



**Americans for Financial Reform**  
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September 6, 2012

Mr. David A. Stawick  
Secretary  
Commodity Futures Trading Commission  
Three Lafayette Center  
1155 21<sup>st</sup> Street, NW  
Washington, DC 20581

Re: Notice of Proposed Rulemaking – Clearing Requirement Determination Under Section 2(h) of the CEA (CFTC RIN 3038–AD86)

Dear Mr. Stawick:

Americans for Financial Reform (“AFR”) appreciates this opportunity to comment on the above-referenced notice of proposed rulemaking (the “NOPR”) by the Commodity Futures Trading Commission (the “Commission”) proposing regulations (the “Proposed Rules”) that establish a clearing requirement under Section 2(h)(1)(A) of the Commodity Exchange Act (“CEA”), enacted under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). The Proposed Rules would require that certain classes of credit default swaps (“CDS”) and interest rate swaps (“IRS”) be cleared by a derivatives clearing organization (“DCO”) registered with the Commission.

AFR is a coalition of over 250 national, state, local groups who have come together to advocate for reform of the financial industry. Members of AFR include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups along with prominent independent experts.

### **Introduction**

The NOPR properly identifies the indisputable Congressional intent regarding the clearing requirement under the Dodd-Frank Act. The Congressional Record makes it clear that mandatory clearing is at the heart of the regulatory regime intended by Congress. The NOPR also accurately identifies CDS and IRS markets as extraordinarily important to the interconnectedness of financial market participants, both because of the size of the markets and the exposure of institutions that operate at the heart of the financial systems to credit risks inherent in bilateral CDS and IRS transactions. Prompt action regarding CDS and IRS is warranted.

AFR also urges the Commission to rapidly designate energy, agriculture and equity swaps for mandatory clearing as well. The DCOs have cleared these types of swaps for years and much is

known regarding this activity. In some ways, the designation process will be more straightforward than the process associated with CDS and IRS. Large financial institutions carry substantial exposures in energy, agriculture and equities derivatives and, as a result, these markets are an integral part of the entire derivatives risk problem. Losses can easily migrate across markets impairing the confidence needed to sustain a properly working system.

AFR commends the Commission for the thoughtfulness and consideration of issues evidenced by the Proposed Rules. Our comments will point out several important elements in the Proposed Rules that must be carried forward into the final rulemaking and will propose some ways in which the final rules should be strengthened to meet the goals of the statute. Since this proposal only represents the first set of designations for mandatory clearing, we also hope that the CFTC's plans for future designations will be responsive to these concerns.

A key issue is the importance of designating for clearing those swaps classes that might currently have low volume but can be used to avoid the clearing mandate, perhaps by being used to closely replicate swaps that are required to be cleared. This is generally true for swaps currently traded in low volumes which are closely related to high-volume swaps designated for clearing. The Commission should investigate the ways in which such swaps can be risk managed based on some modification of the ways that related high-volume swaps are managed. The class-based approach to interest rate swaps proposed in this rule provides a positive example of the kind of approach the Commission should seek to use. This approach bases clearing determinations on the economic substance of the transaction. Unlike a product-based approach, it does not permit the multiplication of similar products to prevent clearing, and avoids any unintended consequences due to such regulatory arbitrage. The Commission should also closely monitor the market to determine whether volume is moving to swaps that are not designated for clearing.

The intention of the Dodd-Frank Act is not simply to mimic current market practices on clearing, but to encourage the safe migration of as much of the swaps market as prudent to centralized clearing. While this goal must of course be balanced off against the critical need for proper clearinghouse risk management, the Commission should take an active role in encouraging the movement of swaps to clearing.

### **Mandatory Clearing of CDS**

*CDS not Cleared by a DCO.* The NOPR identifies a number of types of CDS that are not currently cleared by any DCO and were not included in any submission of currently cleared swaps that form the basis for the Proposed Rules. The Commission has determined that these will not be designated for mandatory clearing as part of a class of CDS that is so designated. The Commission should make clear that this does not imply that such types of CDS will not be designated for mandatory clearing in the future, whether they are submitted by a DCO or the Commission acts on its own initiative.

