THE FINANCIAL SERVICES ROUNDTABLE

*Financing America's Economy*

1001 PENNSYLVANIA AVE., NW
SUITE 500 SOUTH
WASHINGTON, DC 20004
TEL 202-289-4322
FAX 202-628-2507

**RICHARD M. WHITING**
EXECUTIVE DIRECTOR AND
GENERAL COUNSEL

By Electronic Mail (http://comments.cftc.gov)

January 3, 2011

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

**Regarding: RIN 3038–AD00, Process for Review of Swaps for Mandatory Clearing**

Dear Mr. Stawick:

The Financial Services Roundtable[1] respectfully submits these comments in response to the request for comments by the Commodity Futures Trading Commission (the "Commission") with respect to its proposed rulemaking, File RIN 3038-AD00, Process for Review of Swaps for Mandatory Clearing (the "Proposing Release"),[2] to implement certain requirements of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[3] The Proposing Release is part of a massive rulemaking endeavor by the Commission and the Securities and Exchange

[1] The Financial Services Roundtable (the "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 $74.7 trillion in managed assets, $1.1 trillion in revenue, and 2.3 million jobs.
[2] 75 Fed. Reg. 67277 (November 2, 2010).
[3] Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376, 1897 (July 21, 2010).

Commission (the "SEC") to implement the provisions of Title VII of the Dodd-Frank Act and subject swap transactions to comprehensive regulation and regulatory oversight. The Proposing Release in particular relates to Section 723 of the Dodd-Frank Act and the process of reviewing swaps for mandatory clearing and approving derivatives clearing organizations ("DCOs") to clear swap transactions (the "Mandatory Clearing Proposals").

The Financial Services Roundtable appreciates the efforts the Commission has made to implement Title VII within the schedule mandated by Congress. At the same time, we find ourselves significantly challenged to respond to the Commission's proposed rulemakings in the thorough and thoughtful manner they deserve. This Proposing Release, for instance—for which comments are due on January 3, 2011—was issued in the middle of a process of releasing more than thirty other proposed rulemakings the Commission has published for comment during a period beginning in mid-October 2010. Many of these other proposals, as well as some that have not yet been approved by the Commission for publication, will affect the implementation of the Mandatory Clearing Proposals, including the scope of parties they affect, the range of products to which they apply, the means by which those products will be traded, and the financial implications and risks for all parties to swaps transactions. Provisions for capital and margin requirements, which may differentiate between cleared and uncleared swaps, may be critical for many market participants in analyzing the significance of mandatory clearing designations.[4] Accordingly, we may have further comments with respect to mandatory clearing as we develop a more comprehensive understanding of the proposed framework for regulation of swaps transactions and market participants.

Our letter addresses the following six primary areas of concern:

- The categorization of swaps for purposes of determining clearing capacity, authority to clear, and mandatory clearing requirements;

[4] In this regard, we note that our members strongly believe that such differential treatment should not be punitive.

- The potential effects of capacity constraints on DCOs and the markets;

- Timing issues related to the effectiveness of designation of swaps as subject to mandatory clearing and to stays of the clearing requirement;

- Potential adverse effects on liquidity related to the interplay between exchange trading requirements and mandatory clearing determinations;

- The effect of mandatory clearing on swaps between affiliates; and

- Transition issues related to amendments, novations and assignments of swaps entered into prior to the determination of a mandatory clearing requirement.

In addition, we discuss certain procedural matters related to the submission of swaps to the Commission for clearing authority.

Mandatory clearing of swaps is intended to reduce systemic risk, but if it is not implemented prudently, it will increase systemic risk. We are particularly concerned about imposing a mandatory clearing requirement on swaps for which the necessary supporting infrastructure is undeveloped or underdeveloped, and we urge the Commission to approach the designation of swaps required to be cleared prudently and deliberatively.

## I. Categorization of swaps for clearing purposes

Section 39.5(a) of the Commission's proposed rules states that "[a] derivatives clearing organization shall be presumed eligible to accept for clearing any swap that is within a group, category, type, or class of swaps that the derivatives clearing organization

already clears."[5] The Dodd-Frank Act also uses the phrase "group, category, type or class" with respect to swaps. However, neither the Commission nor Congress has defined these terms.

