



January 3, 2011

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

Re: Process for Review of Swaps for Mandatory Clearing (CFTC RIN 3038-AD00)

Dear Mr. Stawick:

Better Markets, Inc.¹ appreciates the opportunity to comment on the above-captioned proposed rules (the “Proposed Rules”) of the Commodity Futures Trading Commission (“CFTC”), the purpose of which are to establish a process to review swaps to determine whether such swaps are required to be cleared as required by provisions of the Dodd-Frank Financial Services Reform Act (the “Dodd-Frank Act”).

Introduction

In the Dodd-Frank Act, “Congress determined that clearing is at the heart of reform....”² The Proposed Rules are critical to implementing the availability of and the requirement for clearing of derivatives. We congratulate the CFTC in the effort to establish a process under which clearing services can be made available broadly and efficiently.

The DCO process of determining which swaps will be offered for clearing is critical to the success of the clearing mandate in the Dodd-Frank Act. It has been obvious from the first consideration of this mandate that DCOs are subject to powerful countervailing influences in making these decisions. In our comment on the CFTC’s proposed rule on mitigation of conflicts of interests, we described an industry that is rife with embedded formal and

¹ Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

² Letter from Senators Christopher Dodd and Blanche Lincoln, respective chairs of the Senate Banking and Agricultural Committees, to Representatives Barney Frank and Collin Peterson, respective chairs of the House Financial Services and Agricultural Committees, dated June 10, 2010.

informal influences which can be used to frustrate or even defeat the intent of the Dodd-Frank Act.³

The process of submission must balance two concerns: the risks associated with a new class of swaps to be cleared and the strong policy requirement of broad clearing of derivatives. Our comments directly address the DCO decision process so that these two concerns – risk and broad clearing of derivatives - are balanced.

Our comments propose:

- Notice to the CFTC and the public by a DCO that it is considering clearing of a new class of swaps (rather than notice only if a decision to submit is made);
- Required DCO solicitation of input from customers and the public to enable a full and fair consideration of a submission;
- Inclusion of member comments in support of submission, as well as those in opposition, in any submission; and
- Notice to the CFTC and the public of a decision not to submit, including comments for and against.

In short, we advocate an open and informed process in which the views of all interested parties can be considered. **This must be the absolute minimum process, given the history and inherent, conflicted structure of the derivatives industry.**⁴

Importantly, this proposed process would also ensure that risk is properly weighted. The comments that follow include suggestions that assure that risk-related issues such as duration and price movement correlations can be effectively considered by the CFTC in evaluating risk issues raised by submissions. We also propose that the CFTC obligation to monitor the need for mandated clearing include swaps that are cleared but not yet mandated. This is particularly important because conditions that affect the mandate requirement can change over time.

The following suggestions will establish a process that assures that the goals of the Dodd-Frank Act regarding clearing are fulfilled.

³ Better Markets, Inc. Comment Letter Dated November 17, 2010 regarding Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding Mitigation of Conflicts of Interest. (A copy is attached with this submission.)

⁴ See note 3 passim.

Framework of the Dodd-Frank Act Clearing Mandate

The mandate for clearing is set forth in the Dodd-Frank Act:

It shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a derivatives clearing organization... if the swap is required to be cleared....

The Commission on an ongoing basis shall review each swap, or any group, category, type, or class of swaps to make a determination as to whether the swap or group, category, type, or class of swaps should be required to be cleared.....

A derivatives clearing organization shall submit to the Commission each swap, or any group, category, type, or class of swaps that it plans to accept for clearing, and provide notice to its members (in a manner to be determined by the Commission) of the submission....

Any swap or group, category, type, or class of swaps listed for clearing by a derivative clearing organization as of the date of enactment... shall be considered submitted to the Commission....

The Commission shall review each submission made... and determine whether the swap, or group, category, type, or class of swaps described in the submission is required to be cleared....⁵

The Dodd-Frank Act also charges the CFTC with the duty to monitor market activity to determine if there are swaps transactions which ought to be cleared, but for which clearing is not available from a derivatives clearing organization ("DCO"):

To the extent the Commission finds that a particular swap, group, category, type, or class of swaps would otherwise be subject to mandatory clearing but no derivatives clearing organization has listed the swap, group, category, type, or class of swaps for clearing, the Commission shall—

- (i) investigate the relevant facts and circumstances;
- (ii) within 30 days issue a public report containing the results of the investigation; and

⁵ Dodd-Frank Act, Section 723(a)(3).

- (iii) take such actions as the Commission determines to be necessary and in the public interest, which may include requiring the retaining of adequate margin or capital by parties to the swap, group, category, type, or class of swaps.⁶

Discussion of Proposed Rules

The Proposed Rules generally implement the clearing mandate effectively. To build on the existing strength of the Proposed Rules, we propose the following amendments to address certain omissions and to improve the process that is established.

