Coalition for Derivatives End-Users

January 3, 2011

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

Submitted via Agency Website

Re: Comments Regarding CFTC's Proposed Rule Pertaining to the Process for Review of Swaps for Mandatory Clearing

The Coalition for Derivatives End-Users (the "Coalition") is pleased to respond to the request for comments by the U.S. Commodity Futures Trading Commission ("Commission") regarding its notice of proposed rulemaking under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") pertaining to "Process for Review of Swaps for Mandatory Clearing" (the "proposed rule").[1] These comments are purposed toward ensuring that end-users continue to be able to efficiently and effectively manage their business risks, and to ensuring that end-users are not subjected to undue risks.

The Coalition represents thousands of companies across the United States that employ derivatives to manage risks they face in connection with their day-to-day businesses. Throughout the legislative process to reform our financial regulatory system, the Coalition advocated for a strong derivatives title that reduces systemic risk, increases transparency in the over-the-counter ("OTC") derivatives market, imposes thoughtful new regulatory standards, and provides a strong, unambiguous exemption for end-users from the act's clearing, trade execution, margin, and capital requirements. More than 270 companies and trade associations have signed letters the Coalition sent to Congress during debate on the Dodd-Frank legislation advocating for a carefully calibrated derivatives regulatory regime that would not impose undue burdens on end-users whose derivatives activities do not pose systemic risk.

Though certain end-users are exempted from clearing requirements, many end-users will or may well be subject to these requirements, including major swap participants, the pension funds of non-financial end-users, and financial end-users. The Coalition believes that end-users should not be subject to clearing requirements and, to the extent that some subset of end-users is so subjected, the clearing requirements must not create undue risks or jeopardize the ability of the end-users to secure efficient pricing when they transact.

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[1] 75 Fed. Reg. 67277 (Nov. 2, 2010).

In this context, the Coalition offers comments on the assessment factors that the Commission will use to determine whether a transaction must be cleared. Most notably, we emphasize the importance of considering the specific attributes of swap transactions and how those attributes may impact the liquidity, pricing, and valuation of the swaps when determining whether swaps should be subject to the mandatory clearing requirement.

Consideration of Liquidity in Determining Mandatory Clearing Requirements

Congress recognized that liquidity is critical for achieving efficient market pricing and determining the required margin for cleared trades. Section 2(h)(2)(D)(ii)(I) of the Commodity Exchange Act, as amended (the "CEA"), requires that the Commission take into account "[t]he existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data" when making mandatory clearing determinations.

The proposed rule emphasizes liquidity in listing the information a Designated Clearing Organization ("DCO") must submit in a request to clear a swap (or group, category, type or class of swaps[2]); specifically, DCOs must supply "[m]easures of market liquidity and trading activity, including information on the sources of such measures." The proposed rule further requires the Commission to perform "[a]n analysis of the effect of a clearing requirement on the market for the group, category, type or class of swaps, both domestically and globally, including the potential effect on market liquidity, trading activity, use of swaps by direct and indirect market participants, and any potential market disruption." DCOs are required to submit such information to inform the Commission's determination of whether to require a class of swaps to be cleared.

These submission requirements indicate the Commission's recognition that this information should be considered to ensure both the safety and soundness of the DCO, and that the clearing requirement does not unduly disrupt the market for the swap subject to the submission. Given the importance of liquidity in the context of clearing, the Coalition urges the Commission to give significant weight to a swap's liquidity in assessing whether that swap should be subject to mandatory clearing.

Liquidity is not only an important factor in determining mandatory clearing requirements, but also for trade execution. Swaps that are subject to mandatory clearing may also be subject to the requirement that trades be executed on a swap execution facility ("SEF") or designated contract market ("DCM")[3] (hereinafter, the "trading requirement"). Liquidity is critical to assure that

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[2] Hereinafter, we refer to a group, category, type or class of swaps as simply a "swap" or a "class of swaps."

[3] CEA section 2(h)(8)(A) stipulates that: "With respect to transactions involving swaps subject to the clearing requirement of paragraph (1), counterparties shall—(i) execute the transaction on a board of trade designated as a contract market under section 5; or (ii) execute

[Footnote continued on next page]

trades subject to the trading requirement achieve price transparency and trade execution beneficial to end-users and the market overall.

The financial and systemic benefits achieved by mandatory clearing and by the trading requirement are similar, but not identical. The Coalition is supportive of increased price transparency for highly liquid swaps, and believes that the trading requirement could benefit end-users and the market overall in those cases. If a swap is not sufficiently liquid and is made subject to the trading requirement, however, end-users could be forced to transact in a venue that is not well-suited for achieving efficient execution or market pricing.