We believe clear definitions are critically important. We appreciate that defining each "group, category, type or class" too narrowly may slow the process of moving swaps into the clearing system, but we are concerned that defining these terms too broadly avoids the careful analysis Congress intended by enacting Section 723.

As an example, the Commission has proposed that one of the factors it would consider in evaluating a submission by a DCO to clear a particular swap or a group, category, type or class, would be "[t]he existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data."[6] We agree that this is an important factor, but also believe that its significance is directly tied to the breadth of the classification. Participants in the Commission's joint roundtable with the SEC on clearing credit default swaps ("CDS") on October 22, 2010 (the "CDS Roundtable"), for instance, noted that most single-name CDS trade fewer than four times a day, but that the statistics for the broad classification of "single-name CDS" would appear much more robust.[7] We would not consider examination of such statistics for an aggregate category of "single-name CDS" to be appropriate with respect to an analysis of "outstanding notional exposures, trading liquidity and adequate pricing data." Similarly, the CDS Roundtable included discussion about the difference between clearing single-name CDS and clearing indices, and about how correlation issues change the considerations in single-name CDS when the entities are in the financial sector.[8] Broad categorizations that ignore such distinctions would, in our view, be inappropriate.

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[5] 75 Fed. Reg. at 67281.
[6] *Id.*
[7] Transcript, CFTC-SEC Staff Roundtable on Clearing of Credit Default Swaps, Washington, DC, October 22, 2010, at 32.
[8] *Id.* At 25.

In general, we believe that the level of variability that would be consistent with swaps being appropriately treated as of the same group, category, type or class is relatively small. Swaps that have the same underlying exposure, such as a specific index, commodity, or company, but differ as to coupon, strike price, tenor or maturity date, might well be treated as a single category for which a clearing decision on a category basis would be appropriate; but where the underlying exposure differs, we believe the Commission should make a separate decision on clearing, rather than relying on a broader but insufficiently correlative classification to expedite the process.

## II. Consideration of systemic capacity constraints in mandatory clearing decisions

Mandatory clearing requirements are a key component of Title VII of the Dodd-Frank Act and the new derivatives regulatory framework it establishes. Mandatory clearing only reduces systemic risk, however, to the extent that DCOs and their members can safely clear all trades that are required to be cleared. Other central aspects of the new regulatory framework, including the expansion of the DCO core principles, margin and capital requirements, position limits, and heightened regulatory oversight are all intended to work in tandem to reduce risk within the system. But the interplay of these aspects, including mandatory clearing, will be new and untested, and if they create feedback issues they may increase rather than reduce systemic risk. In our view, mandatory clearing requirements heighten pressure within the system, especially at times of market growth, as the legal mandate to clear transactions will cause market participants to push clearing organizations to (or possibly beyond) their capacity. And because of the correlation between market growth and increased exposure of the DCO to each of its clearing members, growth of any part of the system beyond expectations may increase the challenges of clearing a variety of transactions that are not subject to such growth.

A decision by the Commission to require mandatory clearing of a particular swap will have significant implications for the DCOs that clear that swap, their clearing members and other market participants. A decision to require mandatory clearing

presumes there is sufficient capacity in the clearing system to clear the entire volume of that particular swap. If there is insufficient capacity, but a mandatory clearing decision is nonetheless made, the system will break down, either with parts of the swap markets shut down for no reason other than a lack of capacity in the relevant clearing organizations, or with clearing organizations and their members pressed to accommodate transactions beyond the limits of what they can safely clear in accordance with their core principles.[9] Congress has given the Commission an important tool through its authority to stay mandatory clearing requirements on its own initiative,[10] and we believe that this stay power should be viewed from the outset as a critical pressure valve that can be quickly opened, even if on a temporary basis, to avoid these types of systemic breakdowns.

