July 13, 2020

By Electronic Submission

Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
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Re: Swap Clearing Exemption Requirements (RIN 3038-AE33)

Ladies and gentlemen,

Better Markets, Inc. ("Better Markets")[1] appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("CFTC") proposed expansion of "financial entity" exemptions from the swaps clearing requirement.[2] The CFTC's proposal would exempt from the clearing requirement certain swaps executed by certain categories of financial entities that otherwise would not be eligible to rely upon the explicit, statutorily permitted exclusions from the "financial entity" definition under section 2(h)(7)(C)(ii) of the Commodity Exchange Act ("CEA").[3] For the reasons discussed below, this extra-textual expansion of the CFTC's statutory authorization to exclude certain financial entities from the swaps clearing requirement would be unnecessary and detrimental to the derivatives reforms implemented in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act").[4] Indeed, it would undermine the G20 and Congress' core commitment to reduce counterparty credit risk throughout the global financial system by requiring most, if not all, financial institutions to clear standardized swaps through derivatives clearinghouses.

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[1] Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americans' jobs, savings, retirements, and more.

[2] CFTC, Swap Clearing Requirement Exemptions, 85 Fed. Reg. 27955 (May 12, 2020), available at https://www.cftc.gov/sites/default/files/2020/05/2020-08603a.pdf.

[3] Under CEA section 2(h)(7)(C)(i), the "financial entity" definition includes, among others, any "person predominantly engaged in activities that are in the business of banking, or in activities that financial in nature, as defined in section 1843(k) of title 12." 7 U.S.C. § 2(h)(7)(C)(i). However, CEA section 2(h)(7)(C)(ii) requires the CFTC to consider *whether* to "exempt small banks, savings associations, farm credit system institutions, and credit unions, including depository institutions with total assets of $10 [billion] or less; farm credit institutions with total assets of $10 [billion] or less; or credit unions with total assets of $10 [billion] or less" from that definition. 7 U.S.C. § 2(h)(7)(C)(ii). The CFTC has granted exemptions pursuant to CEA section 2(h)(7)(C)(ii). Notably, the financial entities contemplated by the present proposed exemption would not be eligible for that statutorily authorized exclusion from the "financial entity" definition (and therefore the clearing requirement). See Section II below.

[4] Pub. L. 111–203, 124 Stat. 1376 (2010).

I. The Dodd-Frank Act mandated the clearing of certain standardized swaps by most, if not all, financial institutions to strengthen industry risk management practices and transition over-the-counter swaps markets to a transparent, multilateral, competitive, fair and open market structure.

Financial entities and various categories of end-users enter into standardized over-the-counter ("OTC") swaps to address or assume various risks. As revealed during the 2008 financial crisis, however, even these standardized OTC derivatives can exacerbate financial markets stresses, facilitate trading abuses, and increase operational, liquidity, market, credit, and other risks. For example, because OTC derivatives depend on and reinforce connections between institutions, markets, and instruments, they also carry the potential to transmit significant risks across such institutions, markets, and instruments. In particular in extreme market conditions, OTC derivatives markets may perversely increase risks they are meant to reduce, or exchange certain types of risks for others, and spread liquidity pressures and losses across a concentrated number of market participants. This occurs, in part, due to the bilateral nature of the OTC derivatives markets, informational asymmetries intrinsic to the dealer-dominated OTC derivatives market structure, governance and risk management incentives and insufficiencies, and regulatory differences or gaps permitting derivatives activities in less regulated or unregulated markets and jurisdictions that permit excessive unmargined leverage.

To address these and other OTC derivatives market deficiencies most obviously exposed during the 2008 financial crisis, the U.S. and the rest of the G20 agreed to prompt, coordinated implementation of OTC derivatives markets reforms. Specifically, in the G20 Leader's Statement in the September 2009 Pittsburgh Summit,[5] the G20 agreed to three core commitments to improving the global OTC derivatives markets:

- All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and **cleared through central counterparties** by the end-2012 latest;
- OTC derivative contracts should be reported to trade repositories; and
- Non-centrally cleared contracts should be subject to higher capital requirements.

