



February 14, 2011

Ms. Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

Re: Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing  
File Number S7-43-10

Dear Ms. Murphy:

Better Markets, Inc.<sup>1</sup> appreciates the opportunity to comment on the above-captioned proposed rules (“Proposed Rules”) of the Securities and Exchange Commission (“Commission”). In accordance with Section 763(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), the Proposed Rules would establish procedures governing the submission by clearing agencies of security-based swaps (“SBS”) to the Commission and the Commission’s review of those SBS to determine whether they should be subject to mandatory clearing.

### **INTRODUCTION**

Mandatory clearing of swaps, including SBS, was “at the heart” of the reforms in the Dodd-Frank Act.<sup>2</sup> The clearing process serves two critically important purposes. First and foremost, clearing mitigates systemic risk by interposing a central counterparty between the original participants in an SBS transaction. That central counterparty employs a reliable margining system that reduces the consequences of default by either party to the transaction. Second, mandatory clearing promotes transparency and price discovery, since under the Dodd-Frank Act, any SBS that must be cleared must also be traded on an exchange or a swap execution facility.

In light of these important benefits, and the unambiguous intent of Congress to establish clearing as a pillar of financial reform, any set of rules governing such a system must be

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<sup>1</sup> Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

<sup>2</sup> 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.

written to maximize the clearing of SBS within the parameters set forth in the Dodd-Frank Act. The Proposed Rules are a commendable effort to achieve this objective, but they need to be strengthened to ensure that the Commission has sufficient information to implement the mandatory clearing requirement. Such information will also ensure that the provisions in the Dodd-Frank Act are properly observed and that clearing agencies follow a transparent process as they submit SBS to the Commission for review.

### **SUMMARY**

Our comments focus on three aspects of the Proposed Rules: increasing the information that clearing agencies must provide to the Commission; limiting the Commission's discretion to weigh factors other than those set forth in the Dodd-Frank Act; and filling a regulatory void by calling upon the Commission to promulgate rules governing its ongoing review of SBS.

First, to ensure that the Commission has sufficient information to properly implement the statutory requirements of the Dodd-Frank Act, the Commission must adopt the following changes in the Proposed Rules:

- Require clearing agencies to submit all of the information identified in the Release and in the instructions for Form 19b-4 relating to the five statutory factors for determining whether SBS should be subject to mandatory clearing.
- Require clearing agencies to include additional information in their submissions regarding SBS pricing, liquidity, and risk management, which is essential for the Commission to make an informed decision.
- Require clearing agencies to disclose more information regarding the decision-making process they follow when deciding whether or not to submit an SBS to the Commission for review.

Second, the Commission must remove all language in the Proposed Rules that suggests or purports to authorize the Commission to consider any unspecified and undisclosed factors it deems appropriate when making mandatory clearing determinations. The Dodd-Frank Act is very clear and specific regarding the rule-making related to mandatory clearing of SBS. The Commission does not have a statutory basis to create such factors, and it certainly has no authority to do so on an undisclosed or entirely discretionary basis.

Third, the Commission must promulgate rules governing its ongoing review of SBS, to ensure that the standards it applies are transparent and consistent with the Dodd-Frank Act.

## **DISCUSSION**

### **The Proposed Rules Should Require the Submission of More Information Regarding the Factors Identified in the Dodd-Frank Act and the Decision-Making Processes that Clearing Agencies Follow**

The Proposed Rules must require clearing agencies to submit two types of additional information to the Commission. First, clearing agencies must be required to file more information regarding the five factors set forth in the Dodd-Frank Act, which guide the Commission in determining whether clearing of an SBS is mandatory. Second, clearing agencies must be required to submit additional information about the procedures they follow when deciding whether to submit an SBS to the Commission for review.

#### **Information Regarding the Five Factors**

The Dodd-Frank Act lists five factors that the Commission must consider in determining whether an SBS submitted by a clearing agency is required to be cleared. Those factors relate to the nature of the SBS submitted for review, as well as the clearing agency's operational and financial capacity to clear the SBS effectively and with appropriate risk controls. The five factors are:

- The existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data.
- 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.
- The effect on the mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the clearing agency available to clear the contract.
- The effect on competition, including appropriate fees and charges applied to clearing.
- The existence of reasonable legal certainty in the event of the insolvency of the relevant clearing agency or one or more of its clearing members with regard to the treatment of customer and security-based swap counterparty positions, funds, and property. Section 763(a) of the Dodd-Frank Act.<sup>3</sup>

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<sup>3</sup> Adding Section 3C(a)(4)(B) of the Securities Exchange Act of 1934.