In the Proposing Release, the Commission indicates that it would require a DCO, as part of its submission of a swap the DCO wished to clear, to include a statement as to the ability of the DCO, if mandatory clearing of such swap were required, to clear such swap while complying with the DCO's core principles. One such core principle is the availability of sufficient financial resources to the DCO. Under Section 725(c) of the Dodd-Frank Act and the Commission's proposed rules,[11] financial resources would be sufficient if they allow the DCO to continue to meet its obligations following the default of the clearing member presenting the largest financial exposure in extreme, but plausible, market conditions.[12] We would expect the growth of the clearing system also

[9] The Commission should not underestimate the risks of these pressures. For example, much has been said in the last few years about the extent to which credit rating agencies failed to adequately diligence and analyze the securitization transactions they rated. But some of the factors that contributed to these failures have been acknowledged less frequently. Rating agencies were effectively gatekeepers to the capital markets for securitization transactions, in that their ratings were necessary to obtain Form S-3 eligibility, to satisfy the Rule 3a-7 exemption from the registration requirements of the Investment Company Act of 1940, to achieve favorable treatment for purposes of regulatory capital requirements and to meet the investment criteria for many institutional investors. Growth of the securitization markets increasingly challenged their capacity to rate the volume of new transactions they were asked to review, but their role as gatekeepers made it difficult for them to decline. We strongly urge the Commission to establish a system for designation and suspension of mandatory clearing requirements that will not place similar pressure on DCOs.

[10] Commodity Exchange Act Section 2(h)(3)(A).

[11] Dodd-Frank Act at 844; Financial Resources Requirements for Derivatives Clearing Organizations, 75 Fed. Reg. 63113 (October 14, 2010).

[12] Systemically important DCOs would have to be able to continue to meet their obligations following the default of their two largest clearing members. *Id.* At 63116.

to increase the amount of financial exposure a DCO has to its clearing members,[13] and accordingly the amount of financial resources the DCO itself must have. Each mandatory clearing determination the Commission will make, however, will likely fuel such systemic growth and increase the need for resources at the DCO.

To maximize the ability of DCOs to clear swaps transactions for which they have sufficient core competencies, we believe granting a DCO the authority to clear particular swaps transactions should not depend on the DCO's ability to handle such swaps if they were subject to a mandatory clearing requirement. Certainly information relevant to the mandatory clearing determination should be included within the application, but a DCO's authority to clear swaps transactions should not be conditioned on its ability to clear the entire market volume of such swaps transactions. To the extent evaluation of the effect of mandatory clearing for a particular swap transaction requires a broader analysis of a DCO's financial resources and exposures, the DCO would arguably have to evaluate the effects of potential mandatory clearing requirements across the full range of products it wishes to clear to determine whether it can clear a particular swap transaction. Such an approach will discourage DCOs from expanding the list of swaps they are willing to clear, a result that appears counter to the intent of the legislation. Accordingly, we believe that the reference to mandatory clearing should be deleted from the Commission's proposed Section 39.5(b)(3)(i).

Under Section 39.5(b)(3)(ii) of the Commission's proposed rules, the DCO is required to provide a statement to the Commission that includes information to give the Commission a reasonable basis to make an assessment of such DCO's eligibility to clear swaps based on an extensive list of factors, including capacity.[14] The Proposing Release, however, provides little detail on how the Commission will determine whether a swap should be *required* to be cleared. We believe a decision to require mandatory clearing of swaps should be made with careful consideration of the effects on the clearing system as

[13] We appreciate that increased financial exposure will likely be accompanied by increased margin, but do not expect margin requirements to fully offset the increased risks.
[14] 75 Fed. Reg. at 67281.

a whole, and not solely by reference to the particular swap under review. We believe it is essential that DCOs not be pressured to accept for clearing swap transactions beyond their capacity to do so safely and that market participants not be required to clear (or forgo) swaps transactions where the capacity of a DCO may be in question.[15]

Section 2(h) of the Commodity Exchange Act, as added by Section 723 of the Dodd-Frank Act, allows the Commission to impose such terms and conditions on the clearing requirement as it deems appropriate. We suggest that, by way of better establishing the pressure valve we discuss earlier, the Commission include within its standard terms and conditions the ability of the Commission to suspend the clearing requirement, either with respect to specific transactions or more broadly, at any time it believes capacity constraints within the clearing system may increase systemic risk.

