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DERIVATIVES CLEARINGHOUSES: OPPORTUNITIES AND CHALLENGES

HEARING

BEFORE THE

SUBCOMMITTEE ON
SECURITIES, INSURANCE, AND INVESTMENT

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

ON

EXAMINING THE OPPORTUNITIES AND CHALLENGES OF DERIVATIVES CLEARINGHOUSES

MAY 25, 2011

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WEDNESDAY, MAY 25, 2011

U.S. SENATE,
SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 9:35 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Jack Reed, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF CHAIRMAN JACK REED

Chairman REED. Let me call the hearing to order, and I want to welcome everyone to the hearing this morning on "Derivatives Clearinghouses: Opportunities and Challenges." The financial crisis revealed some significant weaknesses in our financial sector, and one of the most problematic was the over-the-counter derivatives market. Derivatives contracts involve the transfer of risk from one party to another.

The total notational value of over-the-counter derivatives outstanding at year end increased 645 percent from 1998 to 2008, a significant increase. Looking at it another way, back in 1998 and 1999, derivatives were a relatively small part of the market, but by 2008 they were a huge and continue to be a huge part of the market.

According to the Bank of International Settlements, in December 31, 2010, the total notional amount outstanding was $601 trillion with a market value of $21 trillion, so there are huge potential benefits or dangers to the financial system.

The sheer number and amount of over-the-counter derivatives transactions which were not regulated by the SEC or CFTC proved to be an accelerant during the financial crisis. Uncollateralized losses built up. By September 2008, one of the world's largest insurers, AIG, was on the verge of bankruptcy, triggered by its tremendous investment in credit default swaps. AIG had agreed to pay counterparties in its derivatives transactions if certain credit events occurred. A series of market events required AIG to post billions in collateral—collateral it did not have. The imminent default of AIG would have cascaded throughout the U.S. economy, encompassing private companies, local and State governments, and retirement plans. Accordingly, the Government provided hundreds of billions of dollars in extraordinary relief to AIG, most of which was

paid to AIG counterparties. American taxpayers were exposed to billions of dollars in potential losses.

As a result of that incident, and others, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 developed new rules for the over-the-counter derivatives market to insulate both the U.S. economy and the American taxpayer from any future extraordinary losses in this area. The new rules of the road require the use of centralized derivatives clearing organizations, or clearinghouses. Clearinghouses are not a new invention. They have been a part of financial transactions for a long time, dating back to European coffee and grain exchanges of the late 19th century and in the United States the 1883 creation of the Chicago Board of Trade and the futures market. It later became the Board of Trade Clearing Corporation and serves as the counterparty in all transactions on the exchange.

Clearinghouses place themselves in the middle of transactions, reducing counterparty risk by mutualizing exposure. Clearinghouses transact business with clearinghouse members, and customer losses are absorbed by these members. Clearinghouses deal with risk by constantly evaluating and requiring the posting of margin or collateral as insurance.

In the deficiency Wall Street Reform Act, the mandate to creating clear standardized derivatives is the foundation upon which a more transparent and competitive swaps market may begin to flourish. Clearinghouses and swap execution facilities, SEFs, should allow for better price discovery, more efficient allocation of capital, and a healthier and more resilient derivatives sector.

The purpose of this hearing is to examine both the opportunities and challenges posed by a marketplace dependent upon clearinghouses.

How do we ensure that the clearinghouses themselves do not become significant risks to our economy? What issues affect their safety and soundness? What are the best practices of structuring, governing, and controlling derivatives clearinghouses? How do we minimize conflicts of interest? What barriers to clearinghouse membership or services exist?

All of us have a vested interest in making sure these new derivatives clearinghouses function safely and fairly, and we know from past experience that market players are concerned principally with their own positions and do not always think of the market as a whole when they recommend what the new rules of the road should be. Hopefully our hearing this morning will be focused and help everyone focus on the bigger issue: making sure that these risks do not again overflow onto the American taxpayer.

I look forward to hearing from all of our witnesses this morning on these issues.

Before I introduce our first panel, I would like to recognize Senator Toomey, if he has any comments, and then our other colleagues.

STATEMENT OF SENATOR PATRICK J. TOOMEY

Senator TOOMEY. Thank you very much, Mr. Chairman, and thank you for deciding to do this hearing. I think this is a very im-

portant topic. I want to thank the witnesses for being here. I will just make a brief observation.

I might be the only former derivatives trader on this panel—on this side, anyway—and as such, I just want to observe that with the obvious and very significant exception of AIG, I think the reality of the derivatives market during the financial crisis was that both the OTC derivatives market and the exchange-traded derivatives actually for the most part functioned extremely well. They both have played an enormously important role in allowing financial and nonfinancial institutions to manage risk, and as such, the evolution of derivatives since I was involved in this industry back in the 1980s to more recent days has been enormously constructive for our economy, for the allocation of capital, and for the management of risk.

We have now decided, for better or for worse, that all over-the-counter derivatives—or I should say most over-the-counter derivatives are going to be cleared and executed through exchanges going forward. And I just think it is very, very important that we do this in a very cautious fashion, that we have—this is a very complex process. It has enormous implications, and I just hope that we will do this in a very thoughtful, careful, and I would say, in terms of the implementation of these regulations, Mr. Chairman, I think it is very important that we do this sequentially rather than trying to do this all at once because the sheer volume of regulations is staggering. And in addition to doing it sequentially, I think it is important that we do it over a period of time that is long enough for us to work out the kinks and to allow the market participants to adjust to this very, very new regulatory environment.

I am confident we can do that. I think it is necessary that we take that approach so that the tremendous benefits to the economy from these tools do not get eroded.

Thank you very much, Mr. Chairman.

Chairman REED. Thanks, Senator Toomey.

