there recommendations that are inappropriate for the Canadian market?

Question #11: Are there changes to the existing regulatory framework that would be desirable to accommodate a move to CCP clearing?

Question #12: Do you consider that any changes need to be made to Canadian law to facilitate the efficiency of OTC derivatives clearing, either through a domestic or a foreign CCP? If so, what changes and for what reasons?

We do not comment on specific Canadian laws and its existing regulatory framework, but we recommend that the Committee consider the importance of limiting any clearing mandate to appropriate products and participants as discussed above.

Nonetheless, ISDA believes that a desirable change to existing regulatory frameworks, which does not yet exists in the regulatory frameworks in the United States or European Union, is the introduction of a plan for the mitigation of CCP stress and the procedure for resolving a failing CCP. This area is also not addressed in the proposed international standards for "financial market infrastructures" recently promulgated by CPSS-IOSCO[16]. However, ISDA wishes to emphasize that it is imperative that a comprehensive plan to address CCP stress is agreed ex ante. A credible CCP resolution plan is vital for financial stability, particularly given that a CCP may be the principal venue for clearing a product. In the absence of adequate continuity planning, CCP stress might preclude the functioning of the market for that product or the functioning of the entire financial system.

[16] CPSS-IOSCO consultative report, 'Principles for Financial Market Infrastructures' March 2011

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To facilitate the efficiency of OTC derivatives clearing, Canadian regulation should require that a CCP legally separates its OTC derivative clearing activities from its other businesses. As previously mentioned, this prevents the commingling of default and guarantee funds across products. The Committee should also ensure that a CCP's OTC derivatives clearing activities are independently managed, there is no conflict of interest or exposure to these activities from its other businesses and that the CCP has dedicated resources to manage its OTC clearing activities, which is particularly important in the event of a default.

Second, CMs should only be able introduce risk commensurate with their capital position. Further, entities that become CMs of OTC derivatives CCPs must have the ability to participate in the CCP default management process including the ability to bid for the portfolios of other CMs of the CCP. If a CCP admitted a CM (or a group of CMs) that was unable to participate fully in default management of the product it clears, there could be significant negative repercussions for the CCP and for the market. In particular, the unexpected failure of one or more CMs to participate in default management at a moment of severe stress for the CCP would reduce available resources and liquidity, place heightened burdens on other CMs, and reduce the likelihood that the CCP's risk management process would be effective. Moreover, for there to be the right level of incentives for active participation in default management, there needs to be enough 'skin in the game', which suggests not only that that the default fund needs to be allocated proportionally to risk introduced; but also that the default fund to initial margin ratio should reflect the estimated percentage of market risk remaining following the completion of the default management hedging phase.

* * *

ISDA appreciates the opportunity to provide its comments on the CCP Consultation Paper and looks forward to working with the Committee as it continues to consider the issues outlined in the CCP Consultation Paper. Please feel free to contact me or ISDA's staff at your convenience.

Sincerely,

Katherine Darras

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