## III. Stays of the mandatory clearing requirement should be issued promptly

We appreciate that the Commission has the ability to issue stays of the mandatory clearing requirement and has up to 90 days after the issuance of the stay to evaluate whether clearing should be required.[16] However, there is no discussion in the Dodd-Frank Act or the Proposing Release with respect to the time period for the issuance of the stay after an application has been made. The obvious intent of granting the Commission the ability to stay a mandatory clearing requirement is to provide a review mechanism in circumstances where implementation of the clearing requirement may be inappropriate. A delay in the issuance of such a stay would defeat the purpose of the mechanism, especially in circumstances where complying with a mandatory clearing requirement may not be feasible. The ability to conduct the review of the stay during the 90-day post-stay review period should be sufficient to ensure that inappropriate stays do not remain in

[15] We note, also, that the statute and the Proposing Release require that swaps subject to a mandatory clearing requirement be submitted to a DCO for clearing. We are not sure what happens, however, if the participant submits the swap for clearing but the DCO refuses to accept the swap (or whether this will even be a possible outcome). We believe the Commission should provide clarity as to the consequences of such a breakdown in the clearing system.

[16] See Section 2(h)(3)(A) of the Commodity Exchange Act, Section 723(a)(3) of the Dodd-Frank Act and the Commission's proposed Section 39.5(d), 75 Fed Reg. at 67282.

effect. We therefore encourage the Commission to adopt a policy to issue a stay within one business day of any request for a stay, unless the request on its face appears to be frivolous, so as to avoid any lengthy market disruption while the Commission determines whether the stay should be granted.

Additionally, because the Dodd-Frank Act and the proposed rules[17] allow the Commission to decide to stay a mandatory clearing requirement on its own initiative, and not just at the request of a counterparty, we believe the Commission should take an expansive view of the entities that would be permitted to request such a stay. In particular, we believe that DCOs, DCMs and SEFs should be allowed to request the Commission to stay a mandatory clearing requirement. Because these entities will be in key positions to identify developing market disturbances related to mandatory clearing, we encourage the Commission to clarify in its rules that they may obtain stays of clearing requirements even for swaps transactions for which they have previously supported mandatory clearing.

## IV. Mandatory clearing requirements need to be evaluated in connection with the rules implementing requirements for designated contract markets ("DCMs") and swaps execution facilities ("SEFs")

The Dodd-Frank Act includes, in addition to clearing requirements for swaps, trading requirements that move such cleared swaps onto DCMs and SEFs. SEFs, in particular, will be a new category of market participant for which the rules, and the breadth of participation, are not yet clear. Our members are concerned that a trading system that limits participation will also reduce liquidity in the system, because counterparties will not have the option to complete trades off-exchange when on-exchange trading is unattractive or unavailable. We therefore request that the Commission consider the changes in the trading market structure being effected by the Dodd-Frank Act and related regulations in evaluating mandatory clearing decisions.