To make a meaningful determination as to whether an SBS should be subject to mandatory clearing, the Commission must receive sufficient information to determine how each of these statutory factors applies to the SBS and to the clearing agency that submitted it.

The Proposed Rules incorporate verbatim the five factors set forth in the Dodd-Frank Act, but they do not require the clearing agency to provide any specific information that would elucidate the nature of the SBS or the ability of the clearing agency to clear it. Proposed Rule 240.19b-4(o). The Proposed Rules merely list the five factors and require submission of “information that will assist the Commission in the quantitative and qualitative assessment” of those factors. *Id.*

This requirement is simply inadequate and inappropriately delegates to the **clearing agencies** the discretion to determine what information the **Commission** needs to discharge **its** statutory duties under the Dodd-Frank Act. Moreover, it will also almost certainly result in widely divergent information, in terms of quality, quantity, and format, flowing into the Commission, needlessly burdening the Commission and its staff with having to sift, sort, organize, and interpret such data. This data will then have to be put into some comparable format for Commission review and decision-making. Thus, from a statutory and practical perspective, this approach must not be adopted.

In the proposing release (“Release”), the Commission lays out in considerable detail examples of the information that would address each of the five factors. Release at 82495. The same examples are also described in the instructions to the Form 19b-4, which clearing agencies must use to submit SBS for review. Notes to Proposed General Instructions for Form 19b-4. All of this information is within the scope of the five statutory factors that Congress set forth in the Dodd-Frank Act, and it is also clearly relevant to the Commission’s evaluation of a clearing agency’s submission, regardless of the type of SBS at issue. However, none of the information was actually incorporated into the Proposed Rule.

*Information Described in the Release and in the Instructions.* The Proposed Rules should expressly require every clearing agency to submit all of the information identified in the Release and in the instructions as potentially relevant to the five factors. That information includes:

- pricing models demonstrating the clearing agency’s ability to measure credit exposures in a timely and accurate manner;
- the rules, policies, and procedures that would be applicable to clearing of the SBS;
- risk management procedures, including those relating to monitoring credit exposures, initial and variation margin, settlement, and default management;
- fees and charges, including volume incentive programs;



- segregation of accounts and all other customer protection measures in the event of insolvency;
- product specifications, including standardized legal documentation and generally accepted contract terms;
- financial and operational capacity to provide clearing services to all customers; and
- an analysis of the effect of a clearing requirement on the market for the SBS, both domestically and globally.

All of this information is necessary to enable the Commission to evaluate the clearing agency's ability to clear any SBS and manage the risks associated with it. Its inclusion in the submission to the Commission must be mandated, not left to the clearing agency's discretion.

The Proposed Rules must also require submission of some additional important information regarding pricing, liquidity, and risk management. This information also falls within the five factors that Congress instructed the Commission to consider when evaluating SBS for clearing.

*Information Regarding Price Indices.* The Proposed Rules must require additional detail regarding indices used for pricing the SBS submitted for review. Price indices can result in a series of prices across a duration curve that is inconsistent in terms of quality. For liquid dates, the price may be based on good transaction data; for illiquid dates, the price may result from a model or even an interpolation.

Understanding how an index provider calculates prices is important to understanding the quality and reliability of those prices. This information is essential for the Commission to evaluate whether "adequate pricing" exists for an SBS, as explicitly required by the Dodd-Frank Act.

Accordingly, each clearing agency must be required to include in its submission the following information:

Information about any price reference index used, such as the name of the index, the source that calculates it, the methodology used to calculate the price reference index (including the methods used for each duration and methods used to establish prices for durations with low liquidity), how often it is calculated, and when and where it is published publicly.

*Information About Market Liquidity.* The Proposed Rules must also require the submission of additional information regarding liquidity. Liquidity can vary tremendously depending on the duration or term of an SBS. For certain credit default instruments, the liquidity of the SBS virtually always deteriorates dramatically over the life of the instrument. See CFTC-SEC Roundtable on Clearing of Credit Default Swaps, Washington, D.C., Oct. 22, 2010.<sup>4</sup> A clearing agency's submission must therefore include the following information: A description of the measures of market liquidity and trading activity applicable specifically to each duration of SBS to be offered for clearing, including information on the sources of such measures.

