THE FINANCIAL SERVICES ROUNDTABLE

Financing America's Economy

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By Electronic Mail (http://comments.cftc.gov; rule-comments@sec.gov)

May 12, 2011

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

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Regarding: Title VII Implementation Challenges

Dear Mr. Stawick and Ms. Murphy:

The Financial Services Roundtable[1] respectfully submits these comments with respect to the implementation by the Commodities Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission (the "SEC," and together with the CFTC, the "Commissions") of the requirements of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[2]

Title VII requires the Commissions to take an unregulated, global, opaque, multi-trillion dollar industry, with a vast number of participants who have varying degrees of involvement and sophistication, and a range of products from very simple interest rate and currency swaps to complex bespoke leveraged structures, all generally negotiated on a bilateral basis; and transform it into a fully regulated, exchange-traded, transparent, standardized and centrally cleared market, while navigating around a rapidly evolving system of non-US regulatory changes that is developing concurrently and the broader US regulatory developments to implement other provisions of the Dodd-Frank Act. It is a monumental task.

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[1] The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $92.7 trillion in managed assets, $1.2 trillion in revenue, and 2.3 million jobs.

[2] Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376, 1897 (July 21, 2010).

Given the vast number and variety of issues before you, in this letter we focus only on practical issues and approaches that may assist the Commissions to balance the sometimes competing goals of implementing sweeping changes to the swap markets and preserving robust and liquid markets through the transition.

In preparing our comments, we have identified the following as some of the key challenges for the Commissions and the implementation process:

a. How to develop a consistent, comprehensive set of rules that are coordinated across both Commissions and that reflect ongoing regulatory developments from other agencies

b. Resource constraints within the Commissions and across the industry, including limits on the availability and capacity of appropriately skilled personnel, limits on technology, and the wide variance in the availability of such resources to market participants

c. The lack of established infrastructure entities in key areas, such as swap execution facilities and swap data repositories

d. The need to significantly modify the policies and procedures of existing infrastructure entities, such as derivatives clearing organizations and clearing agencies, where such modifications are rate-limiting steps for industry compliance

e. The need for industry participants to connect to infrastructure entities and each other, both through contractual arrangements and technological linkages

f. The inherently sequential nature of certain aspects of the implementation, and the need to ensure that necessary preconditions to implementation are in place, while not allowing deliberate delays in satisfying those preconditions to prevent more comprehensive implementation

g. The varying degrees of familiarity (or lack thereof) among market participants with operating under a supervised regulatory structure

h. The international scope of the markets, including the desire to preserve the availability of hedges to US entities and to prevent the movement of affected businesses offshore

i. The need to consider legacy swaps while acknowledging that the lack of standardization makes reporting and other issues more difficult for these swaps

j. The involvement of entities that may not have traditionally played a significant role in the swap markets, such as independent custodians; and

k. The effects on the core economics of swap activity as a result of these changes, including margin and capital requirements, and whether such effects will undermine liquidity.

In addition, we believe there are very significant systemic risk issues that may result from the implementation, including the risks of making mandatory the use of an untested system and the risk that the pressures of a mandatory clearing system, in which clearing entities are placed in a gatekeeper role while being charged with providing open access, may prove to be incompatible with prudent risk management by such entities. We recognize that mandatory clearing is a core aspect of the system to be established under Title VII, but we again caution that such requirements should be implemented in a way that includes both a careful testing of the infrastructure and the ability of the Commissions to suspend such requirements if necessary to alleviate systemic risk.

Recommendations

We believe the process for implementation and the timing of implementation deadlines need to be fully informed by consideration of these challenges. In the remainder of the letter, we set out some very specific suggestions and examples that we hope will be helpful to you as you move toward final rulemaking.

A. Take the time to achieve real coordination in rulemaking

We have commented previously on the proposed order of adoption of final rules by the CFTC, and the need to have the product definitions made final at the beginning, rather than the end, of the process. In fact, the two proposals that we recommend for earliest adoption are definitional and must be jointly adopted by the CFTC and the SEC, confirming their consistency. We encourage the Commissions to issue joint final rules in other areas in which they are not required to do so, such as for SEFs and SB SEFs, to ensure that entities with dual registrations do not find themselves operating under competing regulatory regimes. In addition, where other regulatory agencies are adopting rules on the same subjects that the Commissions are addressing, such as the prudential regulators' rules on margin, we likewise encourage the Commissions to effect a joint rulemaking.