In addition, in the 2011 Cannes Summit Final Declaration, the G20 agreed to cooperate more closely to "avoid loopholes and overlapping regulations" and added margin requirements on non-centrally cleared derivatives to the OTC derivatives reform commitments.[6] In the years following the 2008 financial crisis and these G20 commitments, the CFTC and U.S. banking and securities regulators led the world in implementing a comprehensive regulatory framework reforming the OTC derivatives markets. Those reforms addressed each of the G20 commitments but most relevantly, took immediate steps to push a

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[5] See G20 Declaration of the Summit on Financial Markets and the World Economy, The White House President George W. Bush, (Nov. 15, 2008), available at http://www.fsb.org/wp-content/uploads/pr_151108.pdf (stating that supervisors and regulators must "build[] on the imminent launch of central counterparty services for credit default swaps (CDS) . . . [to] speed efforts to reduce systemic risks of CDS and over-the-counter (OTC) derivatives transactions; insist that market participants support exchange traded or electronic trading platforms for CDS contracts; expand derivatives market transparency; and ensure that the infrastructure for OTC derivatives can support growing volumes"); See also G20 Leaders' Statement, the Pittsburgh Summit (Sept. 24-25, 2009), available at http://www.fsb.org/wp-content/uploads/g20_leaders_declaration_pittsburgh_2009.pdf. These commitments have been affirmed numerous times since 2009.

[6] Cannes Summit Final Declaration—Building our Common Future: Renewed Collective Action for the Benefit of All (Nov. 4, 2011), available at http://www.g20.utoronto.ca/2011/2011-cannes-declaration-111104-en.html.

significant proportion of the U.S. interest rate and index credit swaps markets into derivatives clearing organizations ("DCOs").[7]

The Dodd-Frank Act includes a clearing mandate, because the clearing of OTC derivatives provides risk management benefits to derivatives markets and market participants (e.g., mitigating counterparty credit, operational, and other risks). DCOs mitigate counterparty credit risks through novation, a process by which initial bilateral derivatives contracts are transformed into two separate but equivalent contracts between each of the initial counterparties and the clearinghouse. The DCOs, as the new counterparties to all such trades accepted for clearing, then reduce the likelihood that market participants will default on cleared positions using a variety of mechanisms to instill market discipline (e.g., daily variation margining of changes in the value of independently marked positions). DCOs also minimize market disruptions from counterparties that could or do default through initial margin requirements and other resiliency measures, including mutualized risk arrangements, portfolio liquidation and porting rights, and financial resources requirements funded or required to be funded by clearing members. The increased financial stability arising from **broad** central clearing of swaps has been widely acknowledged by academics, market participants, and global regulators.

Broad use of the clearing system also has the potential to increase and diversify derivatives markets participation and liquidity.[8] DCOs facilitate trading between the largest number of available counterparties in a given cleared derivatives market, because each counterparty, in essence, carries the same counterparty credit risk to the DCO as each other market participant and therefore can trade based primarily on economic terms, like price and notional amount, without individually accounting for credit risk. The clearing process also dramatically reduces operational complexities attendant to OTC derivatives trading with dealers (e.g., negotiating multiple sets of legal documentation, bilaterally exchanging collateral). It thereby reduces a significant barrier to participation in the derivatives markets. Operational complexities are also reduced by multilateral position netting of DCO-cleared derivatives, which dramatically reduces exposures in default across cleared portfolios and the operational complexities of maintaining, terminating, and/or porting portfolios.

In addition, by vesting responsibilities for marking, netting, and collateralizing derivatives positions in DCOs, dealers may have fewer direct[9] controls over and informational asymmetries in the derivatives markets. Today, even with the Dodd-Frank Act's derivatives markets reforms, more than 87% of the reported $201 trillion notional in derivatives within the U.S. banking system is controlled by dealers

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[7] See 17 C.F.R. § 50.4 for a description of swaps classes required to be cleared.