*Information About Risk Management Procedures.* The Proposed Rules must require additional information regarding risk management procedures. Specifically, in addition to a description of initial and variation margin methodology, the submission from the clearing agency should specify cross-contract netting and credits relating to initial margin, including correlations to be used and algorithms that result in the netting or credits. Only with this information can the Commission assess the accuracy and reliability of a clearing agency's risk management procedures with respect to margin calculations.

*Information on Hedge and Price Relationships.* The hedging relationships between the SBS proposed to be cleared and other SBS that are cleared by the clearing agency or by other clearing agencies can have an important impact on risk management and margining for the submitting clearing agency as well as its members and customers.

Each submission must therefore also include the following information:

- Observed hedge and price change relationships between the SBS proposed to be cleared and other SBS ("hedge equivalents"), whether cleared or non-cleared.
- Initial margin reduction that might be anticipated from clearing the swaps and the hedge equivalents at the same clearing agency.
- Identification of exchanges or SBS execution facilities that are (a) expected to list the swaps and (b) expected to list hedge equivalents, and information regarding the capability to clear SBS matched at each such exchange or SBS execution facility.

A full data set enabling a comprehensive review of SBS, as required by the Dodd-Frank Act, will only be possible if all of the information described above is also required from the clearing agency.

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<sup>4</sup> Available at [http://cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission7\\_102210-transcrip.pdf](http://cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission7_102210-transcrip.pdf)

Clarification Regarding the Role of Systemic Risk in the Decision to Mandate Clearing. One of the factors that the Commission must consider when reviewing SBS submitted by clearing agencies relates to systemic risk:

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.

Some market participants who oppose mandatory clearing of SBS suggest that, to be subject to mandatory clearing, an SBS must pose a material risk to the US financial system.

However, the Dodd-Frank Act does not suggest that only SBS presenting a direct threat to the financial system must be cleared. Systemic risk must be considered, but only as one factor among many. The obvious intent of the Dodd-Frank Act is that SBS should be presumptively subject to a mandatory clearing requirement, regardless of the specific quantum of systemic risk they may pose at a given point in time.

To preempt any attempt to limit the mandatory clearing requirement through a baseless and distorted interpretation of the systemic risk factor, the Proposed Rules should explicitly state that a given level of contract-specific systemic risk is not a prerequisite for mandatory clearing.

#### Information About the Clearing Agencies' Decision-Making Processes

The Proposed Rules must also require clearing agencies to submit additional information regarding the decision-making process they follow when they submit SBS to the Commission for review.

The Proposed Rules already promote transparency during the review process in several important respects. In accordance with the Dodd-Frank Act, the Proposed Rules require public notice of any submission the Commission receives from a clearing agency, as well as a 30-day comment period regarding the Commission's determination to require clearing of an SBS.

The Release also notes that the current instructions for Form 19b-4 require a clearing agency to file copies of the notices it has issued soliciting comment on the submission, as well as copies of all written comments that the clearing agency received from its members or participants, whether or not the comments were solicited. Release at 82496.

Notwithstanding these provisions, the Commission should receive more information regarding the factors that clearing agencies consider when they decide whether to submit an SBS for review. This additional information will serve two important purposes. First, greater transparency will provide more opportunities for interested parties, including the public, to make their views known and potentially raise additional important factors to be considered. Second, a thorough understanding of all the incentives—both financial and otherwise—that affect a clearing agency's decision to accept or reject an SBS for clearing

will assist the Commission as it manages the clearing regime and determines how best to promote clearing.

To ensure that the Commission has a complete understanding of the factors motivating a clearing agency to submit an SBS for review—or not to do so—the Proposed Rules should require disclosure of the following additional information:

- The submission should include a summary of member support for clearing the SBS as proposed, as well as member objections.
- The clearing agency should be required to notify the Commission, as well as the public, of the type of swap being considered *at the time it notifies members* of the submission or possible submission.
- The clearing agency should be required to solicit input *from both the public and customers* regarding the decision to make a submission, which can be considered alongside member views. The methods used to solicit such input and the outcome should be included in the submission.
- If a clearing agency Risk Committee or similar body solicits input from members, customers or others regarding a submission, and decides not to make the submission, the Commission should be notified of the decision and provided with the objections and supporting statements received regarding the proposed submission.

All of this information is necessary for meaningful transparency and to enable the Commission to oversee the mandatory clearing regime effectively.

