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January 3, 2011

Via Email

David Stawick

Secretary

Commodity Futures Trading Commission

Three Lafayette Centre

1155 21st Street, N.W.

Washington, D.C. 20581

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

Dear Mr. Stawick:

The American Federation of State, County and Municipal Employees (“AFSCME”), is the largest union in the AFL-CIO representing 1.6 million state and local government, health care and child care workers. AFSCME members participate in over 150 public pension systems whose assets total over \$1 trillion. In addition, the AFSCME Employees Pension Plan (the “Plan”) is a long-term shareholder that manages \$850 million in assets for its participants, who are staff members of AFSCME and its affiliates.

During consideration of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), AFSCME strongly supported the inclusion of provisions establishing the strongest possible market reforms, oversight and transparency for the “shadow markets” – principally the over-the-counter market that has grown to a size that dwarfs other more transparent derivatives markets.

The Importance of Strong Derivatives Regulation Is Undeniable

Before passage of the Act, OTC derivatives – including interest rate swaps, foreign exchange contracts, equity swaps, commodity swaps, credit default swaps, and others – were described as bilateral agreements between sophisticated parties. As such, OTC derivatives were not subject to obligations to trade on regulated exchanges and clear the agreements through regulated clearing operations – obligations that apply to other segments of the derivatives markets. However, the need to bring OTC derivatives into these regulated markets is clear: CFTC Chairman Gensler has repeatedly confirmed, “Unregulated swaps were at the center of the 2008 financial crisis. Taxpayers bailed out AIG with \$180

American Federation of State, County and Municipal Employees, AFL-CIO

TEL (202) 429-1000 FAX (202) 429-1293 TDD (202) 659-0446 WEB www.afscme.org 1625 L Street, NW, Washington, DC 20036-5687

billion, for example, when that company's ineffectively regulated \$2 trillion derivatives portfolio nearly brought down the financial system.”¹ Warren Buffett famously labeled OTC derivatives “financial weapons of mass destruction.” The public record of analyses gathered in the months following crises in the financial industry, and in the economy overall, confirmed the same conclusion: “It is widely acknowledged that OTC derivatives contracts, and particularly CDS, played a significant role in the current financial crisis. . . Although OTC derivatives have been justified as vehicles for managing financial risk, they have also spread and multiplied risk throughout the economy in the current crisis, causing great financial harm.”²

With the passage of Dodd-Frank – and strong implementation – standardized swaps, with some exceptions, will be traded or entered into on regulated exchanges or swap execution facilities. This will improve the extent to which buyers and sellers meet in an open marketplace where prices are publicly available. Standardized swaps will be cleared through a regulated clearinghouse charged with acting as intermediary to the transaction, collecting and protecting collateral from the parties, mitigating counterparty risk for individual transactions as well as the possibility that systemic risk can build invisibly.

Strong Implementation of the Responsibility to Require Clearing Is Vital

Strong rules regarding mandatory clearing are vital to the operation of a derivatives marketplace that earns investor confidence. AFSCME will be closely engaged with pending proposals addressing, among other things:

- rules regarding open access to membership in clearing organizations so that they are not dominated by a limited number of players with conflicting incentives regarding clearing and exchange-trading;
- rules regarding governance and control of clearing organizations and other efforts to protect against conflicts of interest that might undermine the protection that clearing can provide;
- rules regarding clearing organizations' procedures for seeking approval for rule changes or new product listings they propose;
- rules regarding the protection of customers' collateral;
- rules addressing the strength of clearing organizations' ability to measure risk; and more.

Obviously, HOW clearing is handled matters immensely.

¹ Remarks of CFTC Chairman Gary Gensler before the National Economists Club, Washington, D.C., November 9, 2010.

² “U.S. Financial Regulatory Reform: The Investors' Perspective” Investors Working Group, an Independent Taskforce Sponsored by CFA Institute Centre for Financial Market Integrity and Council of Institutional Investors, published in July 2009, submitted to the Federal Reserve Board September 22, 2010.

And HOW MUCH is cleared matters, too. Recent CFTC testimony estimated that the current cleared derivatives market is one-tenth of the uncleared market.³ That proportion will change, and the financial markets in particular and the economy overall will be stronger for it. Dodd-Frank requires that market participants clear any swap that the Commission has determined must be cleared and that a registered clearing agency will agree to clear. To that end, the Commission's Proposed Rule (RIN 3038-AD00) is very important, setting out the procedure through which derivatives clearing organizations (DCOs) will submit swaps they plan to clear to the Commission for a determination as to whether clearing for those swaps will be required, as well as a determination of the DCO's eligibility to clear those swaps, whether clearing is required or voluntary. AFSCME welcomes the specificity of the submissions required by the proposed rule and will study carefully assertions that less would be adequate.