We note that the Commissions have indicated an intention to achieve a significant degree of alignment between the rules, but there are currently significant differences that do not seem directly correlated to product differences. The process of jointly adopting final rules would ensure consistency on the most critical points. It would also ensure that final rules are adopted at the same time, so that market participants do not have to bear the cost of complying with one set of rules before they know whether their actions will be consistent with the other rules to which they will be subject. We urge the Commissions to work together and with other regulators to ensure that an already complex process is not further complicated by the possibility of inconsistent regulations implemented on divergent schedules.

B. Disaggregate elements of different sets of rules to allow incremental adoption

The Commissions' rule proposals are grouped by topic or statutory section, which is logical in terms of providing a comprehensive picture of the proposed regulatory system. In terms of implementation and effective dates, however, it may be prudent to have different portions of a single rulemaking proposal take effect at different times and with due consideration of steps that are preconditions to other steps. For example, we believe that the Commissions

achieve a significant portion of the goals of requiring a chief compliance officer (CCO) by mandating the relatively swift appointment of the CCO. After the CCO is appointed, however, he or she must be given time to do the job of designing, implementing and testing the compliance system. Thus, the requirement to hire a CCO could have a relatively short implementation period, but the chief compliance officer should then be given a very extended period of time before the effectiveness of any certification requirements. In other words, the CCO should be allowed to do his or her job of establishing the compliance system before becoming subject to onerous requirements to report on that system, or liability for its proper functioning.

Similarly, reporting poses one of the greatest technological challenges given the existing non-standardized, bespoke, bilateral markets. The move toward standardized products traded on central markets and centrally cleared will make that increasingly feasible, but the level of transparency the Commissions desire is ultimately an end result of a fully functioning new system, not a cornerstone of its development. At the same time, we recognize the Commissions' desire for greater regulatory transparency with respect to the existing swap market. We recommend that the Commissions approach the reporting requirements incrementally. We believe, for instance, that it should be relatively easy for each participant in this market to prepare a report that indicates the aggregate notional amount of swaps it has outstanding, subdivided by major category (e.g., interest rate, currency, commodity), and the identity of any counterparty representing 5% or more of its open positions by notional amount in that major category. Such reporting would provide the Commissions with significant new insight into the swap markets without imposing a significant reporting burden or providing data that will require complex analytics to evaluate. We therefore recommend that the Commissions consider imposing such a macro reporting requirement with a relatively short effective date, and provide extended time periods, and sequential targets, for implementation of more comprehensive reporting.

Trade documentation requirements are another example where disaggregation may be advisable. For instance, most participants should be able to comply relatively quickly with the CFTC's proposed requirement that swaps shall be "in writing and shall include all terms governing the trading relationship between the swap dealer or major swap participant and its counterparty, including, without limitation, terms addressing payment obligations, netting of payments, events of default or other termination events, calculation and netting of obligations upon termination, transfer of rights and obligations, governing law, valuation, and dispute resolution procedures."[3] Documenting credit support arrangements will take more time, as will arranging tri-party custodial arrangements where applicable. Moreover, as we will note in a separate comment letter, we believe the CFTC's proposals requiring agreement on valuation methodology raise significant issues. To the extent any portion of those proposals is retained in a final rule, they may require lengthy research, analysis and negotiation and will be a limiting factor on implementation. We therefore suggest a longer implementation window for the aspects of the trade documentations rules that would represent a significant shift from current industry best practices.