### **The Commission Should Not Create Standards for Reviewing SBS Other Than the Criteria Set Forth in the Dodd-Frank Act**

The Dodd-Frank Act carefully delineated the five factors that the Commission must apply when determining whether SBS are required to be cleared. The intent of those standards is to maximize clearing of SBS for the purpose of limiting systemic risk, while at the same time ensuring that the SBS can be cleared effectively and efficiently by the clearing agency. Neither the text of the law nor its underlying purposes provide justification for deviating from those standards in the manner suggested by the Commission.

### **Review of SBS Submitted by Clearing Agencies**

The Proposed Rules would allow the Commission to go beyond the statutory criteria. They purport to authorize the Commission to take into account not only the factors set forth in the Dodd-Frank Act, but also “**any additional factors the Commission determines to be appropriate**” when it is deciding whether to impose the mandatory clearing requirement. Release at 82522; Proposed Rule 240.19b-4(o)(6)(i).



This open-ended provision would give the Commission unfettered authority to determine whether mandatory clearing should apply based on factors that are not found in the law or in the Proposed Rules. Relying on such “additional factors,” the Commission may refrain from imposing the mandatory clearing requirement even where the statutory criteria would require mandatory clearing. Such outcomes would be antithetical to the letter and spirit of the Dodd-Frank Act. Accordingly, this attempt to create additional, undisclosed factors when the Commission is applying the clearing requirement must be removed from the Proposed Rules.

The Release demonstrates that these concerns about the scope of the Commission’s regulatory authority are more than mere conjecture. In the Release, the Commission repeatedly expresses the view that mandatory clearing of SBS may not necessarily be desirable and should perhaps be implemented slowly:

As previously noted, moving security-based swaps into clearing in a gradual manner through non-mandatory clearing may in certain circumstances be appropriate. For example, a premature determination that a product is subject to mandatory clearing may, in certain circumstances, limit the ability of certain market participants to utilize that product (including for risk management purposes) which in turn could ultimately result in less clearing and more limited use of the product that might otherwise have been the case if it had been permitted to trade without being subject to a mandatory clearing requirement for a longer period of time. Release at 82501.

This is simply baseless speculation that troublingly echoes unsupported claims by certain market participants, who, not coincidentally, are adamantly opposed to clearing. Not surprisingly, the Release provides **no empirical or analytical support** for these assertions.<sup>5</sup>

As important, these observations suggest that the Commission may be inclined to substitute its judgment with respect to mandatory clearing for that of Congress. It should refrain from this approach, and it should adhere strictly to the statutory framework for imposing the mandatory clearing requirement.

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<sup>5</sup> As we have pointed out in a prior comment letter, the frequently asserted position that the cost of clearing margin is high compared with bi-lateral transactions for which no margin is required is based on flawed logic or disingenuous representations. It is very likely that mandated clearing will not deter prudent commercial hedging, but will instead improve disclosure and lower costs to end-users. *See* Letter from Better Markets, Inc. to the Securities and Exchange Commission on Proposed Rules Governing the End-User Exception to Mandatory Clearing of Security-Based Swaps, File Number S7-43-10 (submitted Feb. 4, 2011), at p. 4, n.4.

Altering the statutory criteria for mandatory clearing will erode the clearing regime required by the Dodd-Frank Act, which is already vulnerable to abuse through the end-user exception. If the Commission injects new and undisclosed criteria—**not** based on the statute—into the process for imposing mandatory clearing requirements, market participants will have new opportunities for evading the law.

It must never be forgotten that, as noted in the Release, “**every company, regardless of the type of business they are engaged in, has a strong commercial incentive to evade regulatory requirements.**” Release at 82499 (emphasis added).<sup>6</sup>

In keeping with this desire to avoid regulation, market participants will seek grounds for challenging the Commission’s finding that an SBS must be cleared. If the Commission creates any latitude in the mandatory clearing requirement, market participants will exploit it. The Commission must not facilitate this effort by creating more factors governing the mandatory clearing requirement, factors which ultimately will interfere with fulfilling the purposes of the Dodd-Frank Act.

It is referred to as “mandatory clearing” for a reason and the Commission must be vigilant in guarding against any impermissible reasons for limiting, inhibiting, or narrowing the mandatory clearing requirement.