Before I recognize Senator Moran, the Ranking Member has arrived, and I would like to recognize Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Well, thank you, Senator Reed. I apologize. I got hung up, and I appreciate you going ahead and not waiting. I apologize for any inconvenience.

Federal Reserve Chairman Ben Bernanke's speech in April provides a good perspective, I think, on both the opportunities and the challenges of clearing. He said, " . . . by centralizing and standardizing specific classes of financial transactions, clearinghouses reduce the costs and operational risks of clearing and settlement among multiple market participants . . . . However, the flip side of the centralization of clearing and settlement activities in clearinghouses is the concentration of substantial financial and operational risk in a small number of organizations, a development with potentially important systemic implications."

In formulating clearinghouse regulations and conducting oversight, regulators need to fully understand the complexity, the interconnectedness, and the potential for systemic risk for clearinghouses. The decisions that regulators and clearinghouses make re-

garding risk management will have significant implications for the soundness of our financial system.

It is important that the regulators and the market participants look carefully at both the individual proposed rules and how the overall interaction of all the proposed regulations designed by the different regulators either fit together or cause unintended consequences. This is not a simple task, and I would encourage the regulators to take the necessary time to get the rules right by incorporating the meaningful public comments and economic analysis in their proposed rules.

I remain concerned that the mandatory clearing requirement could force clearinghouses to take on risk that is not adequately understood or managed. Some of the international regulators have indicated a preference that derivatives denominated in their respective countries or traded by entities subject to their authority be cleared via clearinghouses in their respective jurisdictions.

What kind of systemic risks and regulatory challenges does this create? American manufacturing companies, energy producers, and farming groups, otherwise known as end users, have testified before Congress that if they were required to clear their over-the-counter risk management transactions, they would lose the benefits of customization, and the cost to them of cash collateralization would be much more significant and in some cases insurmountable.

At this point the regulators continue to send mixed signals on how end users will be treated. Our witnesses today will provide a broad spectrum of views on these and other issues, and I appreciate their time and thoughtfulness in answering these questions. And, again, Mr. Chairman, I appreciate your holding this hearing today.

Chairman REED. Thank you very much, Senator Crapo.

Senator Moran.

Senator MORAN. Chairman Reed, thank you very much. I have no opening statement. I am interested in hearing what our witnesses have to say. I have a 10 o'clock Financial Services and General Government Subcommittee on a similar topic, and I will be departing shortly.

Chairman REED. Thank you very much, Senator.

I think just to reinforce what both Senator Crapo and Senator Toomey said, this is an opportunity and a challenge in terms of getting this right. I think we want to have it done right. That is why we are having this hearing and will have other hearings because we have to listen to industry experts and experts from academia and from other areas. And I suspect after this hearing we will have more questions, and we will have other hearings, but I think we have to get it right. I concur.

Let me just say that all the testimony of the witnesses will be made, without objection, part of the record, so there is no need to read every word. If you would like to summarize or abridge in any way, please feel free to do that. Your testimony will be part of the record. Let me introduce the first panel.

Chris Edmonds is president of the ICE Trust, the wholly owned credit default swap clearinghouse of international exchange. Mr. Edmonds was named to his post in February 2010. As president of ICE Trust, Mr. Edmonds oversees ICE's U.S. credit derivatives

clearing operations. Prior to joining ICE, Mr. Edmonds was chief executive officer of the International Derivatives Exchange Group, LLC, a clearinghouse for interest rate swaps.

Terrence Duffy has served as the executive chairman of CME Group since 2006 when he first became an officer of CME. Previous to his current position, he served as chairman of the CME Board from 2002 to 2006 and as vice chairman from 1998 to 2002. He also has been president of TDA Trading Incorporated since 1981.

Mr. Edmonds, you may begin.

STATEMENT OF CHRISTOPHER EDMONDS, PRESIDENT, ICE TRUST

Mr. EDMONDS. Chairman Reed, Ranking Member Crapo, I am Chris Edmonds, president of ICE Trust, a limited purpose New York bank operating as a clearinghouse for credit default swaps. I very much appreciate the opportunity to appear before you today to testify on clearing over-the-counter derivatives.

As background, ICE Trust serves as the leading U.S. clearinghouse for credit default swaps, having cleared approximately $11 trillion in gross notional value since March 9, 2009. Globally, ICE Trust and our European counterpart have cleared more than $18 trillion in CDS since the financial crisis.

ICE's experience in energy and credit derivatives demonstrates that when clearing is offered to a market, the market overwhelmingly chooses to clear its products. Over the next few months, the mandatory clearing and trading provisions of Dodd-Frank should take effect, and market participants will be forced to clear over-the-counter derivatives as a matter of law.

While ICE supports the clearing principles of Dodd-Frank, we respectfully submit that the regulators responsible for determining which contracts must be cleared should consider any mandate carefully. ICE believes the best path to meet this goal is to allow clearinghouses and market participants to find the best way to clear markets within defined principles, as opposed to promulgating prescriptive rules. In addition, regulators should make certain unnecessary regulatory hurdles and other impediments are removed.

For example, one key regulatory hurdle to clearing is cooperation between regulators. Many over-the-counter derivatives, especially credit default swaps, have characteristics of securities and commodities. Close regulatory cooperation between the CFTC and the SEC is necessary, and required by law, in order to make sure that market participants have legal certainty, including bankruptcy certainty. This is particularly important in regards to portfolio margining allowing security-based and commodity-based derivatives to be held in the same account and margined in a holistic manner and subject to a single bankruptcy regime. Historically, the CFTC and SEC have had little success creating portfolio margining. Without portfolio margining relief for CDS specifically, the unintended regulatory divide will create significant and noticeable setbacks for the implementation of Dodd-Frank.