[8] For a more detailed explanation of how clearing and related straight-through processing and other market structure reforms increase swaps market quality and liquidity, see, e.g., Better Markets, Comment Letter to CFTC, Re: Public Comment on Swap Execution Facilities and Trade Execution Requirement (RIN 3038-AE25); Public Comment on Request for Comment on Post-Trade Name Give-Up on Swap Execution Facilities (RIN 3038-AE79) (Mar. 15, 2019), available at https://bettermarkets.com/sites/default/files/Better%20Markets%20Comment%20Letter%20on%20Swap%20Execution%20Facilities%20and%20Trade%20Execution%20Requirement_0.pdf.

[9] Derivatives dealers and their affiliates are prominent members of or participants in clearinghouses, swap execution facilities, middleware providers, and trade reporting and settlement organizations. For this reason, direct and indirect measures can be used to maintain market bottlenecks and advantages, even in a cleared market structure, demanding close, independent supervisory oversight by the CFTC and global regulators. For a description of one recently employed control mechanism, see Better Markets, Comment Letter to CFTC, Re: Prohibition of Post-Trade Name Give-Up on Swap Execution Facilities (RIN 3038-AE79) (Mar. 2, 2020), available at https://bettermarkets.com/sites/default/files/Better_Markets_Comment_Letter_on_Post-Trade_Name_Give-Up_on_Swap_Execution_Facilities%28RIN_3038-AE79%29%28March_2_2020%29.pdf.

within just four U.S. bank holding companies ("BHCs").[10] Each of these four BHCs also facilitates trading in a significant percentage of the $640 trillion notional global derivatives markets through multiple affiliated non-U.S. dealers.[11] To be sure, cleared derivatives markets also evidence significant dealer concentration.[12] They are nevertheless viewed as fairer, less susceptible to market abuses, having lower costs of entry and exit, and having more integrity in other ways than the bilateral OTC derivatives markets. Broad participation in the clearing system also may encourage standardization. These perceptions and the corresponding realities are likely to support liquidity formation to a greater degree than differentiated OTC derivatives trading.

For all of these reasons, the Dodd-Frank Act authorized a swaps clearing mandate as part of the comprehensive regulatory reforms designed to reduce market, credit, and operational risks throughout the OTC derivatives markets. The CFTC's objective must be, first and foremost, to faithfully implement that statutory framework and provide the foundational rules that both promote the safety and soundness of market intermediaries and facilitate the competitive interaction of the greatest number of participants in the swaps markets. **Piecemeal exemptions, exceptions, exclusions, and definitional and guidance-based carve-outs only sabotage those fundamental objectives, fragment markets, undermine global regulatory cooperation, and diminish the effectiveness of transparency and other reforms to the swaps markets.**

II. CEA section 2(h)(7)(C)(ii) provides that the CFTC may consider excluding only certain categories of "financial entities" from the swaps clearing requirement, demonstrating Congress' intent to limit the scope of exemptions from the Dodd-Frank Act's clearing and trading mandates.

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[10] Office of the Comptroller of the Currency, Quarterly Report on Bank Trading and Derivatives Activities, Third Quarter 2019 (Dec. 2019), available at https://www.occ.gov/publications-and-resources/publications/quarterly-report-on-bank-trading-and-derivatives-activities/files/pub-derivatives-quarterly-qtr3-2019.pdf (noting that "[a] small group of large financial institutions continues to dominate trading and derivatives activity in the U.S. commercial banking system" and that "four large commercial banks represented 87.2 percent of the total banking industry notional amounts and 83.2 percent of industry net current credit exposure").

[11] Bank for International Settlements, Statistical release: OTC derivative statistics at end-June 2019 (Nov. 8, 2019), available at https://www.bis.org/publ/otc_hy1911.pdf (noting that "[l]arge dealers in advanced economies (AEs), who report data to the semiannual survey, accounted for the overwhelming majority (92% of notional amounts, 87% of gross market value) of outstanding positions at end-June 2019").