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[17] *Id.*

## V. Transition issues for swaps executed prior to a mandatory clearing determination

The Dodd-Frank Act amended the CEA to make it unlawful for any person to engage in a swap if the swap is required to be cleared, unless the swap has been submitted for clearing.[18] The point at which a swap is "required to be cleared," however, has not yet been established. We believe the Commission should provide for a sufficient amount of time after it determines a swap should be subject to mandatory clearing before it is determined that the swap must in fact be "required to be cleared," to avoid creating market uncertainty during any period that mandatory clearing of a swap is under consideration by the Commission and to provide for an orderly transition by market participants. Notwithstanding the 60-day period between the end of the public comment period and the approval (or disapproval) by the Commission of a DCO's application to clear a swap, we believe market participants may need additional time before they will be able to clear all transactions in that swap. Clearing requires a significant investment in time, money, and other resources, both initially and on an ongoing basis, and market participants may therefore be reluctant to begin the process until the regulatory decision has been made. This will be particularly true for market participants that do not have a pre-existing relationship with the DCO approved to clear a particular swap. Providing additional time after a clearing decision has been made, but before it becomes effective, will allow such market participants, among other things, to review and enter into the necessary documentation with the relevant DCO, revise their systems to allow them to trade with the DCO and conduct a credit analysis of the DCO. While some of these activities can be undertaken by market participants prior to the approval by the Commission of an application by such DCO, it would be an inefficient and costly use of resources to undertake all necessary actions before a final determination is made by the Commission on a specific application. Our members believe that transitioning to mandatory clearing for a particular swap may well take months to complete. Relevant factors, as noted above, would include, among other things, whether the market participants have a pre-existing relationship with the relevant DCO, its clearing members,

[18] Section 723(a)(3) of the Dodd-Frank Act.

or the SEF or DCM on which the swap would be traded, and this in turn may be affected by the degree of fragmentation of the markets that develops as new DCOs, SEFs and DCMs are approved. As a result, we believe the Commission should provide a substantial transition period with respect to the effectiveness of any mandatory clearing determination.[19]

The Dodd-Frank Act exempts swaps from the clearing requirement if they were entered into before the date of the enactment of the Dodd-Frank Act and are reported to a swap data repository in accordance with the requirements of the CEA.[20] However, the statute does not address the status of swaps entered into after the date of enactment of the Dodd-Frank Act but prior to the Commission's establishment of rules or determination of a clearing requirement. We believe the Commission should address the clearing requirement as it relates to these swaps, and that any such rules should recognize that it may be difficult or impossible, or impose undue costs or burdens on participants, to have to transition swaps into a clearing arrangement, especially where such swaps have terms that differ from the standardized terms established by the DCO for cleared swaps.[21] We request that the Commission provide exemptions from the clearing requirement for these swaps entered into prior to the adoption of the relevant clearing requirement.

As noted above, the Dodd-Frank Act amended the CEA to make it unlawful for any person to "engage in a swap" if the swap is required to be cleared unless the swap has been submitted for clearing.[22] We believe the Commission needs to clarify what it means to "engage in a swap," and in particular to address whether entering into amendments to, and assignments and novations of, existing swap transactions will be considered to be

[19] In this regard, we note that Title VII of the Dodd-Frank Act contemplates that end-users will have the ability to determine whether a swap should be cleared and to designate the DCO on which it will be cleared. We believe there may be practical constraints to the extent that swap dealers or major swap participants, SEFs or DCMs do not have existing relationships with the relevant DCOs, and that the Commission should not penalize market participants that cannot comply with such a selection because of the lack of the necessary contractual relationships, systems interfaces or trading privileges on the relevant SEF or DCM while the system is developing.

[20] *Id.*

[21] We note, as well, that some of these swaps may have already expired by the time the Commission makes a clearing determination.

[22] Section 723(a)(3) of the Dodd-Frank Act.

engaging in a swap. It is our view, for instance, that legacy swaps (those entered into prior to the effectiveness of a mandatory clearing requirement for that particular swap) should be able to amended, assigned and novated without the counterparties being considered to be "engaged in a swap."[23]

Similarly, the Commission has not addressed what variances in the terms of a swap from those of swaps required to be cleared (which we presume will be standardized) will justify a determination not to clear such a swap. We appreciate that the Commission may be concerned about possible evasion of the clearing requirement by creating minor variances, but we also believe that proper hedging may in many instances require bespoke transactions. The Dodd-Frank Act provides a clear exemption for hedging transactions if one party to the hedge is not a financial entity and notice is provided to the Commission.[24] Although the Dodd-Frank Act does not contain an equivalent exemption for financial entities where the swap is subject to a mandatory clearing requirement, the Dodd-Frank Act does permit financial entities to enter into swaps that are not eligible for clearing. We believe that the need to establish appropriate hedges may require financial entities to enter into transactions that are similar to swaps that are subject to a mandatory clearing requirement but are not themselves eligible for clearing. In these circumstances, we believe the presumption should be that the terms of the swap were determined to support the hedge and not to evade the mandatory clearing requirement.