Appropriate regulation of clearinghouses is of utmost importance to the financial system. Pursuant to Dodd-Frank, clearinghouses will be a key part of the efforts to decrease systemic risk in the derivatives markets. In overseeing clearinghouses, regulators must be

prudential, understanding their markets, and tailoring regulation to ensure market integrity and consumer protection.

It is also vital to recognize that the over-the-counter derivatives markets are global. The U.S. regulators must work within international regulators from a common set of regulatory principles. Dodd-Frank has created significant uncertainty over whether a transaction will be subject to U.S. regulation or foreign regulation. This lack of clarity may begin to have an impact on markets, reducing liquidity and hampering regulatory reform efforts because market participants are unsure which laws apply. Therefore, harmonizing regulatory systems across geographies and giving market participants clarity is of utmost importance.

Earlier this month, the CFTC and SEC held a roundtable to hear views on the implementation of Dodd-Frank. As the CFTC and SEC have come to realize, the legislation cannot take effect all at once.

ICE believes that regulators should pursue an aggressive timetable to implement most sections of Dodd-Frank as soon as possible. While Dodd-Frank requires an enormous effort from both market participants and regulators, the cost of uncertainty is much greater. ICE has suggested to regulators that they pursue a phased implementation plan. This approach has broad-based support from market participants and should motivate quicker adoption by the industry.

Flexibility is central to meeting the implementation goals. Regulators have an immense burden to implement Dodd-Frank, but creating a one-size-fits-all prescriptive system of regulations will only increase the burden as regulators will be required to constantly consider exemptions for markets that do not quite fit the proposed model.

Likewise, market participants will have an easier time meeting implementation goals if they have the freedom to meet the goals of Dodd-Frank without radically modifying their operations to meet prescriptive rules.

Mr. Chairman, thank you again for the opportunity to share our views with you. I would be happy to answer any questions you or this Committee may have.

Chairman REED. Thank you.

Mr. Duffy.

STATEMENT OF TERRENCE A. DUFFY, EXECUTIVE CHAIRMAN, CME GROUP INC.

Mr. DUFFY. Chairman Reed, Ranking Member Crapo, Members of the Subcommittee, I am Terry Duffy, executive chairman of CME Group, which includes our clearinghouse and four exchanges: the CME, the CBOT, NYMEX, and COMEX.

The clearing mandate for OTC swaps should be staged in measured steps. The Committee asked five important questions that deserve direct answers.

First, the safety and soundness of clearinghouses is a major focus of Dodd-Frank. The core principles compel clearinghouses to have adequate financial resources, comprehensive risk management procedures, and safeguards against system failures. In addition, Dodd-Frank includes eight core principles dealing with the safety and

soundness of clearinghouses. The CFTC is authorized to bring a clearinghouse into compliance. However, the CFTC's proposed new rules are so rigid that many impair the flexibility necessary to preserve the safety and soundness of clearinghouses. Indeed, the CFTC's proposed rules governing systemically important clearinghouses increase this systemic risk.

Regarding the second question, swaps clearing and futures clearing are variations on the same theme. If a swaps contract and a futures contract have similar volatility and trade in a mature liquid market, the considerations for clearing the contracts are identical. This should be the case for major plain-vanilla swaps. Thinly traded swaps present more difficult problems. Our clearinghouse aims to overcome these problems through its admission and risk management processes.

The third question in regards to unique attributes of certain asset classes that should be highlighted, the key to safety and soundness is risk management based on volatility, liquidity, and other characteristics of the market for a swap in a normal and stressed circumstance. Futures on U.S. debt and eurodollars are easy to liquidate in the event of a default. The same should hold true for interest rate swaps based on U.S., UK, and European Union instruments.

As we look at the fourth question, the CFTC should hold off implementing the proposed rules respecting ownership, governance, and control of clearinghouses. They can and should wait until there is evidence that specific limitations in Dodd-Frank do not adequately control the potential problem.

The core principles for clearinghouses provide ample protections against potential conflicts of interest. They are clear, comprehensive, and easily enforced by the Commission as needed. Section 5(b) of the Commodity Exchange Act specifically ensures fairness respecting participant and product eligibility, appropriate governance and fitness standards, prevention of conflicts of interest, and appropriate composition of governing boards. Dodd-Frank's core principles, coupled with CFTC's enhanced enforcement powers, are sufficient to guard against conflicts of interest.

The fifth question, end users of swaps with sufficient credit and resources to enter into a swap will experience no barrier to clearing under Dodd-Frank. A firm that seeks to act as a clearing member of a swaps clearinghouse must meet the operational and financial requirements of that clearinghouse. These requirements should be set sufficiently high to meet the clearinghouse's obligations under Dodd-Frank's core principles for DCOs.

Dodd-Frank's requirements regarding safety and soundness modify a clearinghouse's obligation to grant open access to any potential clearing member. The issues of managing a default involving immature or illiquid swaps contracts require higher admission standards than those for a futures clearinghouse.

I appreciate the time this morning. I look forward to answering your questions.

Chairman REED. Thank you very much, gentlemen, for both of your excellent testimonies.

We are all concerned about safety and soundness. I think that is a point of departure. We do not want to create a structure in re-

sponse to a financial crisis that could precipitate another financial crisis if it is not handled well, so that is the starting point.

But there are some other aspects, too, in terms of the overall scheme of Dodd-Frank. The notion was to pull as many possible derivatives onto, first, a clearing platform, and then within the authority of Dodd-Frank, the regulators could direct that the standardized products—some could be specifically or should be traded. So there is that progression to a trading platform.

But both of you have alluded to the issue of potential conflicts of interest in bringing particular products on to the clearing platform. Right now over-the-counter derivatives are a very lucrative business, specialized derivatives, and there have been at least questions raised about whether there are proper incentives, proper rules so that the maximum number of derivatives products will be cleared; *i.e.*, people making the decisions have an incentive perhaps to keep things off because there is a more lucrative product over the counter rather than a clearing platform and a trading platform.