*Tenor.* The Commission has properly proposed the mandatory clearing of 3-, 5-, 7- and 10-year tenors for North American Investment Grade CDS. However, 1- and 2-year tenors are excluded based on volume issues. The excluded tenors should be included. They are intimately related to the longer tenors and the NOPR recognizes that market participants might shift to those tenors to

avoid mandatory clearing. The risk associated with shorter tenors is correlated to the 5-year tenor, and since the exclusion of the shorter tenors could easily undermine the effectiveness of the mandatory clearing designation for the longer tenors, it is necessary to include the entire range of tenors.

More generally all tenors for CDS categories should be included in each designation, even if they are not currently cleared. Various tenors are directly related in terms of price. If the entire tenor range is not included, the designation process is subject to evasion as market participants move to undesignated tenors.

*Off the Run CDS.* Issues similar to those related to tenor are presented by off the run CDS. While market participants historically have preferred on the run CDS, there are strong price relationships between on the run and off the run. It is likely that excluding off the run CDS would alter market behavior to avoid the clearing mandate. Therefore including off the run CDS in the mandate for clearing of a class of CDS is the proper approach.

*Tranched CDS Indexes:* The Commission is proposing to require clearing of untranching CDS indices but not tranches of such indices. It is obvious that the payoff properties desired from an index can be closely or even exactly replicated by buying or selling tranches of that index. While risk management concerns may dictate placing tranches in a different class than untranching indices, the possibilities for arbitrage dictate that both must be cleared. We hope that this concern will be addressed in future Commission actions.

*Availability of Rule Framework.* The NOPR considers five issues required by the CEA in making the determination. One is the availability of a framework of rules. The Commission properly focuses on the status of the clearing entity as a DCO and the compliance with core principles. This is, by definition, a sufficient rule framework.

*Mitigation of Systemic Risk.* Another issue for consideration is the effect on the mitigation of systemic risk. As recognized by the Commission, certain commenters have suggested that only swap categories that would pose a distinct systemic risk should be designated. The Commission properly interprets the statutory mandate as a consideration of the effect of designation on systemic risk mitigation. The NOPR's analytical approach and its conclusions are proper.

*Effect on Competition.* A third issue for consideration is the effect on competition. The outcome reached by the NOPR under this consideration is the correct one. However, the NOPR considers the fact that Markit is the predominant or exclusive provider of indices for various segments of the CDS market. AFR urges the Commission to take an alternative approach, notwithstanding the fact that the outcome would be unchanged. Otherwise, a precedent for an inappropriate analytical approach would be established. The statutory language is: "The effect on competition, including appropriate fees and charges applied to clearing."<sup>1</sup> The best reading of this provision is that it refers to competition among clearing entities, not a third party services provider that might be benefitted or harmed.

## **Mandatory Clearing of IRS**

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<sup>1</sup> Dodd-Frank Act, Section 723.

*Class-Based Approach.* The Proposed Rules designate IRS by class and not on a product-by-product basis. AFR strongly supports this approach. As discussed in the NOPR, this properly reflects the risk profile of the IRS market and will avoid uncertainty and complexity for both the Commission and for the market participants. Details of product specifications (for example, slightly different tenors) are largely irrelevant, especially in the IRS market. Any suggestion of a product-by-product approach should be interpreted as a tactic to delay implementation of the clearing mandate.

*Negative Specifications.* The Commission identifies certain negative specifications that could exclude some types of IRS from mandatory clearing requirements. One is a dual currency denomination. Another is optionality. In each of these cases, the swap in question is clearly a composite of a basic IRS and another derivative. Swaps with these negative specifications can easily be transacted simultaneously with the opposite version of the derivative that is paired with the conventional IRS. For instance the currency risk in a dual currency IRS could be reversed with a currency derivative, with the result that the risk of the counterparty is the same as if he or she transacted an IRS that is clearly subject to the mandate. Market participants should be required to clear components of swaps that are subject to mandatory clearing. To allow otherwise would be to facilitate evasion.

