



March 25, 2011

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

Re: Risk Management Requirements for Derivatives
Clearing Organizations; 17 CFR Part 39, RIN 3038-AC98

Dear Mr. Stawick:

The Swaps & Derivatives Market Association (“SDMA”) appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the “Commission”) on the Notice of Proposed Rulemaking regarding Part 39 of Title 17 of the Code of Federal Regulation (“Part 39”) entitled “Risk Management Requirements for Derivatives Clearing Organizations”.

The SDMA, formed in January 2010, is a non-profit financial markets trade group of United States and internationally based broker-dealers, investment banks, futures commission merchants, and asset managers who participate in all segments of the exchange-traded and over the-counter derivatives and securities markets.

The SDMA supports the goals of the Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), and the amendments to the Commodity Exchange Act, which create a comprehensive regulatory framework for the trading of swaps. An important aspect of the Dodd-Frank Act is the Section 723 requirement that

all swaps are cleared on a “non-discriminatory” basis, regardless of how the swap has been executed. The SDMA believes that there are three components to the non-discriminatory clearing of swaps: (1) the clearing member application process; (2) neutrality of trade execution; and (3) trade anonymity. The clearing member application process must be transparent, objective, and promote fair and open access to clearing. Trade neutrality requires that regardless of whether a trade is executed on a swap execution facility, designated contract market, or bilaterally, the trade is cleared in the same manner and permits trading to occur: (a) dealer to customer, (b) customer to customer, and (c) dealer to dealer. The clearing process should not result in the loss of trade anonymity.

1. The Benefits of Clearing

The SDMA believes that the non-discriminatory clearing of swaps, as envisioned by the Dodd-Frank Act, will: (a) reduce systemic risk, (b) increase price transparency, (c) lower transaction costs; and (d) increase liquidity. The Derivatives Clearing Organization (“DCO”) is the gatekeeper to bringing central clearing to the swaps market. In no event should a DCO be permitted to use restrictive and discriminatory clearing member eligibility requirements to undermine the goals of the Dodd-Frank Act. Over two years have passed since the financial crisis, and still a small group of financial institutions control and limit the availability of clearing in the swaps market. Capital and operational requirements that limit access to clearing have no bearing on a clearing member’s capital adequacy or capability and are transparent attempts to limit competition. For the benefits of clearing to be realized, all discriminatory impediments to obtaining clearing house membership must be removed. As discussed below, the SDMA supports proposed rule 39.12(a) where a DCO “shall establish appropriate admission requirements for clearing members of the derivatives clearing organization that are objective, publicly disclosed, and risk-based.” The SDMA believes proposed rule 39.12(a) promotes the goals of the Dodd-Frank Act.

2. Fair and Open Access

Since their inception, clearing houses have played a vital role in the market by managing the default risk of counterparties and spreading that risk over the members of the clearing house. This system is most effective when an aggregate group of clearing members is large and uncorrelated, and conversely, least effective when the group is small and correlated. Systemic risk is especially problematic in the current environment where DCO's are monopolies controlled by a handful of highly correlated firms. In the event of a clearing member default, where there are a relatively small number of correlated clearing members, there is a greater chance that other clearing members may also default. In order to reduce systemic risk the DCO's must have a large, non-correlated group of clearing members. This can only be accomplished through clearing membership standards that are based upon fair and open access.

Discriminatory barriers to DCO membership that protect entrenched interests and limit membership to a small correlated group result in increased systemic risk. To make the Dodd-Frank Act's goal of non-discriminatory clearing a reality, clearing member eligibility requirements must promote fair and open access to the DCO's. The SDMA supports proposed rule 39.12(a)(1), as the SDMA believes the proposed rule promotes fair and open access by: (a) prohibiting a DCO from adopting restrictive eligibility standards if less restrictive standards "would not materially increase risk" to the DCO; (b) allowing all participants who satisfy eligibility requirements to become clearing members; and (c) prohibiting the DCO from restricting clearing membership to certain types of market participants.

3. Financial Requirements

Excessive minimum capital requirements for clearing member eligibility are an anticompetitive barrier to clearing. The \$1 billion capital requirement suggested by DCOs is discriminatory and serves only to limit clearing house membership. In the

current economic environment, \$1 billion in capital does not, in itself, guaranty financial stability. As the Global Financial crisis of 2008 has readily shown, once there is a loss of confidence in a financial institution its capital evaporates rapidly. For example, both Bear Sterns and Lehman Brothers could have met the proposed \$1 billion capital requirement. But, once confidence in their financial stability was shaken, both firms saw their capital vanish virtually overnight.

The SDMA believes that capital requirements must be scalable and relate to the amount of risk a clearing member brings to the market, and not some arbitrary, discriminatory monetary threshold. The SDMA agrees capital requirements are necessary; however the threshold should be tied to the amount of risk the clearing member brings to the market and should be calculated per trade and by the total value of the customer portfolios that it clears. The SDMA supports the Commission's proposed rule 39.12(a)(2)(ii) which provides that capital requirements should be "...based upon objective, transparent, and commonly accepted standards that appropriately match capital to risk." In addition, the SDMA supports the CFTC proposal to cap minimum capital requirements for clearing house membership at \$50 million, stated in proposed rule 39.12(a)(2)(iii). This level of capital would permit broad participation by clearing members and reduce systemic risk.