Both gentlemen, Mr. Edmonds and Mr. Duffy, can you address this issue of how do you ensure that there is the fullest possible universe of products being cleared?

Mr. EDMONDS. Mr. Chairman, I believe the way to answer that question is these are points-in-time conversations. The standardization of the credit default swap market, for example, has been an evolution going on for, you know, we will call it 10 years or so to get to the standardization product set that you put in there, investment grade pieces of an index, the investment grade single names, and then there is a whole list of other names that we may want to clear in the future that at the end of the day do not lend themselves to clearing based on the current tool sets that are available to clearinghouses.

If you ask me the question of where we are going to start, we have done a lot to get started in that direction. Where we go is all about innovation and competition between, you know, the different service providers that act in those markets. I am certain that, you know, every day those that Mr. Duffy and I compete with are looking for new ways to bring something else to the clearing which will require us to respond, and the same thing happens to Mr. Duffy on other products that they have a dominant market share in at this point in time.

So for us, this is about what do we need to get the most systemic risk out of the gate to begin with. If you look at the creation of ICE Trust back in the fall of 2008 and in the first quarter of 2009, the products that represented the most liquidity, the most systemic risk, we were trying to put in the clearinghouse impacting the most active market participants at that point in time. Things will evolve, and we will manage that evolution through commercial reasons because it is good for our shareholders and good for our business.

Chairman REED. Well, one of the aspects particular with ICE is that the owners—that might not be the most precise term—are also the broker-dealer banks generally, and they have, I would think, conflicting incentives. One is to get standardization products onto your platform, but also to keep lucrative over-the-counter products in their own trading, which does not have to be cleared. And that is a tension that would not exist if your organization was

composed not of the broker-dealer banks but of other financial entities if it was a truly independent entity.

Does that sort of compound or complicate your specific dilemma?

Mr. EDMONDS. Well, I want to take issue with who the owners are, and we are a wholly owned subsidiary of a publicly traded company, so there are all sorts of rules and regulations around, you know, who owns what. I mean, certainly we have a partnership with our membership, not dissimilar to any other clearinghouse that operates in the United States or, for that matter, around the globe. There are only 120-plus or so entities registered with the CFTC that can be a clearing member. We started with nine. We are up to 15. We continue to grow that, and make no mistake, we want as many of those clearing members as we possibly can.

That does not mean all of those clearing members actually use the product that we offer. Some will over time. Some will make the decision to make the investment to enter these markets as time progresses. Some have not made that decision today. Others are being opportunistic, seeing that the opportunity represented by the changes with regard to Dodd-Frank are the time for them to make that investment and come that direction.

You know, we are completely open access. Our rule book has said we are open access from day one. You provide us with two matched trades an accountants gets, we clear and reduce the systemic risk associated with that.

So, you know, I appreciate the point. I think you will have an opportunity on the second panel to ask folks what motivates them of what they want to keep cleared versus noncleared. From the commercial aspects of ICE Trust, we absolutely are incentivized to clear as much as we possibly can, both in product and the number of times that product is cleared.

Chairman REED. Mr. Duffy.

Mr. DUFFY. Well, there are a couple questions I would like to answer for you, sir, on what should be cleared and what should not be cleared. The plain-vanilla swaps that are being traded today over the counter are obviously prepared to be cleared, so my colleague over here has already demonstrated some of the numbers that they have done in the credit market. The interest rate market is obviously much easier to even clear. So some of those plain-vanilla swaps are prepared to be cleared.

Some of the illiquid products or the products that Senator Crapo had mentioned that are really some of the issues that we have, and I'm sure ICE also. If we today are going to collect 5 days' margin for some of these products that we are going to have in our clearinghouse, that might not even be the tip of the iceberg for some of these illiquid products. So you just cannot bring them into clearing to blow up the whole system.

So we do a very rigorous risk management system, so we think that bringing the plain-vanilla swaps in first—and as it relates to what some have alleged is a cartel or whatever you want to call the banks in these clearinghouses, I think you are not giving the customer enough sophistication here. When these products become more vanilla-like, they want more transparency associated with them. They will demand that that happen with that product. It is really the illiquid products that are not conducive for clearing

today. So I do not think anybody is trying to hold them out from clearing. I think if the customer, when they trade them, they know what is being traded. The more that is being traded, they want to make certain that they are getting the best possible price also. And the only way they can do that is to seed the market.

So I do think there is an incentive for the clearinghouses and the owners of those clearinghouses to bring them in as they see fit.

Chairman REED. Just one other point. Sometimes the complexity of these products is such that the customer, even sophisticated customers, are not quite sure what their best choice is, and many times the information or the structuring is being done not by the customer but by the broker-dealer or the financial institution.

Again, I guess the heart of this question is, Is there real sort of pressure by the market and by you to demand more simplified products that can, in fact, be usually identified by customers and preferred by customers? Is that——

Mr. EDMONDS. The simple answer to that is yes. The more standard we can make the products, the easier it is for those products to move into the systems. I mean, there are other service providers that link up to our clearinghouse, both for Mr. Duffy and myself, that they have a responsibility to take this information to perform analytics on this information and to take it downstream to the other user base, the folks you are talking about that need access to this.

The more simplified we can make those standards, the easier it is for them to more quickly adopt those types of instruments and put them into the supported category. When they are in the supported category, we have the opportunity to realize our commercial interest and generate more revenue from that. So certainly the interests are aligned from that perspective.

Chairman REED. Thank you very much. Thank you.

Senator Crapo, please.

Senator CRAPO. Thank you, Mr. Chairman, and Mr. Edmonds and Mr. Duffy, I appreciate you being here.