[12] The cleared U.S. swaps markets evidence considerable dealer market power and concentration as well. The eight largest U.S. futures commission merchants ("FCMs") hold $113.87 billion of cleared swaps customer collateral, which constitutes 96% of the total across only 18 FCMs providing material clearing services in the U.S. cleared swaps markets. See CFTC, Selected FCM Financial Data as of November 30, 2019 from Reports Filed by December 24, 2019, available at https://www.cftc.gov/sites/default/files/idc/groups/public/%40financialdataforfcms/11-%20FCM%20Webpage%20Update%20-%20November%202019.pdf. More broadly, "five firms, all bank-affiliated, account for over 80% of total client margin for cleared interest rate swaps in the United States, United Kingdom and Japan," three jurisdictions overseeing a very significant majority of the global swaps markets. See Basel Committee on Banking Supervision ("BCBS"), Committee on Payments and Market Infrastructures ("CPMI"), Financial Stability Board ("FSB") et al., Incentives to centrally clear over-the-counter (OTC) derivatives, 3 (Nov. 19, 2018) (noting that "[t]he provision of client clearing services is concentrated in a relatively small number of bank-affiliated clearing firms"), available at https://www.bis.org/publ/othp29.pdf. This clearing concentration is also a serious systemic risk concern, because each of the BHCs and affiliates continue to maintain complex interconnections between financial markets and remain critical to the functioning of clearing, data, settlements, custodial, and payments infrastructure. See, e.g., Oliver Wyman and World Federation of Exchanges, The Future of Clearing, 21 (2019) (noting that "[t]he largest 11 clearing members (out of 306, as measured by prefunded financial resources contributions to the [central counterparties]) are connected to between 16 and 25 [central counterparties]"), available at https://www.oliverwyman.com/content/dam/oliver-wyman/v2/publications/2019/apr/The-Future- Of-Clearing.pdf. These dealers compete for a relatively concentrated cleared swaps customer base as well. In fact, by one measure, "[t]he 50 largest clients represent more than half of all [global] client margin, even though there are over 1,800 clients in total." BCBS, CPMI, and FSB et. al, at 23.

CEA section 2(h)(1)(A) states that it shall be "unlawful for any person to engage in a swap unless that person submits such swap for clearing to a [CFTC-registered or exempted] [DCO]" if the CFTC has determined that such swap is "required to be cleared."[13] However, CEA section 2(h)(7)(A) provides that the clearing requirement shall not apply to a swap if one of the counterparties meets certain conditions, including most relevantly that it is "not a financial entity."[14] Under CEA section 2(h)(7)(C)(i), the "financial entity" definition broadly includes, among others, any "person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 1843(k) of title 12."[15] **The initial limitation of this statutory clearing exception primarily[16] to non-financial entities using swaps to hedge or mitigate commercial risks makes it abundantly clear that Congress intended to ensure financial institutions broadly mitigate risks through the derivatives clearing system**.

The CFTC acknowledges that the categories of financial institutions that would be eligible for its proposed new exemptions fall squarely within CEA section 2(h)(7)(C)(i)'s definition of "financial entity." Accordingly, the proposed exemptions apply to swaps that otherwise would be subject to swaps clearing (and trading) requirements. In this regard, the CFTC proposes to exempt from the clearing requirement any swap entered into to hedge or mitigate commercial risk, provided a counterparty to the swap meets at least one of the following conditions, in addition to others:

- It is a bank holding company ("BHC") or a savings and loan holding company ("SLHC"), in each case having no more than $10 billion in consolidated assets; or

- It is a community development financial institution ("CDFI") transacting in U.S. dollar denominated interest rate swaps in the fixed-to-floating class or the forward rate agreement class of swaps, where the total aggregate notional value of all swaps entered into by the CDFI during a previous 365-calendar-day period was less than or equal to $200 million.

Although the CFTC rightly conditions reliance on the proposed exemptions both to limit their scope and provide oversight of financial institutions relying on them (conditions that the CFTC must retain if it finalizes the exemptions, which it should not), the undeniable reality is that the CFTC need not and should not use public interest exemptive authority to provide unnecessary exceptions from critical financial reforms for BHCs, SLHCs, and CDFIs.