[3] 76 Fed. Reg. 6715, 6726 (February 8, 2011)

The following list contains a number of other suggestions as to where some portion of a rule might precede other portions of a rule. This list is intended to be illustrative only, and is by no means comprehensive. We are not commenting on the desirability of this approach or whether it is consistent with achieving the Commissions' goals, but offer these merely to provide a broader range of examples in which the disaggregation of implementation deadlines for proposed rules might allow portions of Title VII to be implemented more quickly while allowing adequate time and slower implementation for more complex developments. For instance:

- Recordkeeping may rely on internal resources, and therefore may be able to be implemented more quickly than reporting that requires interfaces with third parties;
- Reporting by providing copies of existing documentation can be completed more quickly than reporting that requires such documentation to be broken into separate reportable data fields.
- End of day price reporting can be implemented more quickly than real time price reporting.
- Central clearing may be available for products before clearing organizations are in a position to meet the CFTC's timing proposals for moving completed trades into clearing.
- SEFs may be able to have functional trading platforms before they have the ability to move trades automatically into central clearing or report such trades to swap data repositories.

C. Phase in compliance among different categories of market participants and different products

The Commissions have asked whether a phased approach to implementation would be helpful, and we support the idea of an approach that recognizes the varying levels of sophistication, resources and scale of operations within a particular category of market participant. For instance, as we have noted, it will be difficult for swap dealers that are not clearing members to establish the necessary interfaces to support a clearing function until the clearing members on which they rely have done so.[4] Smaller dealers also have more constrained resources, smaller compliance staff and a greater reliance on external vendors for critical systems and other support than do large dealers. At the same time, larger dealers may face challenges given the scale of their operations, especially in areas like renegotiating customer agreements that will not benefit from economies of scale.

We also believe that implementing regulations on a product-by-product basis would reduce the risk of significant market dislocation during a transition period. For example, certain credit default swaps that are already reported to a trade information warehouse, are highly standardized, and are being regularly submitted for central clearing (such as dealer to dealer

[4] Similarly, reporting and recordkeeping requirements for end-users should be phased in only after their swap dealers are in a position to guide them through the process.

trading of standardized CDS indices) may be a natural choice with which to confirm that systems are operating appropriately before expanding regulatory requirements to other classes.

D. Acknowledge that limited resources, the scope of new regulations and competing regulatory priorities will lead to longer implementation times than if such regulations were adopted in isolation.

The scale and scope of the changes to the financial regulatory system as a result of the Dodd-Frank Act are unprecedented, and compliance departments, lawyers, information technology support teams, treasury groups, investment managers and others must prioritize and implement many regulations concurrently. Moreover, even when final regulations are adopted, it will take a significant amount of time to read, analyze, and develop an implementation plan for such regulations, all of which will have to occur before implementation itself can begin. We note that the CFTC has frequently discussed the 31 rulemaking teams that have been involved in developing the proposed Dodd-Frank regulations, and the extraordinary amount of effort that has been involved in these endeavors. For entities that are likely to be affected by a large portion of the new rules, establishing new compliance policies and procedures and changes to governing documents may well be equally daunting. We assume, moreover, that the Commissions would wish such policies and procedures to be developed or modified in a careful and analytical manner, rather than through blind transcription.

The amount of time needed to implement one rule in isolation is different from the amount of time needed to implement that one rule in tandem with dozens of other rules that must be implemented concurrently, often by the same personnel and utilizing the same resources. Technology imposes additional constraints, in that it may not be possible for multiple personnel to be working on a single system at the same time. The Commissions must consider those resource constraints in evaluating transition deadlines. For instance, if there are a dozen rules that would each take about a month to implement in isolation under normal circumstances, it is unrealistic to expect all twelve rules to be implemented one month from passage of final rules. Whether it would take a year to implement all twelve, or some lesser period such as six or nine months, would depend on resource constraints and the extent to which compliance with one rule is a necessary precondition to commencing compliance activities for the next.

The SEC has recently extended the implementation deadlines for several final rules, and we support the flexibility the SEC has shown in responding to market concerns that implementation schedules did not allow sufficient time for appropriate testing of new systems. We believe that such extensions should be granted generously with respect to Title VII compliance, but we also believe the Commissions should establish clear priorities to guide participants, for instance by establishing staggered deadlines even for matters that are not sequentially dependent, given the resource constraints that will apply to many market participants.