I want to focus my questions on the end user issue. Frankly, as I try to navigate what the regulators are saying with regard to end users, I am not sure that I understand exactly what the proposal on the table is as to how we will treat end users. So my first question to you is, how do you understand the treatment of end users under what we see now from the various proposed rules?

Mr. DUFFY. My understanding, Senator, is that any nonfinancial party would be considered an end user and thus exempt from the clearing mandate. So, example, IBM, a company like that, would be exempt from the clearing mandate. If they make the trade, obviously, with a dealer, both parties are exempt because you cannot put one side of the trade into the clearinghouse and leave the other side out, so it would leave an unbalanced book. My understanding is anybody that is nonfinancial is exempt in the end user category.

Senator CRAPO. Mr. Edmonds, is that your understanding, as well?

Mr. EDMONDS. That would be my understanding. I would add to that, there are some requirements in there for those types of transactions Mr. Duffy——

Senator CRAPO. Like the margin requirements?

Mr. EDMONDS. You would have margin requirements between the broker-dealer and the end user. So the cost to the end user still has an upward trend under that model.

Senator CRAPO. And with regard to the margin requirements, is it clear to you what that is among the various regulators in the proposals we have out today? In other words——

Mr. EDMONDS. I do not think we have enough clarify of what direction they are headed. I mean, there have been some conversations at this point in time as it relates to, you know, it cannot be any less than what a similar product on the clearinghouse or some benchmark that the regulators could look to to begin establishing those, but I do not think that we have gotten to a point where it is final enough for people to do the cost-benefit analysis yet.

Senator CRAPO. So if I were to look at two of the important issues related to end users, one, their ability to have a customized product, and two, the impact of margin requirements, would you say that you feel that there is adequate protection for those who need a customized product, that they would not be subject to the requirement?

Mr. DUFFY. That would be my understanding of the way the law reads, sir.

Senator CRAPO. So, then, the real question would be, what is the impact of the margin requirements, whatever they may be, on this portion of our market. Is that a fair question?

Mr. EDMONDS. I do not see any way that it cannot increase the cost of trade.

Mr. DUFFY. Well, I would also suggest that even though they would be exempt from the margin requirements under the end user exemption, there are still capital requirements they have to face with the broker-dealer that could be simply called something else, such as margin. So it may be that they are pledging their cornfields instead of capital or cash for margin, but they are still putting up something on behalf of those transactions.

Senator CRAPO. And you would agree, also, Mr. Duffy, though, that it will undoubtedly drive up the cost of these transactions?

Mr. DUFFY. I do not know if margin will drive up the cost of these transactions, only because I have looked at the growth in the futures business that has had margin with it historically and we have been able to grow at 20-some-odd percent year over year for the last 40 years, 35 years now, and people have participated in the marketplace, been able to do risk management just fine with the margin requirements that we have in place today.

Senator CRAPO. Mr. Edmonds, would you——

Mr. EDMONDS. I would agree with Mr. Duffy on the growth of the futures market. The difference here is, these same types of customized transactions are happening today and this margin is not being collected. So at least there is a time value of money associated with the collateral they are going to have to post in some form or fashion, or the lien they are going to put on the cornfield or whatever that is going to put in there. There is an intrinsic cost, whether it is the drafting of a legal agreement, the execution of that legal agreement, you know, the lien and things that you need in order do that. So while they may not be a direct cost as the picture that Mr. Duffy wants to paint, there is going to be some in-

trinsic cost associated with just managing the additional requirements that are forthcoming.

Senator CRAPO. It seems to me that that is going to be a significant impact on capital formation in these companies, that at least a lot of them are claiming this to be the case. Do you believe that this increased cost that you see, Mr. Edmonds, would increase safety or soundness of the transactions over the current *status quo?*

Mr. EDMONDS. Just to clarify the question, for the end user or for the market as a whole?

Senator CRAPO. I would say for the market as a whole.

Mr. EDMONDS. Certainly, more collateralized positions have a safety benefit and a soundness benefit associated with that. I mean, if you take the earlier comments by the Chairman as it related to AIG and the developments we experienced there, that was a market that was under-collateralized, or not collateralized at all in some cases, and they were very customized products, that at some point in time had collateral been associated with those positions and there had been an adequate mark-to-market based of those positions based on the collateral on hand, we would have seen the difficulties being perpetrated by those positions sooner.

Senator CRAPO. I understand that. I guess the way I am looking at this, though, I can understand that if you were to require 100 percent collateral for every transaction, you would certainly increase safety and soundness of the overall market for those transactions. You might not be increasing it in incrementally justifiable levels by doing so. And those in the end user community often disagree with being lumped in with the AIG situation, claiming that their industries and their markets had nothing to do with the crisis we faced and that the safety and soundness issues that we are seeking to solve there simply do not exist, or to any significant level, in their markets. How would you address that?

Mr. DUFFY. Well, I would agree with that, and I think that the end users have put on a very good case why they should have exemptions to the Dodd-Frank Act, and I think, obviously, they are getting them. Our position at CME has been from the beginning, for the last several years, we never believed that there should be a mandatory clearing component to Dodd-Frank. We thought there should be capital incentives for clearing and then a different capital charge for noncleared products. So we never supported it. But the law is what the law is today and we are dealing with it.

So I think that the end users being carved out the way they are, they have done a good job putting their case forward and they deserve the exemption. They did not cause it, I agree with that, nor did the futures industry cause this problem. We had a housing bubble and under-capitalized credit default swaps.

Senator CRAPO. Thank you. Mr. Edmonds, do you want to say anything before——

Mr. EDMONDS. The only thing I would say to that is to do the cost-benefit analysis, Senator, you are looking for, I think the rules around margin need to come out.