AFSCME believes it is particularly important that the proposal requires DCO submissions to include the notice of the submission that the DCOs provided to their members and a summary of any opposition that they express, and that the submission will then be made public on the CFTC's web site for a 30-day comment period. With respect to the CFTC's request for comment "regarding the appropriateness and sufficiency of providing notice of the submission on the Commission Web site as compared to publishing notice of the submission in the Federal Register", AFSCME urges that both options be used. Public input into – and confidence in the integrity and transparency of – the analysis of particular swaps or classes of swaps, the approach taken by different DCOs, and the evolution of the markets that result in more and more swaps being appropriate for mandatory clearing, is essential. Accordingly, it is appropriate to utilize both the Commission web site and the Federal Register in order to disseminate as broadly as possible the opportunity to comment and to build the richest possible body of analysis and commentary as part of the official public record.

Swaps currently being cleared are deemed by the statute to be submitted to the CFTC for a determination as to whether clearing is mandatory; those determinations will proceed once regulations governing this process are final. AFSCME looks forward to hearing how the Commission will include public notice and comment into those "deemed submissions" in a manner similar to that put forward for the submissions DCOs will make in the future.

This proposal also addresses the Commission's new statutory responsibility to review on an ongoing basis swaps that have not been accepted for clearing by a DCO and to determine whether those swaps should be required to be cleared. If the answer is yes, the Commission is to investigate the relevant facts and circumstances, issue a public report regarding the results of its investigation, and act as it determines necessary and in the public interest by, e.g., establishing margin or capital requirements for parties to the swaps. Here, too, AFSCME encourages strong use of this investigative tool and

³ Commodity Futures Trading Commission, Open Hearing on the First Series of Proposed Rulemakings Under the Dodd-Frank Act. October 1, 2010

welcomes the Commission's efforts to ensure that intellectual property arguments aren't used to evade the statute's mandatory clearing direction.

The statutory definition of this duty as "ongoing" is critical. Facts and circumstances that shape whether clearing should be mandatory or voluntary will change. The Commission must have both resources with which to follow these developments and sufficient mechanisms for public input from varied market participants, to target and exercise efficiently this ongoing responsibility. AFSCME urges that future rulemakings continue to identify clearly the way in which public input will be gathered for mandatory determinations, public notice will be made of determinations, and public input will help to identify swaps that have not yet been submitted by a DCO but could be submitted.

Clearing Is a Fundamental Part of Systemic Risk Reduction, Investor Protection and Economic Stability – Both for How It Affects the Cleared Market and Uncleared Swaps

We believe strongly, along with many other varied market participants, that "central clearing will play an essential role in reducing systemic, operational and counterparty risk, as it does in the equity and futures markets"⁴. Risk will not be eliminated, but it will be better measured, monitored, and mitigated. And the expansion of market fundamentals through expanded clearing and exchange-trading will contribute to financial stability, investor and consumer confidence, and economic stability. Nothing less is at stake.

To that end, we welcome the efforts the Commission continues to make to include broad public input in its interpretation and implementation of the Act. In addition:

- We look forward to additional consultation about the way in which public input will be included in mandatory clearing determinations;
- We await additional opportunities through upcoming proposed rules to discuss the importance of swap, end user, and other definitions that are key components in ensuring meaningful expansions of clearing, exchange-trading, and other elements of improved market transparency and oversight; and
- We encourage the Commission to continue to move away from judging buyers on their "sophistication" or size, and instead toward the systemic strength derived from market-based operations that allow buyers to better evaluate transactions requiring clearing, choices presented by voluntary clearing (e.g., whether to clear, which clearing organization to use, etc.), collateral protections available for uncleared transactions, and more.

⁴ Managed Funds Association, Comments on SEC Regulatory initiatives Under the Dodd-Frank Act, September 22, 2010

Investor demand – when backed by a market structure that facilitates informed choices – will be increasingly powerful: “Standardized exchange-traded derivatives will create high hurdles for any nonstandardized OTC product a bank wants to push into the market. The OTC product will have worse counterparty characteristics, be less liquid, have a higher spread, and have inferior price discovery. To overcome these disadvantages, the nonstandard OTC product will have to demonstrate substantial improvement in meeting the needs of the investor compared to the standardized product.”⁵

Clearly, an OTC market will remain. “There will be legitimate reasons for customized derivatives, and no doubt innovations will emerge with broad value to the financial markets. The point is not to stifle innovation, but to assure it is directed toward an economic rather than gaming end. . . Properly executed, we can have a combination of standardized exchange-traded instruments along with the continued development of customized OTC instruments.”⁶

Strong Funding Is Essential for Market Reforms and Economic Protection

“Proper execution”, we believe strongly, means respect for the deadlines Congress set in crafting legislation to prevent future financial and economic instability. Clear and concrete implementation is needed, delay is harmful to market participants and uncertain and unsettling to the economy, and underfunding this work means delay. We believe a broad chorus of voices will urge strong funding and fulfillment of the Act’s promise and we will be with them.

* * *

We appreciate the opportunity to express our views on this matter.

Sincerely,



GERALD W. McENTEE

International President

⁵ Testimony of Richard Brookstaber, Submitted to the Senate Agriculture Committee for its Hearing on Regulatory Reform and the Derivatives Markets, June 4, 2009.

⁶ Ibid.