E. Consider the inherent sequencing of implementation steps in establishing deadlines

Effectiveness dates need to recognize the intrinsically sequential nature of certain implementation aspects and the extent to which each party in the process may be dependent on

others in implementing these rules. We appreciate that the industry has been evaluating and preparing for the implementation of Title VII, but those preparations have been limited by the lack of final rules (and in some instances, such as margin requirements and customer protection, by the lack of proposed rules). We offer two examples of these intrinsic sequencing issues, while noting that there are many other regulatory requirements that will require such sequential implementation:

<u>Swap dealer implementation (macro)</u>

- *Determination of status.* Market participants that believe they may be swap dealers or major swap participants will need to determine their status under the final rules and whether registration will be required *before* beginning the registration process. For many market participants, such a determination will depend on, among other things, the final *de minimis* exemption, final levels for "substantial exposure," the effect of affiliate positions on major participant status, breadth of the exemption for insured depository institutions in connection with loans and the standard for "highly leveraged." Given the regulatory burden imposed on entities that will fall within these categories, we believe that those entities that are unsure of their status will not commence regulatory implementation until they know definitively whether they are required to register. For many entities, especially those who have never been subject to prudential regulation, we believe this may take [one to two months] after the issuance of final rules

- *Registration.* Section 731 of the Dodd-Frank makes it unlawful for an entity to act as a swap dealer or major swap participant unless such person is registered as such. The Commission has already acknowledged the sequencing issues inherent in requiring swap dealers to certify compliance with core principles and other requirements before the effective dates of the rules with which compliance would be required. Swap dealers should only have to certify compliance with core principles and other requirements *after* such requirements have become effective. We support a temporary registration process with applications effective on filing to prevent market disruptions. At most, such temporary registrations should require no more than a commitment to use good faith efforts to comply with all relevant requirements by their effective dates.

- *Establishing or modifying compliance manuals, policies and procedures.* Swap dealers will have to prepare or update compliance manuals, educate and train their personnel, evaluate and modify existing procedures or policies as needed to accommodate new regulations, and consider effects on internal audit functions and reporting/supervisory structures. Moreover, at least some of this activity will need to be completed *before* the systems work for the enterprise can begin so that those designing the systems modifications have a clear understanding of the policies and procedures those systems will need to support. The amount of effort involved in updating policies and procedures and the amount of time necessary to accomplish this will depend on the scale of the derivatives business, the extent of existing compliance structures and the experience of management and other personnel in establishing a compliance regime.

- *Systems implementation.* Entities that determine they are swap dealers or MSPs will have to evaluate final regulations as they relate to reporting and recordkeeping, audit trail and other systems issues, disaster recovery plans, systems to flag swaps subject to a mandatory clearing and/or exchange trading requirement and to monitor compliance with position limits and interfaces with other market participants, such as DCMs, DCOs, SEFs and SDRs, to the extent such interfaces have not already been established. They will have to evaluate existing systems capability and identify necessary modifications (including legal entity identifier and similar requirements, if adopted), develop a work plan, implement system changes, and test the systems. A large portion of the internal systems work will need to be completed and tested *before* any interfaces with other entities can be established and tested, and any implementation schedule should reflect the sequential nature of technology changes.

- *Reporting.* Much of the systems work will need to be completed *before* reporting requirements take effect, at least with respect to any requirements that cannot be handled as part of GAAP reporting at an enterprise level. Much of this work will also be dependent on the nature of the systems and capabilities of swap data repositories, clearing organizations and other entities that may play a role in reporting compliance. Swap data repositories thus need to provide clear guidance to swap dealers and sufficient time to implement such guidance *before* swap dealers become subject to the reporting requirements.

  In addition to the on-going reporting requirements that will be established by regulation, swap dealers and MSPs will be required to report the terms of all legacy swaps. The amount of effort involved will depend on the definition of a "swap" (including whether it encompasses bilateral agreements that are not in the form of ISDA agreements), the number of swaps to which the entity is a party, the extent to which records have been maintained in a well-organized fashion, and the form of those records. Records existing only in physical form will be more difficult to deal with than those in electronic form. Another factor is the extent to which the reporting obligations require some form of breakdown of the economic terms of bespoke swaps.