4. Operational Requirements

Discriminatory operational capabilities and requirements that undermine the clear mandate of the Dodd-Frank Act should not be permitted. Imposing clearing membership operational requirements that are not part of a clearing member's core business creates discriminatory barriers to clearing. Examples of discriminatory operational eligibility requirements are that clearing members must (a) have both execution and clearing capabilities, (b) provide end of day prices ("EOD") to mark its positions, and (c) have extensive experience in clearing swaps or "sophistication".

DCO clearing member eligibility rules that require that a clearing member must use its own dealer desk to participate in the default auction process is a discriminatory standard intended to limit clearing house membership. There is no reason why a clearing member should not be able to contract with third parties to handle the prompt liquidation or hedging of default positions. A default auction's success is dependent upon the DCO's ability to neutralize the default risk of the distressed clearing member by selling of its entire portfolio. There are two key components to this default auction process: (a) diversification of risk, and (b) obtaining the best price for the distressed positions. Both components are directly affected by the number of participants in the default auction.

As discussed above, clearing houses work most effectively when the risk of default is spread over many non-correlated clearing members. In times of distress clearing, members would be given distressed positions in direct proportion to the size of the positions it typically carried. A greater number of smaller clearing members can have a significant, positive effect on shouldering the responsibility of handling distressed assets. Therefore, as the number of clearing members increase, the level of risk diversification increases in direct proportion. In addition, a larger number of participants create a greater likelihood that the best price possible for the distressed positions will be obtained. ISDA's default auction process is a good example of a rapid and highly organized default auction for swaps. There were over 400 participants in the Lehman Brother auction, which clearly yielded better prices than if there were less than 10 participants.

Currently, certain DCO's require that the FCM provide EOD prices to the clearing house. For now, while transparency is still limited in the marketplace (before SEF's go online), such a requirement is a legitimate request so that the DCO can mark positions.

The DCO, however, requires that such prices can only come from an FCM's own dealer desk. Clearly, such actionable prices can also come from a third party dealer who acts

in concert or under contract with an independent FCM seeking to clear OTC derivatives. There is no evidence to suggest, as certain parties have suggested, that somehow a legal arrangement with a third party dealer somehow lessens the integrity to the system. With regard to EOD prices, the SDMA believes that such a linkage of clearing to execution, where no compromise, or a more inclusive solution has been offered, should be seen for what it is-- nothing more than a transparent attempt to limit competition. Simply put, any DCO seeking to deny access and limit competition in such a way should be prevented from doing so.

The SDMA believes that clearing eligibility requirements that relate to “sophistication” is another unnecessary and unreasonable barrier to clearing house membership, and contradicts goals of the Dodd-Frank Act to provide open access to clearing. There is no similar requirement in other markets. In fact, the Chicago Mercantile Exchange (CME), which is one of the largest central clearing parties in the world, has no such rule and has never – its 110 plus years of existence – defaulted on a clearing member obligation. Clearing member eligibility requirements should instead be focused upon the operational functions as set out in proposed rule 39.12(a)(3), which are the functions clearing members have traditionally provided to the clearinghouse.

In addition, limiting broad participation in OTC clearing dangerously increases the risk among the few qualifying players in the marketplace. Such an increase in the systemic risk brings us back to where we were before the Dodd-Frank Act became law.

The SDMA supports the operational requirements outlined in proposed rule 39.12(a)(3) because they are relevant to the functions that clearing members traditionally provide in reducing systemic risk in the market. The operational qualifications stated in proposed rule 39.12(a)(3) require that clearing members have the ability to: (a) process expected volumes and values of transactions cleared by clearing member in the required time frame; (b) fulfill collateral, payment, and delivery obligations imposed by DCO; and (c) participate in default management activities. Unlike the discriminatory requirements of

having a dealer desk or providing EOD pricing, these operational requirements are directly related to the core business of the clearing member and provide the services needed and relied upon by the DCO to clear trades.

Conclusion

The SDMA supports the goals of the Dodd-Frank Act to reduce risk, improve market integrity and provide price transparency. DCO clearing member eligibility requirements should not undermine the requirement of Section 723 Dodd-Frank Act, which stipulates all swaps must be cleared on a “non-discriminatory” basis regardless of how the swap has been executed. The SDMA supports the proposed rule 39.12(a) as it promotes the goals of Dodd-Frank Act by creating a regulatory framework that makes central clearing available for derivatives by requiring that standards for clearing member eligibility requirements be transparent, objective, and provide fair and open access.

Sincerely,

A handwritten signature in black ink, appearing to read "Michael Hisler". The signature is fluid and cursive, with a large initial "M" and "H".

Michael Hisler
The Swaps & Derivatives Market Association
(646) 588-2011