Senator CRAPO. Thank you. I appreciate that observation.

Chairman REED. Senator Merkley.

Senator MERKLEY. Thank you, Mr. Chair, and thank you all for your testimony.

Mr. Duffy, in your testimony, you noted that the futures market performed flawlessly during the financial crisis, and I was wondering if you could take and expand on what went right and what insights that might give us in seeking to regulate the rest of the derivatives markets.

Mr. DUFFY. And again, the futures market is different from the OTC market. The plain vanilla swaps are closer to the futures market. Some of the products that got us in trouble are these illiquid products that even a clearinghouse today would not be able to risk manage during the crisis.

So we were able to function flawlessly during the crisis because of a couple things that we have deployed for over 100 years, and that is to do risk management on a real-time basis. So we make certain that the people who are losing money put up the money. The people who are ahead in the market receive that money. So we would go back and forth all day long at a zero sum outcome, and I think that is very important when you have this type of notional values going back and forth in both futures markets and over-the-counter markets. So that is why we operated flawlessly, because the risk management discipline that we have put into our company over the last 100-plus years.

Again, I do not know if that would have stopped the crisis, sir, of 2008, because the problem, as I said earlier, was not futures markets. It was not plain vanilla swaps. It was illiquid swaps. It was illiquid credit default swaps. It was under-collateralized swaps in a bubble in some other markets.

Senator MERKLEY. My colleague was asking about kind of the impacts on capital formation and putting up margins. I was reading in this article, the CEO of Robinson Oil who noted that when he uses derivatives like swaps and options to create fixed plans, he just has no idea how much lower his prices possibly should be because the fees are not disclosed, there is not a clearing function. And he says, quote, "At the end of the day, I do not know if I got a fair price or really what they are charging me." How does one tradeoff kind of understanding essentially the efficiencies of an open competitive market in providing derivatives risk management, if you will, at a lower price, versus the issues of capital formation margins that was being raised by my colleague?

Mr. DUFFY. I think the gentleman that asked the question has a very good question because it is very hard to distinguish what the costs are when you are doing an over-the-counter transaction such as that. On a regulated futures exchange, it is completely transparent. All the fees and everything are seen up front so you know exactly what you are doing ahead of time.

So in our world, sir, he would not have that same question. And I cannot answer the question in the over-the-counter only because there has been a lack of transparency in these markets.

Senator MERKLEY. OK, great. Anything you would like to add, Mr. Edmonds? OK.

Chairman REED. Senator Toomey.

Senator TOOMEY. Thank you very much, Mr. Chairman.

A couple of things I just wanted to follow up on from the previous questions. One, would it be fair to say that—and Mr. Duffy in particular, I think you alluded to this—that there are some

kinds of transactions that probably just never belong on a clearinghouse, right? If they are not uniform, if there is not sufficient liquidity, then it is just not a good fit. Is that a fair statement?

Mr. DUFFY. That is exactly fair, sir.

Senator TOOMEY. Yes. So it seems to me that we will always have a category of over-the-counter derivatives and it would be up to end users to decide whether the customization that they get in return for something over the counter outweighs the fact that there is not as much transparency, and that is a decision that individuals will make.

Mr. DUFFY. We agree.

Senator TOOMEY. OK. The other point I wanted to make, follow up on my colleague, Senator Crapo's point, is I do think it is—and I know this does not directly affect you gentlemen. My understanding, though, is that the promulgation of the regulations does create the possibility that end users will have margin requirements in some cases, but not necessarily be required to use clearinghouse, but have margin requirements, and I do think that is a potentially big problem.

As to whether or not an end user should have a margin requirement, I think that is a credit decision that should be made by the counterparty. The counterparties are capable of making that decision, and the cost to an end user that is not—especially a nonfinancial that does not have ready access to the kind of cash that is necessary for a margin call, could actually make the hedging exercise prohibitively impractical. And so I am very concerned. In fact, Senator Johanns and I have introduced legislation that would deal with this which would really specify and make it clear that this requirement would not apply to end users. But I digress.

To get to the point that I wanted to ask of you, Davis Polk has put together a memo that suggests that there are 175 new derivatives provisions coming out of Dodd-Frank. I do not think that is comprehensive yet. I think that is what we have so far. And it just seems to me that it is really, really important that we sequence the implementation in a thoughtful way and over a long enough period of time that this is manageable, because it strikes me that it could be very problematic if we tried to do this too suddenly.

Now, you have both indicated importance of sequencing and I know you have given a lot of thought to that, but could you just underscore, how important is it that the sequencing be right, and specifically, could there be some market disruptions if the sequencing is not done appropriately?

Mr. EDMONDS. I do believe there will be market disruptions if it is not done appropriately. Certainly, doing it all at once, the problems with going all at once is you are going to have everyone scrambling with a finite bandwidth, both from service providers and both their own internal allocation of resources. We talk about the cost it would take for folks to respond to that. It would be insurmountable at that point in time. So what you will see is you will see liquidity, I think, move away at that point in time. That is a real risk.

The purpose of Dodd-Frank was to remove systemic risk. We have got to get to a point that we understand what products have the systemic—represent the systemic risk, how they can be cleared,

how they can be standardized or not standardized, and if they are not standardized, what are the capital charges associated with that. And then once you get those things figured out, then you have got some opportunity for people to see that in a transparent manner, whether it is standard or nonstandard. That means more products being traded in a listed environment, other products not being traded but being reported to the STR function that was in Dodd-Frank, and things of that nature.

Then you get to a point where execution becomes a lot easier to implement over time, because people know what the product is. They know what the product specification requires them to do as a buyer or seller. They know how it is going to be margined. They can properly do capital planning around that.