There are numerous circumstances in which a financial entity may enter into a bilateral bespoke transaction to hedge a particular risk, rather than entering into a similar product that is eligible for clearing. One example is where a financial entity determines that it is necessary to enter into a bespoke transaction to satisfy the conditions for treating

[23] We acknowledge that there may be circumstances in which the terms of a legacy swap are changed so extensively that the swap is arguably a wholly different transaction. We are not suggesting that market participants should be permitted to amend legacy swaps for the purpose of evading the clearing requirements of Title VII of the Dodd-Frank Act. We believe, however, that the Commission has sufficient tools available to it to address abusive use of amendment provisions without limiting or conditioning the ability of market participants to make ordinary course amendments to existing transactions.

[24] Section 723(a)(3) of the Dodd-Frank Act.

a swap as a hedging transaction under ASC Topic 815 (previously FAS 133) or any other similar or replacement accounting standard. Another is a bespoke swap transaction entered into by an insured depository institution ("IDI") in connection with a loan, where the transaction meets the conditions of Title VII of the Dodd-Frank Act and the Commission's regulations for exclusion of the IDI from designation as a swap dealer. We believe that such a transaction should be presumed to be not required to be cleared, even if the borrower is also a financial entity. There are a myriad of other reasons that a small variance in the terms of a swap from those available for a cleared product are essential for business reasons, and where there is a clear business need for the variance we believe that entry into the uncleared swap should be viewed as legitimate.

## VI. Swaps entered into between affiliates

In connection with the Commission's proposed definitions of swap dealer and major swap participant, the Commission has asked whether swaps between affiliates that reflect the allocation of risk within a corporate structure should be counted in determining the *de minimis* exemption or status as a major swap participant.[25] We believe that there are special considerations with respect to inter-affiliate swaps in the context of mandatory clearing requirements that should be considered as well. In the case of swaps between members of a corporate group, mandatory clearing does not appear to add any value in terms of reducing systemic risk, and requires affiliated entities to post margin and incur other unnecessary costs. Where all the risk is intercompany, such a requirement may simply discourage the use of swaps. In addition, it is not uncommon for an affiliated group to have a designated entity that enters into all third-party swaps on behalf of the group and then enters into back-to-back swaps within the affiliated group. All of the efficiencies of such an arrangement would be lost if not only the third-party swap but the internal back-to-back swaps had to be cleared. We therefore encourage the Commission to exempt swap transactions between affiliated entities from the mandatory clearing requirements.

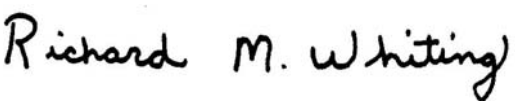
[25] 75 Fed. Reg. 80183 (December 21, 2010).

## VII. Additional procedural matters

DCOs that intend to begin clearing swaps transactions must make a submission to the Commission for review and must provide advance notice to their members of the proposed submission. In the Proposing Release, the Commission has asked for comment on whether a DCO should have to provide this notice of a proposed submission of a swap to the Commission for review in accordance with the DCO's established policies, or whether the Commission should establish minimum standards.[26] We believe that the DCO and its clearing members—all of whom we expect to be sophisticated financial markets participants—will be in the best position to determine appropriate notice and voting procedures with respect to these matters. We also believe that these requirements are generally internal governance requirements and imposing minimum standards that may differ from the DCO's internal policies serves no purpose with respect to the purposes of the Dodd-Frank Act. Therefore, we believe the Commission should allow the DCO to determine these procedures for itself.

We appreciate the opportunity to express our views on these extremely complex issues. We are confident that the Commission will adequately address the six areas of specific concern that the Roundtable has addressed 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
Executive Director and General Counsel
Financial Services Roundtable

[26] 75 Fed. Reg. at 67279.