Senator Lincoln, then-chairman of the Senate Agriculture Committee, acknowledged this problem during the Senate's consideration of the Dodd-Frank Act. Regarding the statutory exception from the trade execution requirement "if no board of trade or swap execution facility makes the swap available to trade,"[4] she stated:

> In interpreting the phrase "makes the swap available to trade," it is intended that the Commission should take a practical rather than a formal or legalistic approach. Thus, in determining whether a swap execution facility "makes the swap available to trade," the Commission should evaluate not just whether the swap execution facility permits the swap to be traded on the facility, or identifies the swap as a candidate for trading on the facility, but also whether, as a practical matter, it is in fact possible to trade the swap on the facility. The Commission could consider, for example, whether there is a minimum amount of liquidity such that the swap can actually be traded on the facility. The mere "listing" of the swap by a swap execution facility, in and of itself, without a minimum amount of liquidity to make trading possible, should not be sufficient to trigger the Trade Execution Requirement."[5]

Importantly, Chairman Lincoln directed regulators to consider liquidity when determining whether a transaction is suitable for the trading requirement.

[Footnote continued from previous page]
the transaction on a swap execution facility registered under 5h or a swap execution facility that is exempt from registration under section 5(h)(f) of this Act."

[4] 7 U.S.C. § 2(h)(8)(B).

[5] 156 CONG. REC. S5923 (daily ed. July 15, 2010) (statement of Senator Blanche Lincoln) (emphasis added).

It is conceivable that some less liquid trades could be suitable for clearing, especially if clearinghouses establish certain legal arrangements with their clearing members.[6] This notion, though perhaps reasonable for very limited groups of transactions, does not hold true for the trading requirement. Applying the trading requirement to certain mandatorily cleared swaps may arguably have the effect of reducing systemic risk, but may not result in meaningful price transparency and efficient trade execution for end-users and other market participants. Imposing the trading requirement on illiquid swaps could have a deleterious impact on the availability of such illiquid swaps for use in hedging legitimate business risks by end-users. Accordingly, the Coalition urges regulators to consider the link between the clearing requirement and the trading requirement and to be cautious to apply the trading requirement only to highly liquid swaps.

Managing DCO Risk

Though many end-users may not be subject to the central clearing requirements of Dodd-Frank, they appreciate the risk-reducing benefits that central clearing will bring to the financial markets as a whole. If properly risk-managed, the Act's central clearing mandates will serve to diminish substantially the risk that derivatives could pose to the financial system. However, absent proper risk-management and oversight, clearinghouses could increase risk to the financial system. Regulator decisions about the products that should be subject to the Act's mandatory clearing requirements could diminish or increase such risks.

As for-profit institutions, clearinghouses have incentives to clear as many transaction types as possible. The more products clearinghouses make available for clearing and regulators require to be cleared, the more revenue clearinghouses will generate. Of course, clearinghouses also must establish adequate safeguards to protect against undue risks. The advancement of the countervailing objectives of maximizing revenue and minimizing risks may result in increased costs for clearinghouses' members and their customers.

Specifically, clearinghouses can manage these risks by increasing initial margin. Riskier or more volatile transactions can be subjected to very high initial margin requirements, whereas liquid or less volatile transactions can be subject to low initial margin requirements. In this way, initial margin requirements can absorb some of the risks that result from limited liquidity. However, high initial margin requirements represent costly uses of capital for end-users. Rather than

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[6] *See, e.g.*, Financial Stability Board Report, *Implementing OTC Derivatives Market Reforms* (Oct. 25, 2010), available at http://www.financialstabilityboard.org/publications/r_101025.pdf. ("Nevertheless, a derivatives product still may be suitable for clearing by a CCP, even if it cannot be reasonably ruled out that the market for the product could become illiquid in times of stress. In such circumstances, a CCP may have rules establishing default management arrangements whereby their clearing members agree ex ante to bid in an auction of the defaulting member's portfolio, and, in extreme cases (i.e., if the auction process fails), although not a solution for illiquidity, accept an allocation of the portfolio.").

deploying funds productively, such requirements would cause companies to divert funds from their businesses—funds that otherwise might be deployed to productive, job-creating activities.

If the Commission requires a certain class of swaps to be cleared and if such swaps are illiquid and require high initial margin requirements, end-users subject to the clearing requirement will be faced with an unwarranted dilemma: deploy capital unproductively or retain risk by not hedging. Neither choice results in a desirable public policy outcome.

We thus further urge the Commission to prioritize liquidity when exercising its authority to subject swaps to the clearing requirement. Similarly, the Coalition urges the Commission to ensure that DCOs do not set initial margin requirements that effectively discourage end-users from engaging in swaps that might be less-liquid but that efficiently manage risk. The Commission may do so by precluding illiquid transactions from being cleared and by using high proposed initial margin levels as a barometer for identifying potentially illiquid transactions.

Defining Groups, Categories, Types, or Classes of Swaps Subject to the Clearing Requirement

Under the Dodd-Frank Act, the Commission is granted the authority to determine that a "group, category, or class of swaps" must be cleared.[7] End-users are concerned that these groups or categories could be defined too broadly, without due consideration of the important differences between swaps within these groups or categories.

For example, it may be that a particular clearinghouse is well-equipped, as is the case today, to clear certain U.S. Dollar interest rate swaps, providing that the swaps are standardized, or "plain vanilla."[8] The clearinghouse may not, however, be well-equipped to clear more customized U.S. Dollar interest rate swaps.[9] While these two types of trades are both in the broad category of U.S. Dollar interest rate swaps, there could be important differences in the liquidity, pricing, and valuation for each of the trades.