Cleared Swaps not Subject to Mandate. The Proposed Rules comprehensively deal with several categories of CFTC responsibility under the Dodd-Frank Act:

- Review of swaps that a DCO seeks to clear, which swaps are not of a class category or type already cleared by the DCO, for a determination that the DCO is eligible to clear such swaps;
- Review of swaps submitted by DCOs as those which will be cleared, including swaps which are currently cleared and therefore deemed submitted, for a determination whether such swaps will be required to be cleared; and
- Review of swaps that are transacted exclusively in the bi-lateral (uncleared) market for determination that they should be required to be cleared.

However, to be truly effective and complete, this list must include the fourth statutory responsibility assigned to the CFTC by the Dodd-Frank Act: the CFTC “on an ongoing basis... must review each swap, or any group, category, type, or class of swaps to make a determination as to whether the swap or group, category, type, or class of swaps should be required to be cleared.”⁷

Swaps may be approved for clearing, but the CFTC may determine that mandatory clearing is not required. The circumstances which led to a determination that cleared swaps are not subject to *mandatory* clearing may change. Under the Proposed Rules, “Commission-initiated reviews” are limited to “swaps that have not been accepted for clearing by a derivatives clearing organization.”⁸ But, ongoing review of swaps which are cleared, but for which clearing is not mandated, must be included as a CFTC function under the Proposed Rules.

⁶ Id.

⁷ Id.

⁸ Proposed Rules, Section 39.5(c).

Public Notice of Consideration of New Swaps. If a DCO seeks approval to clear a new swap, it must make a submission to the CFTC that includes:

A description of the manner in which the derivatives clearing organization has provided notice of the submission to its members and a summary of any opposition to the submission expressed by the members. A copy of the notice to members shall be included with the submission.⁹

This provision of the Proposed Rules implements a requirement in the Dodd-Frank Act that DCOs provide notice to members of a submission.¹⁰ The focus of the Proposed Rules -- **but not the Dodd-Frank Act** -- is on potential objections from clearing members, requiring that such objections be included in the submission. This is, of course, designed to allow members to oppose the clearing of a type of swap because it is imprudent or for other reasons. The major concern addressed is that the DCO would endeavor to clear swaps that would be excessively risky.

While DCO creditworthiness is a goal of the Dodd-Frank Act, so is broad-based clearing of swaps under the clearing mandate. Clearing members may object on credit risk grounds, **but they also might object because mandatory clearing does not serve their business interests.**¹¹ If self-interest contributes to a decision by a DCO not to clear a swap, the goal of mandatory clearing for as much of the derivatives market as possible is not served. On the subject of the breadth of the market which is cleared, the Dodd-Frank Act requires the CFTC to balance DCO risk issues with the goal of broad clearing of derivatives. This, of course, must be done – and can only be done – by the CFTC.

There are four elements missing from this provision of the Proposed Rules which are required to achieve the balance required by the statute:

- The submission should include a summary of member support of clearing the swap as proposed, as well as member objections.
- A DCO should be required to notify the CFTC and to provide public notice of the type of swap being considered at the time it notifies members of the submission or possible submission. There is a public interest in broadening clearing to cover additional swaps. If the public has no knowledge that the matter is being debated by clearing members, there is no opportunity for discussion.

⁹ Proposed Rules, Section 39.5(b)(3)(vi).

¹⁰ Dodd-Frank Act, Section 723(a)(2).

¹¹ We refer you to the Comment Letter regarding “Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding Mitigation of Conflicts of Interest” filed by Better Markets on November 17, 2010 which discusses in detail the potential for conflicts and undue influence exerted by clearing members.

- DCOs should be required to solicit input *from both the public and customers* in the decision to make a submission, which can be considered alongside member views. The methods used to solicit such input and the outcome should be included in the submission.
- If a DCO Risk Committee or similar body solicits input from members, customers or others regarding a submission, and decides not to make the submission, the CFTC should be notified of the decision and provided with the objections and supporting statements received regarding the proposed submission.

Information on Hedge and Price Relationships. The Proposed Rules require a DCO to submit a great deal of information regarding swaps proposed to be cleared, including information on pricing and risk management.¹² However, an extremely important set of information is omitted. The hedging relationships between the swap proposed to be cleared and other swaps which are cleared by the DCO or by other DCOs are important to understand the effects on risk management and margining for the submitting DCO as well as its members and customers.

Importantly, this will also impact the potential for position concentration and speculative trading volumes that are relevant to swap execution facilities ("SEFs") and designated contract markets ("DCMs") cleared by the DCO and other DCOs.

Each submission should, therefore, also include the following information:

- Observed hedge and price change correlation relationships between the swaps proposed to be cleared and other swaps ("hedge equivalents") which are cleared by the DCO, cleared by another DCO or are uncleared.
- Initial margin reduction that might be anticipated from clearing the swaps and the hedge equivalents at the same DCO.
- Identification of SEFs and DCMs which are (a) expected to list the swaps and (b) expected to list hedge equivalents, and the capability to clear swaps matched at each such SEF and DCM at the submitting DCO and other DCOs.

