



BETTER MARKETS

July 18, 2016

Mr. Christopher Kirkpatrick
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

Re: Clearing Requirement Determination Under Section 2(h) of the CEA for Interest Rate Swaps (CFTC RIN: 3038-AE20)

Dear Mr. Kirkpatrick,

Better Markets Inc.¹ appreciates the opportunity to comment on the above-captioned proposed clearing requirement determination (“Proposal” or “Proposed Rule”), issued by the Commodity Futures Trading Commission (“CFTC” or “Commission”).

INTRODUCTION

In the Dodd-Frank Act, “Congress determined that clearing is at the heart of reform....”² Moreover, a fundamental premise of the Dodd-Frank Act is that the central clearing of derivatives reduces systemic risk, not perfectly and not in all cases, but decidedly better than the pre-crash arrangements and the post-crash alternatives. Therefore, this Proposal serves a critical role in further implementing the availability of, and the requirement for, clearing of derivatives.

As the market structure continues to evolve, the vast majority of derivatives transactions will be intermediated by clearing members of derivatives clearing organizations (“DCOs”), and the DCOs will be responsible for managing counterparty credit risk between the DCO and its members. This Proposal takes an important step in

¹ Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans’ jobs, savings, retirements, and more.

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.

this direction. The proposal would amend CFTC Rule 50.4(a) to add fixed-to-floating interest rate swaps denominated in nine additional currencies, as well as certain non-U.S. denominated forward rate agreements. The nine new currencies are the Australian dollar (“AUD”), Canadian dollar (“CAD”), Hong Kong dollar (“HKD”), Mexican peso (“MXN”), Norwegian krone (“NOK”), Polish zloty (“PLN”), Singapore dollar (“SGD”), Swedish krona (“SEK”), and Swiss franc (“CHF”). The CFTC also is proposing to amend its original clearing determination to raise the maturity limit for clearing overnight index swaps from two to three years. The scope of this proposal would make the CFTC's clearing requirement consistent with those that were proposed and finalized in 2015 and 2016 by the CFTC's counterparts in Australia, Canada, the European Union, Hong Kong, Mexico, and Singapore.

The Proposal is an important step in reducing systemic risk and increasing transparency in the swaps market. Interest rate swaps markets significantly contribute to the interconnectedness of financial market participants because of the sheer size of the markets and the generally large exposures of major swap dealer banks that control the markets. As such, losses at one of the major swap dealer banks can easily and quickly spread across the markets and cause serious contagion risk. Therefore, we commend the CFTC in the effort to further expand the types of swaps that are subject to mandatory clearing to include additional interest-rate swaps.

DISCUSSION

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....³

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 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
- (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.⁴

The Proposal satisfies the five statutory factors for clearing requirement determination

Under the Commodity Exchange Act, as amended by the Dodd-Frank Act, the Commission must take into account five factors in making a clearing requirement determination. These factors are as follows:

- (1) The existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data;
- (2) The availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded;
- (3) 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;
- (4) The effect on competition, including appropriate fees and charges applied to clearing; and

³ Dodd-Frank Act, Section 723(a)(3).

⁴ *Id.*

(5) The existence of reasonable legal certainty in the event of the insolvency of the relevant DCO or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property.”⁵

We find that the Commission properly interpreted the statutory mandate and that the Commission’s analytical approach and its conclusions are proper for the following reasons, numbered in accordance with the factors.

- First, the data⁶ from CME, Eurex, LCH, and SGX, which the Commission has reviewed and presented, demonstrates the existence of sufficient regular trading activity and outstanding notional exposures in the fixed-to-floating interest rate swaps, basis swaps denominated in AUD, and AUD-, NOK-, PLN-, and SEK-denominated FRAs to provide liquidity necessary for DCOs to successfully risk manage these products and to support a clearing requirement.
- Second, the four DCO’s which the Commission has reviewed for purposes of this proposal are already clearing the swaps in the Proposal, and are in compliance with the DCO core principles, which by definition give them the ability to clear swaps subject to this Proposal, even during times of market stress.
- Third, as the Commission noted in the release, the central clearing of the interest-rate swaps that are subject to this proposal would serve to mitigate counterparty credit risk, and may increase the number of clearing members and market participants in these swaps, which would ultimately reduce systemic risk.
- Fourth, central clearing of the additional interest-rate swaps in this Proposal will remove a significant barrier to entry for alternative liquidity providers in the swaps market and will enable smaller swap dealers and swap participants to compete on more leveled playing field with the large swap dealer banks who continue to control the vast majority of the swaps market. Additionally, the increase in competition will usher in numerous benefits such as: reduced bid/ask spreads, true liquidity, and improved access to best execution for all market participants.
- Fifth, while we agree that there is “reasonable” legal certainty in the event of the insolvency of the relevant DCO or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property, the best circumstance is one in which member defaults are

⁵ See CEA section 2(h)(2)(D)(I)-(V).

⁶ Release at 39513-23.

prevented so that those procedures and reserves are not put to the test. A default may not simply be an event between the clearing member and its counterparty. It would far more likely be a catastrophic credit event that triggers liquidation by all or many intermediaries and direct counterparties. Thus, we urge the Commission to strictly surveil DCO's risk management procedures, as Better Markets has advocated for in the past.⁷

CONCLUSION

We hope these comments are helpful.

Sincerely,



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⁷ See <http://bettermarkets.com/sites/default/files/documents/CFTC-%20CL%20Clearing%20Member%20RM%209-30-2011.pdf>.