Given the regulatory mandate, clearinghouses would have an incentive to clear all types of swaps within a given group or category, which could subject the clearinghouse and the broader market to substantial risks. Moreover, as we mentioned above, this could have a deleterious impact on a firm's ability to secure efficient pricing as the trading requirement could apply to any group or category of swaps that is deemed required to be cleared.

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[7] 7 U.S.C. § 2(h)(2)(a)(i).

[8] For example, a semi-bond swap based on 3-month USD LIBOR.

[9] The tenor and underlying interest rate index, among other trade attributes, could make an interest rate swap less liquid and more difficult to price and value.

We urge the Commission, when it makes a determination that a particular "group, category, type or class of swaps" should be subject to the mandatory clearing requirement, to carefully consider all of the specific attributes of different types of swaps and how those attributes affect the liquidity, pricing, and valuation of the swaps.

Other Relevant Features of Swaps

When assessing whether a swap is sufficiently liquid to be subject to the mandatory clearing requirement, regulators should consider both economic and non-economic terms. Non-economic terms could include key legal, credit, and contingent features. Though market participants often favor standardized terms, there are numerous situations in which non-standardized terms are important to end-users.

For example, swaps are occasionally executed as a part of a broader financing package. In such situations, the swap is often pledged as collateral to the lender. In the event that the borrower defaults and the swap is an asset to the borrower, the lender can use the positive value of the swap to offset losses on the underlying financing. Requiring such a swap to be cleared might prevent the borrower and lender from utilizing this risk-mitigating feature as the borrower could not pledge the swap as collateral for the loan.

In addition, swaps may have contingent features that would affect the liquidity, pricing, and valuation of the swaps. For example, with deal-contingent foreign currency forwards, the forward would only become effective if a particular event occurs—for example, if a planned asset purchase takes place. These contracts are beneficial because parties agree to cancel the forward in the event the underlying asset purchase fails to close, thus relieving either party of settlement obligations if the underlying risk fails to materialize. However, if the purchase contract closes, the forward becomes effective and serves to mitigate the currency risk incurred as a result of the purchase. This contingent feature would render an otherwise liquid contract—a currency forward contract—illiquid. Such specialized features are difficult to value because they depend on events the occurrence of which third parties cannot accurately predict. If such transactions were subject to mandatory clearing requirements, end-users could be subject to margin requirements that are arbitrarily determined.

In certain types of financings (e.g., loan syndications) borrowers will secure their swap obligations by using non-standard collateral. Such non-standard collateral could include receivables, security interests in the cash flows of an asset, real property, fixtures, or other similar forms of collateral. Moreover, the same non-standard collateral could be used to secure a swap executed in connection with such a loan syndication or financing. In each case, the pledged collateral is effective in mitigating against potential credit losses associated with the underlying loan. However, in each case it would be challenging for borrowers to clear such transactions. This is so because DCOs cannot share collateral with a bank lending syndicate.

These examples serve to illustrate an important point—that regulators should not limit their analysis of whether a particular transaction type should be cleared to the economic properties of the transaction, but rather should contemplate non-economic features as well.

Also, end-users enter into customized hedging transactions that often, but not always, receive hedge accounting treatment under relevant accounting guidance. These swaps may have some economic terms in common with swaps that are well-suited to mandatory clearing, but not all. For instance, an end-user may enter into a 5-year U.S. Dollar interest rate swap that has different coupon dates or references a different rate index than a swap that is readily able to be accepted for clearing by a DCO. We urge regulators to avoid rules that would serve to discourage end-users from utilizing customized transactions, and thereby preserve end-users' ability to enter into transactions that are tailored to meet specific economic and accounting objectives.

Affiliate Transactions

We further urge the Commission to consider the unique circumstances of transactions between affiliates. End-users often use internal swap transactions to allocate and manage business risks efficiently and effectively within a corporate group. Such transactions do not create any external counterparty exposure and, therefore, pose none of the systemic or other risks that the mandatory clearing requirement is designed to protect against. Accordingly, the imposition of mandatory clearing on these transactions would have no benefit to the reduction of systemic risk, and instead, would impose unnecessary cost and substantial administrative burdens upon market participants, as well as tie up valuable liquidity. We therefore urge the Commission to adopt an exemption from the mandatory clearing requirement for intra-group transactions.

Conclusion

We thank the Commission for the opportunity to comment on these important issues. We also want to express our appreciation for the willingness of Commission officials to meet with us in order to share perspectives on implementation of the derivatives title.

The Coalition looks forward to working with the Commission to help implement rules that serve to strengthen the derivatives market without unduly burdening business end-users and the economy at large. We are available to meet with the Commission to discuss these issues in more detail.

Sincerely,

Business Roundtable
National Association of Corporate Treasurers
National Association of Manufacturers
National Association of Real Estate Investment Trusts
The Real Estate Roundtable
U.S. Chamber of Commerce