#### Requests for a Stay of the Clearing Requirement.

The Proposed Rules similarly afford the Commission too much latitude in applying the clearing requirement after a stay has been issued. The Dodd-Frank Act provides that the Commission may stay the clearing requirement applicable to an SBS on the application of a counterparty to the SBS or on the Commission’s own initiative. The purpose of the stay is to allow the Commission additional time to complete “a review of the terms of the SBS . . . and the clearing arrangement.” Once the review is complete, the Commission may determine either that the SBS must be cleared, (conditionally or unconditionally), or that mandatory clearing shall not apply to the SBS. The Commission may require clearing of the SBS if the Commission “finds that such clearing is consistent with” the same criteria that are applicable to all SBS submitted to the Commission by clearing agencies. Section 763(a) of the Dodd-Frank Act.<sup>7</sup>

The text of the stay provision dispels any notion that the Commission should adopt or consider special criteria when it evaluates SBS in the context of a stay request. As noted above, the purpose of the stay provision is to afford the Commission more time to complete its review, not to inject new criteria into the process. In addition, once the Commission completes its review and reaches the question as to whether mandatory clearing is appropriate, the statute expressly requires application of the same factors that govern the review of SBS submitted to the Commission in the ordinary course.

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<sup>6</sup> Quoting S. Rep. No. 111-176 at 34.

<sup>7</sup> Adding Section 3C(c) of the Securities Exchange Act of 1934.

The Proposed Rules adhere to these statutory provisions with one important exception that must be remedied. The rules correctly provide that a counterparty seeking a stay must “specifically [address] the same factors a clearing agency must address in its security-based swap submission pursuant to Section 240.19b-4(o)(3).” That provision sets forth the five statutory factors governing the Commission’s review of SBS. Thus, the Proposed Rules faithfully adhere to the law with respect to the **showing** that a party seeking a stay must make.

However, the Proposed Rules also provide that “[t]he Commission’s review shall include, **but need not be limited to,**” its review of the factors specified in Section 240.19b-4(o)(3). As with the normal review of SBS submitted by clearing agencies, the Commission is inappropriately reserving the right to apply the mandatory clearing requirement according to criteria that are unspecified and, therefore, beyond the statutory requirements of the Dodd-Frank Act. The Proposed Rules should incorporate only factors that are consistent with the standards provided for in the statute. Accordingly, the phrase “but need not be limited to” must be deleted.

### **The Commission Should Promulgate Rules Governing its Ongoing Review of SBS.**

The Dodd-Frank Act requires the Commission, in addition to reviewing SBS submitted by clearing agencies, to conduct an ongoing review of all SBS to determine whether they should be required to be cleared. The statute does not specify the process that the Commission will follow, or the criteria that it will apply, in this ongoing review. Furthermore, as the Commission notes, the statute does not expressly require the Commission to promulgate rules on these issues. Release at 82498, n. 59; Section 763(a) of the Dodd-Frank Act.<sup>8</sup>

The lack of rules regarding the Commission’s ongoing review of SBS is a regulatory void that must be filled. The absence of any standards on an issue of such central importance is, on its face, unacceptable. The Release adds further cause for concern by inviting comment on whether, during the ongoing review of SBS, the Commission should consider **different** information than it considers when evaluating SBS submitted by clearing agencies. Release at 82499. This question raises two troubling possibilities: first, that during its ongoing review of SBS, the Commission will apply standards that are not publicly known, and second, that those standards will deviate from the strictures carefully incorporated by Congress into the Dodd-Frank Act.

These concerns must be addressed through rule-making. The rule-making process will ensure that the standards are vetted and made publicly known. In addition, the rules will make sure that the correct substantive standard is adopted. Those rules can—and indeed must—make clear that during its ongoing review of SBS, the Commission will apply standards that are **no different** than the standards applicable to the review of SBS submitted by clearing agencies. Nothing in the text of the statute suggests that new or different factors should apply or that the Commission has any authority to create new

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<sup>8</sup> Adding Section 3C(b)(1) of the Securities Exchange Act of 1934.

standards for its review of SBS. Indeed, any such action would be inconsistent with the rationale underlying the Dodd-Frank Act.

To ensure that the Commission's ongoing review of SBS is transparent and in accordance with the Dodd-Frank Act, the Commission should promulgate rules governing the process. Those rules should adopt the same substantive criteria that apply when the Commission is determining whether SBS submitted by clearing agencies should be subject to mandatory clearing.

### **CONCLUSION**

The clearing mandate is one of the most important reforms contained in the Dodd-Frank Act. The rules designed to implement this reform must promote a strong clearing regime through adherence to the standards set forth in the Dodd-Frank Act and an insistence on transparency in the process.

We hope these comments are helpful in your consideration of the Proposed Rules.

Sincerely,



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