*Swaptions.* The NOPR seeks comment on whether a swap that results from the exercise of a swaption should be subject to mandatory clearing. AFR emphatically responds that it should. There is no reason under the clear intent of Congress related to the clearing mandate that it should not. Furthermore, swaptions with short-term execution dates could easily be used to avoid the clearing mandate.

## **Conclusion**

The designation of swaps for mandatory clearing is critically important and the urgency is greatest for CDS and IRS. However, AFR urges the Commission to move on energy, agricultural and equity swaps promptly as well. The Commission should also move to designate CDS and IRS that are closely related to those swaps already proposed for mandatory clearing in this release.

Thank you for the opportunity to comment on this proposal. We hope that the comments set forth above are helpful to the CFTC. For any questions, please feel free to contact Marcus Stanley, AFR's Policy Director, at [marcus@ourfinancialsecurity.org](mailto:marcus@ourfinancialsecurity.org) or (202) 466-3672.

Sincerely,

Americans for Financial Reform

## **Following are the partners of Americans for Financial Reform.**

*All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.*

- A New Way Forward
- AFL-CIO
- AFSCME
- Alliance For Justice
- American Income Life Insurance
- American Sustainable Business Council
- Americans for Democratic Action, Inc
- Americans United for Change
- Campaign for America's Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
- Center for Justice and Democracy
- Center of Concern
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
- Common Cause
- Communications Workers of America
- Community Development Transportation Lending Services
- Consumer Action
- Consumer Association Council
- Consumers for Auto Safety and Reliability
- Consumer Federation of America
- Consumer Watchdog
- Consumers Union
- Corporation for Enterprise Development
- CREDO Mobile
- CTW Investment Group
- Demos
- Economic Policy Institute
- Essential Action
- Greenlining Institute
- Good Business International
- HNMA Funding Company

- Home Actions
- Home Defenders League
- Housing Counseling Services
- Information Press
- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project
- International Brotherhood of Teamsters
- Institute of Women's Policy Research
- Krull & Company
- Laborers' International Union of North America
- Lake Research Partners
- Lawyers' Committee for Civil Rights Under Law
- Move On
- NAACP
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Trust
- National Housing Trust Community Development Fund
- National Housing Resource Center
- National NeighborWorks Association
- National Nurses United
- National People's Action
- National Council of Women's Organizations
- Next Step
- OMB Watch
- OpenTheGovernment.org
- Opportunity Finance Network
- Partners for the Common Good
- PICO National Network
- Progress Now Action
- Progressive States Network
- Poverty and Race Research Action Council
- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer's for Common Sense
- The Association for Housing and Neighborhood Development
- The Fuel Savers Club
- The Leadership Conference on Civil and Human Rights
- The Seminal

- TICAS
- U.S. Public Interest Research Group
- UNITE HERE
- United Food and Commercial Workers
- United States Student Association
- USAction
- Veris Wealth Partners
- Western States Center
- We the People Now
- Woodstock Institute
- World Privacy Forum
- UNET
- Union Plus
- Unitarian Universalist for a Just Economic Community

*List of State and Local Signers*

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation (NY)
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG
- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina
- Community Resource Group, Fayetteville A
- Connecticut PIRG

- Consumer Assistance Council
- Cooper Square Committee (NYC)
- Cooperative Fund of New England, Wilmington NC
- Corporacion de Desarrollo Economico de Ceiba, Ceiba PR
- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA
- Empire Justice Center NY
- Empowering and Strengthening Ohio's People (ESOP), Cleveland OH
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network
- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers
- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG
- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- Neighborhood Economic Development Advocacy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG



- New York PIRG
- New York City Aids Housing Network
- New Yorkers for Responsible Lending
- NOAH Community Development Fund, Inc., Boston MA
- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis M
- North Carolina PIRG
- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council
- Virginia Poverty Law Center
- War on Poverty - Florida
- WashPIRG
- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG

### ***Small Businesses***

- Blu
- Bowden-Gill Environmental
- Community MedPAC
- Diversified Environmental Planning
- Hayden & Craig, PLLC
- Mid City Animal Hospital, Pheonix AZ
- The Holographic Repatterning Institute at Austin

- UNET