Mr. DUFFY. I agree with what Mr. Edmonds said, sir. I think if we do not implement sequencing properly, such as putting plain vanilla swaps out first and making certain that it is not only dealer-to-dealer, but dealer-to-client at the same exact time so there is no disadvantage to the client to get forced into going where the dealer wants him to go, I think that is important.

But also, there are some provisions that the CFTC, that they are trying to put forward, such as systemically important DCOs which would require a firm like ours, if we were in that category, to put up two of our largest clients' defaults. So what would it do? It would introduce a participant to go to a less capitalized clearinghouse that would not have the onerous of CME because we are a systemically important organization. That is in there.

There is also risk that if we have the $50 million, which Chairman Gensler would like to have, put forward to allow people to participate in the clearing of swaps and we had that implemented and we were to have a default and these people were not able to participate in the default, this is another issue that could introduce more systemic risk to the system.

So there are a couple flaws. We are trying to get away from systemic risk. We are concerned that if we push this without doing the proper sequencing, we will introduce more systemic risk.

Senator TOOMEY. Thank you, Mr. Chairman.

Chairman REED. Thank you, Senator Toomey.

Senator Kirk.

Senator KIRK. Thank you. I am obviously representing the Chicagoland area, where these markets, and be able to set up a database and exchange where buyers', sellers' prices are disclosed in real time is critical to real-time risk management.

I wonder, Mr. Duffy, if you could specifically describe your foreign competition. If we have a danger of over-regulating, customers will simply manage their risk in markets overseas. Who is on your heels and who is hoping that the Congress gets this wrong so that you are too heavily encumbered to serve customers and then would pick up the business overseas?

Mr. DUFFY. Well, I think there are a couple that would like to see that. Maybe one sitting to my right would like to see that with his London operation. There are obviously participants throughout Europe that compete with the CME Group, that compete with Intercontinental Exchange, also. They have not gone forward with any regulation whatsoever. We have passed Dodd-Frank in this

country. I believe that we have to be very careful. I like being a leader, but at the same time, let us do it in a judicious fashion. Let us just not overreact, try to implement the whole Act in 2 days.

I am very concerned about the regulatory arbitrage, Senator, that could occur, and the business getting taken off of the U.S. markets, putting onto foreign jurisdictions. These banks have books all over the world. They do not need to be in the U.S. So if they are a non-U.S. bank, they can be in Europe participating in these markets without being subjected to the laws of Dodd-Frank. Not only do they put CME at a disadvantage, they are going to put U.S. banks at a disadvantage.

Senator KIRK. Right. And then correct me if I am wrong, but my impression of European and Chinese interests are that their feeling about Dodd-Frank-related regulation is we are completely for it, but "*apres vous,* Gaston." You guys go ahead and kill your markets first. Oh, by the way, we are right behind you. We are going to kill our markets as fast as you kill yours——

Mr. DUFFY. I think——

Senator KIRK. ——fully knowing that they are not going to do that, and then they will pick up this business and the employment will transfer outside the United States.

Mr. DUFFY. I absolutely think that is the most realistic fear that we have, and I think if people do not recognize it, they are just in denial. These markets have grown. They have matured throughout Asia. They have grown and matured throughout Europe. They are looking for us to make this gigantic mistake. That is why it is critically important that we implement this law in the way that makes sense.

Senator KIRK. So can you describe—characterize the implementation of Dodd-Frank-related activities affecting similar markets in Europe.

Mr. DUFFY. Do you want to address that or do you want me to?

Mr. EDMONDS. You can start.

Mr. DUFFY. OK. So the question would be, how does Dodd-Frank affect——

Senator KIRK. No. Tell me the progress of them putting similar regulations——

Mr. DUFFY. There is no progress there. There is no progress in Europe. The G20 has made some noise that they are going to come up with a proposal sometime this summer. I have seen nothing coming out of the European Commission or regulators that they are going to support any particular new laws. One of the things they did say as it relates to position limits that obviously affects both of us, that they have recognized if, in fact, they see a problem in a market, they have the right to step in. That is about all I have seen coming out of Europe, and as far as Asia goes, I have seen absolutely zero——

Senator KIRK. And have any of them been open about saying, we are hoping the Americans cripple their markets?

Mr. DUFFY. I do not know if they have been open about it, but I am pretty certain a lot of the participants in London and other places of the world are very much hoping that happens.

Mr. EDMONDS. Senator, they hold a free option right now. I mean, we are sprinting down to this implementation, trying to get

as much done as possible, trying to get the market to behave. They get a full menu. They are going to have the chance to pick what they like and what they do not like. There is no obligation for them to implement that.

Mr. DUFFY. Right.

Mr. EDMONDS. But they have already said that their time line is much further than ours. They have already said that this is a 2012 and after type of event. I mean, if you look at the G20 comments that Mr. Duffy made reference to, this is not something they are trying to get done yet this calendar year. This is something they are going to start talking about in earnest next year, and that was to give us complete time to create the menu for them to choose from.

Senator KIRK. So would you rather be them or us right now if you were trying to build a business and add clients?

Mr. EDMONDS. I believe that the, from my personal—my personal belief is that we ought to let the commercial competition that takes place with very established businesses with very clean track records take—and do that. And there will be other innovators that come into this market. There will be others who step in. But if they are going to rely on prescriptive rules to step in, well, we had better hope that the prescriptive rules have captured everything that could possibly go wrong——

Senator KIRK. Which——

Mr. DUFFY. I would rather be us, sir. I mean, I think this is obviously the greatest country in the world. It has got a great, dynamic financial services industry. I would hope that the Congress recognizes that and lets the regulators know that. Let us compete globally. I like being a leader. I think that if we implement small portions of Dodd-Frank, like I said, in a judicious way, I think the rest of the world would have no choice but to follow on a few of these things. I think if we overreach, which has been what the regulator has been doing, that is when our European competition will destroy us, on the overreaching of the regulators. So right now, I would rather be us, if we do it right.