- *Interfaces with other infrastructure entities*. The new regulatory system is going to require connectivity among many newly formed, newly regulated or differently regulated entities, and agreements, membership interests, trading privileges or other relationships or interests will have to be established as necessary to act in compliance with the regulations. These entities will have to establish their requirements, forms and systems specifications *before* swap dealers can enter into appropriate agreements and systems interfaces, delaying the time by which swap dealers will be in a position to trade on SEFs and centrally clear their trades.

- *Updating customer account agreements and establishing custodial accounts*. Swap dealers will need to have compliance policies and procedures, and will have to know what will be required of them by clearing organizations, clearing members, SDRs,

SEFs and independent custodians *before* they will be able to finalize customer agreements, custodial agreements, and updated trade documents. Swap dealers will then have to go through the process of rolling out new agreements to hundreds or thousands of customers.

- *Product diligence*. Clearing organizations will have to have defined the terms and documentation for cleared products *before* swap dealers will be able to evaluate how those products differ from the bilateral swaps they have traditionally entered into, and what effects such changes have on the effectiveness of their hedging or the economics of their investments. Although we recognize that major dealers have been involved in extensive discussions with central counterparties with respect to these terms, smaller dealers who are not clearing members have had less opportunity for ongoing assessment.

<u>Revised risk management and financial integrity standards for derivatives clearing organizations and clearing agencies.</u>

- Clearing organizations should implement governance requirements, including forming a compliant board of directors, appointing a CCO, establishing required conflicts of interest policies and forming a risk committee, *before* developing definitive risk management policies and systems. We recognize that such organizations may be engaged in risk planning even before the Commissions adopt final rules. However, the Commissions have indicated that balanced boards, conflicts of interest policies and other governance requirements will facilitate the establishment of a fair and open clearing system. If the Commissions' concerns about existing governance structures have validity, then the Commissions' goals will not be well-served if the central aspects of the new system are determined before the governance requirements take effect.

- Clearing organizations should have their risk committees establish risk management systems, including margin requirements, guarantee requirements and financial responsibility standards for clearing members *before* the legal team and CCO revise by-laws, operating manuals and forms of clearing member agreements to reflect these new risk management systems, financial responsibility standards and other fundamental compliance aspects. Compliance policies and procedures and key legal documents should fully reflect the clearing organization's risk management determinations, which means that they should not be drafted until those risk management determinations take shape. The clearing organizations and their clearing members should only finalize new clearing membership agreements after these policies, procedures and legal documents have been completed.

- Clearing organizations' technology teams should establish and test their systems to reflect risk management determinations *before* working with clearing members to develop and test appropriate interfaces or modifications to existing interfaces. Clearing members should have functional and tested systems in place with the relevant clearing organization *before* establishing, modifying or testing further interfaces with swap dealers, other intermediaries and end-users.

- Clearing members should establish appropriate form agreements, and negotiate those agreements with swap dealers, other intermediaries and customers that will not be direct clearing members, only *after* the clearing organizations have revised their policies, procedures and agreements, to ensure that these new agreements appropriately capture the terms and conditions of the clearing organization's policies and structures.

- Swap dealers and other intermediaries should establish appropriate form agreements, and negotiate those agreements with their clients, only *after* they understand what will be required of them by their clearing members.

F. Avoid overburdening compliance personnel and systems in a way that creates systemic risk

One of the factors contributing to the financial crisis was arguably the expansion of the securitization markets beyond the oversight capacity of those with the relevant expertise, coupled with a fairly steep learning curve. It is easier to think of the securitization markets overheating than to think of the regulatory and compliance infrastructure of the economy overheating, but the same factors potentially come into play: a surge in activity, rapid development of new structures of increasing complexity, capacity constraints among those with appropriate expertise, and insufficient time to adequately train new personnel given the degree to which they must be brought up to speed not only on new developments but also on existing structures. If implementation occurs too rapidly, it will lead to mistakes—potentially critical ones. It is essential that the implementation process be managed in such a way that it is not itself a cause of systemic risk.