Every trade that would remain uncleared pursuant to these proposed exemptions and that would be conducted bilaterally with one of a handful of already dominant derivatives dealers limits participation and diversity in the cleared swaps markets. This drain of much-needed liquidity—in combination with multiple other exclusions, exemptions, and exceptions—jeopardizes transparency and market quality measures critical to the success of the new swaps market structure envisioned by the Dodd-Frank Act.

Moreover, these exemptions not only apply to financial entities under Congress' statutory framework for clearing but to categories of financial institutions that Congress deliberately excluded from statutorily authorized exemptions from the "financial entity" definition. CEA section 2(h)(7)(C)(ii) requires

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[13] See 7 U.S.C. § 2(h)(1)(A).

[14] See 7 U.S.C. § 2(h)(7)(A)(i).

[15] See 7 U.S.C. § 2(h)(7)(C)(i).

[16] See also, e.g., 7 U.S.C. § 2(h)(7)(C)(iii).

the CFTC to consider whether to "exempt small banks, savings associations, farm credit system institutions, and credit unions, including depository institutions with total assets of $10 [billion] or less; farm credit institutions with total assets of $10 [billion] or less; or credit unions with total assets of $10 [billion] or less" from that definition.[17] Notably, that provision makes no mention of BHCs or SLHCs, for example, despite Congress' extensive statutory consideration of such financial entities elsewhere in the Dodd-Frank Act.

In fact, the CFTC acknowledges that the proposed exemptions reach well beyond CEA section 2(h)(7)(C)(ii)'s statutorily authorized exclusions. Nevertheless, it fails to recognize that Congress placed clear limitations on the scope of exclusions from the "financial entity" definition and intended to substantially limit exemptive relief from the clearing requirement for financial institutions. **If Congress intended to authorize an exemption for additional types of entities, like BHCs, it could and would have done so explicitly.**

III. Conclusion

The new exemptions, at least as currently drafted, apparently would not dramatically shift swaps activities away from clearinghouses and multilateral trading platforms or exchanges. For example, the CFTC's data analysis observes the following backward-looking scope for the two key proposed exemptions:

Potential CFTC Scope of the New Financial Entity Exemptions
Based on 2018 Swaps Reporting

Categories of Financial Entities	Number of Entities	Number of Swaps	Aggregate Notional Value
CDFIs	8	13	$83.9 Million
BHCs	11	18	$152.5 Million

Source: CFTC Proposal[18]

Yet, our concerns rest principally on two facts. First, although the scope of the exemption is apparently limited and would not dramatically shift swaps current trading away from the Dodd-Frank Act's clearing and multilateral trading framework, it nevertheless would permit more than $200 million of swaps activities to occur outside of regulated, transparent, impartially accessed markets. That, all things being equal, is not good for markets; it is not good for financial reforms; and in the long run, it is exceedingly unlikely to be good for the exempted firms. Furthermore, it is difficult to predict how markets will develop with such exemptions, so it is conceivable that future trading within the scope of the exemption may be more pronounced.[19]

Second, this exemption supplements existing exemptions for banks and other financial institutions with less than $10 billion in consolidated assets, which, as mentioned, draws liquidity away from

[17] See 7 U.S.C. § 2(h)(7)(C)(ii).

[18] See, e.g., CFTC, Swap Clearing Requirement Exemptions, 85 Fed. Reg. 27955, 27965 (May 12, 2020).

[19] The CFTC essentially acknowledges this point. See Id ("This information about past swaps activity is not used as a predictive measure of future swaps activity, but rather, it is included here to provide context about the current use of uncleared swaps by the entities discussed in this proposal.").

multilateral markets and empowers dealers to maintain their stranglehold on large trades with exempted entities. Thus, although the newest exemption likely would have an initially minimal impact on liquidity, it would incrementally undermine the Dodd-Frank Act's swaps market reforms, including the statutory objective that the most liquid and standardized swaps should be cleared and traded by most financial entities through regulated intermediaries.

The proposed exemptions are only the latest addition to an increasingly and unnecessarily complexified swaps regulatory framework. These and many other actions like it collectively present a threat to derivatives market reforms and may, if continued, spell death by 1,000 little noticed and seemingly insignificant cuts.

Sincerely,

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