A full data set enabling a comprehensive review will only be possible if this information is also required.

¹² Proposed Rules, Section 39.5(b)(3).

Systemic Risk and the Decision to Mandate Clearing. One of several issues to be considered by the CFTC in regard to DCO submissions under the Proposed Rules relates to systemic risk:

The effect on the mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the DCO available to clear the contract.¹³

Commentators who seek to restrict the impact of the Dodd-Frank Act on the marketplace often interpret references to systemic risk very specifically. There is no suggestion in the Dodd-Frank Act or in the Proposed Rules that the specific contract under consideration for mandatory clearing must pose a material risk to the U.S. financial system.

The Dodd-Frank Act in no way suggests that only contract types which, by themselves, pose a risk to the financial system be cleared. Systemic risk must be considered; but only in the context of broad classes of derivatives contracts. The obvious intent of the Dodd-Frank Act is that the vast majority of contracts be cleared mandatorily. We propose that the quoted provision of the Proposed Rules make clear that a given level of contract-specific systemic risk avoided by mandatory clearing **does not** constitute a threshold for a determination by the CFTC.

Information Required in Submission. The Dodd-Frank Act requires the CFTC to take into account five factors in its review of a submission by a DCO.¹⁴ The Proposed Rules require that each submission by a DCO include a statement that includes information related to each such factor.¹⁵ The Proposed Rules also require that each submission include statements and other materials, in addition to the statement related to the five factors.¹⁶ It appears that these additional statements and materials are intended to assist the CFTC in its review based on the five factors in the Dodd-Frank Act.

However, we are concerned that a market participant might, in the future, incorrectly assert that the requirements of additional statements and materials were intended to expand the scope of the review of the submission beyond the five factors in the Dodd-Frank Act. We propose that the Proposed Rules clearly state that these additional statements and materials are not intended to increase the factors to be taken into account by the CFTC in its review beyond the five factors set forth in the Dodd-Frank Act.

Price Indices. The Proposed Rules require that a DCO submitting a new swap for clearing must include the following in the submission:

¹³ Proposed Rules, Section 39.5(b)(3)(ii)(C).

¹⁴ Dodd-Frank Act, Section 723(e)(3).

¹⁵ Proposed Rules, Section 39.5(b)(3)(ii).

¹⁶ Proposed Rules, Section 39.5(b)(3)(iii) – (xi).

information about any price reference index used, such as the name of the index, the source that calculates it, the methodology used to calculate the price reference index and how often it is calculated....¹⁷

We propose that the following phrase be added after the phrase “methodology used to calculate the price reference index:” “specifying methods used for each duration and methods used to establish prices for durations with low liquidity.” Thus, the provision would read as follows:

information about any price reference index used, such as the name of the index, the source that calculates it, the methodology used to calculate the price reference index specifying methods used for each duration and methods used to establish prices for durations with low liquidity and how often it is calculated....

The reason for this is very important: price indices can result in a series of prices across a duration curve that is inconsistent in terms of quality. For liquid dates, the price may be based on good transaction data; for illiquid dates, the price may result from a model or even interpolation. The approach to this issue which is used by the index provider (as discussed in our earlier comment letter referenced above) is important to understanding its quality.

Risk Management Procedures. A DCO’s submission must specify risk management procedures, “including the margin methodology.”¹⁸ The Proposed Rules should specify that the description of the risk management procedures should specify cross-contract netting and credits relating to initial margin, including correlations to be used and algorithms which result in the netting or credits.

Market Liquidity. A DCO’s submission must specify with respect to the swap to be cleared:

Measures of market liquidity and trading activity, including information on the sources of such measures.¹⁹

Liquidity can vary tremendously depending on duration. We propose the addition of the following phrase after the word “activity” in the above-quoted language: “applicable specifically to each duration to be offered for clearing.”

Conclusion

The clearing mandate is at the very center of financial reform as envisioned by the Dodd-Frank Act. We support the CFTC’s effort to reflect this in your Proposed Rules to implement the mandate.

¹⁷ Proposed Rules, Section 39.5(b)(3)(v).

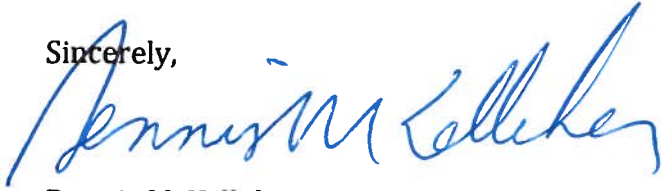
¹⁸ Proposed Rules, Section 39.5(b)(3)(vi).

¹⁹ Proposed Rules, Section 39.5(b)(3)(vii).

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We hope these comments are helpful in your consideration of the Proposed Rules.

Sincerely,



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