G. Consider timing and financial implications of establishing interconnectivity among multiple infrastructure entities

Key infrastructure entities, such as SEFs, do not yet exist; existing infrastructure entities such as DCOs and DCMs do not have the connectivity the Commission proposes and transact in a limited range of products; and these factors, combined with the elimination of an exclusive vertical integration system between trading markets and clearing organizations, potentially create a continually shifting web of interconnections that will have to be established and maintained for each new participant or product, creating timing and other issues. The rule proposals seem to contemplate that, once the new regulatory system is effective, the necessary new interconnections can be established essentially instantaneously. We do not believe that to be the case. When a new SEF or DCO does begin operations, or adds new products, there are practical considerations in terms of the timing on which other parties can be required to interface with them. Consider, for example, a SEF that, at the time of registration, plans only to trade certain credit default swaps and has spent an extended period of time before registering developing a fully compliant system with the one DCO that clears those credit default swaps. If another DCO decides to also clear those swaps, will the SEF be forced to establish connectivity with that new DCO? What if the SEF has the resources to run its business with the existing DCO, but will no longer meet its financial resource requirements if it has to invest in a significant project to bring on board a new DCO? If the SEF and the DCO cannot reach an agreement on key terms, or make their systems work together, what happens? And how long will other market participants

have to onboard a new DCO so that they can provide the choice to their customers that is contemplated? We believe the implementation rules should contemplate (i) an extended transition period to allow market participants to catch up with each new entity that enters the market or extends its product offerings, and (ii) some form of hardship exemption or resolution process to address real problems that may arise from the introduction of new entities.

H. Ensure that systems are functioning before their use becomes mandatory

Although we recognize that central clearing, exchange trading and transparent reporting are core aspects of the new regulatory system, they require a web of interconnections that will take time to establish and test, and their use should not become obligatory until such establishment and testing is complete. As discussed above, there are numerous sequential steps that must be completed before these systems are fully functional, and a very significant investment that will have to be made to bring the new system to that point. We cannot express strongly enough our view that this should not be rushed.

I. Do not extend new regulations in a way that would require changes to the substance or documentation of legacy swap transactions

The existing swap markets are unregulated, and their participants have not been required to adhere to substantive or recordkeeping requirements prior to the adoption of the Dodd-Frank Act. In addition, modifying existing legacy trades is a very different process than making forward-looking changes, and may, among other effects, create significant accounting issues or alter key economic aspects of the swap relationship. We believe that any effort to alter the terms or documentation of existing swaps would be resource intensive with potentially significant negative consequences for entities using hedge accounting. And it would be a distraction from the primary goal, which is to launch a new, more transparent, safer system for swap transactions. We recommend, therefore, that the new regulations apply only on a prospective basis.

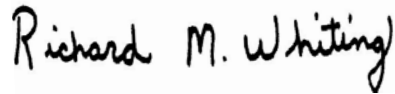
J. Consider the financial implications of margin and capital requirements and allow adequate time for market participants to address these issues

Capital and margin requirements may require fundraising activity and may lead to significant changes in available cash resources that will have broader financial repercussions for affected organizations, including end-users. Swap dealers or major swap participants that need to conduct a capital raise to meet regulatory capital requirements will need time to complete such a process, which may be affected by market conditions and by competing efforts by industry participants. Requirements to segregate margin and prohibitions on rehypothecation may lead to significant liquidity constraints for many counterparties. Moreover, because the proposed regulations for capital and margin are coming late in the process, market participants will have had less time to evaluate the broader financial repercussions for their businesses. We believe these are real concerns that may affect the viability of businesses and their willingness to continue their market roles. We believe the implementation plan should recognize the significance of these issues and allow market participants sufficient time to revise their financial planning to accommodate them.

Conclusion

We appreciate the opportunity to express our views on these extremely complex issues. We are confident that the Commissions will adequately address the areas of specific concern that the Roundtable has described above. If you have any questions about this letter, or any of the issues raised by our comments, please do not hesitate to call me or Brad Ipema, the Roundtable's Senior Regulatory Counsel, at (202) 589-2424.

Sincerely,



Richard M. Whiting
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