Senator KIRK. Thank you, Mr. Chairman.

Chairman REED. Thank you, Senator Kirk.

Gentlemen, thank you for your excellent testimony. I presume and I know that we will be meeting again, because this issue of implementation is critical and your advice and your insights are absolutely essential to get this right, so thank you both very much.

Mr. EDMONDS. Thank you, sir.

Chairman REED. Let me call up the second panel.

[Pause.]

Chairman REED. I would like to welcome the second panel and begin by introducing Dr. Benn Steil. Dr. Steil is Senior Fellow and Director of International Economics at the Council of Foreign Relations in New York. He is also the founding editor of *International Finance,* a scholarly ISI accredited economics journal, as well as a cofounder and managing member of Efficient Frontiers LLC, a markets consultancy. Dr. Steil's most recent book, *Money, Markets, and Sovereignty,* was awarded the 2010 Hayek Book Prize. Welcome, Dr. Steil. Thank you.

Dr. Chester Spatt will be introduced by my colleague, Senator Patrick Toomey of Pennsylvania.

Senator TOOMEY. Thank you very much, Chairman Reed, for this opportunity to welcome Dr. Chester Spatt, the Pamela R. and Kenneth B. Dunn Professor of Finance at the Tepper School of Business at Carnegie Mellon University and Director of its Center for Financial Markets. The Tepper School consistently ranks among the Nation's very best business schools and Dr. Spatt has taught at the university since 1979. Dr. Spatt also served as the Chief Economist and Director of the Office of Economic Analysis at the SEC from 2004 through 2007.

In addition to that, he has served as Executive Editor and one of the founding editors of the Review of Financial Studies, President and a member of the founding committee of the Society for Financial Studies, and President of the Western Finance Association. His coauthored 2004 paper in the *Journal of Finance* on asset allocation won TIAA–CREF's Paul Samuelson award for the best publication on lifelong financial security.

Dr. Spatt earned his Ph.D. in economics from the University of Pennsylvania and his undergraduate degree from Princeton University.

Dr. Spatt, we are pleased that you could be with us today and I look forward to your testimony.

Mr. SPATT. Thank you for that very kind introduction.

Chairman REED. Our next witness is Mr. Cliff Lewis. Mr. Lewis is Executive Vice President of the State Street Global Markets, State Street's investment research and trading arm. In that capacity, he is responsible for the e-Exchange business, which provides electronic trading solutions for foreign exchange, precious metals, cash, U.S. Treasury securities, futures, money markets, and exchange traded funds. Mr. Lewis joined State Street in 2006 as part of the acquisition of Currenex, where he served as Chief Executive Officer. Welcome.

Mr. Don Thompson is Managing Director and Associate General Counsel at JPMorgan Chase and Company. He is cohead of JPM's Derivatives Practice Group and Legal Department and cochair of the ISDA Documentation Committee. Since 1985, he has represented JPM in its full range of derivatives activities, with a focus on regulatory documentation and litigation matters.

Mr. James Cawley is a founder of the Swaps and Derivatives Market Association, an industry trade group with over 20-plus dealer and clearing broker members that advocate open access and transparency in centrally cleared interest rate swap and credit derivatives markets. He is also the CEO of Javelin Capital Markets, an electronic execution venue of OTC derivatives that expects to register as a Swaps Execution Facility, or SEF. Previously, Mr. Cawley was the founder and CEO of IDX Capital, a New York-based electronic trading platform for credit default swaps executed between dealers, so welcome, Mr. Cawley.

Dr. Steil, please begin.

STATEMENT OF BENN STEIL, SENIOR FELLOW AND DIRECTOR OF INTERNATIONAL ECONOMICS, COUNCIL ON FOREIGN RELATIONS

Mr. STEIL. Thank you, Mr. Chairman——

Chairman REED. Could you turn on your microphone, Doctor, and let me for the record once again state, all of your statements are part of the record. Feel free to summarize and abridge.

Dr. Steil.

Mr. STEIL. Thank you, Mr. Chairman, Ranking Member Crapo, Members of the Committee. I appreciate the opportunity to testify here this morning.

The collapse of Lehman Brothers and AIG in September of 2008 highlighted the importance of regulatory reforms that go beyond trying to prevent individual financial institutions from failing. We need reforms that act to make our markets more resilient in the face of such failures, what engineers and risk managers call "safe-fail" approaches to risk management. Well capitalized and regulated central derivatives clearinghouses to track exposures, to net trades and to novate them, to collect proper margin on a timely basis, and to absorb default risk have historically provided the best example of successful safe-fail risk management in the derivatives industry.

Encouraging a shift in derivatives trading from OTC markets without central clearing to organized Government-regulated markets with central clearing is challenging, however, for two reasons. First, the dealers that dominate the OTC derivatives business have no incentive to accommodate such a shift. Dealers earn approximately $55 billion in annual revenues from bilateral OTC derivatives trading. Some of the largest can earn up to 16 percent of their revenues from such trading. It is natural that dealers should resist a movement in trading activity onto exchanges and clearinghouses.

Where compelled by regulation to accommodate it, dealers can also be expected to take measures to control the structure of and limit direct access to the clearing operations. The use of measures such as unnecessarily high capital requirements in order to keep smaller competitors or buy-side institutions from participating directly as clearinghouse members are to be expected. Indeed, trading infrastructure providers organized as exclusive mutual societies of major banks or dealers have a long history of restricting market access.

For example, in the foreign exchange markets, the bank-controlled CLS settlement system has long resisted initiatives by exchanges and other trading service providers to prenet trades through a third-party clearing system prior to settlement. Such netting would significantly reduce FX trading costs for many market participants, but would also reduce the settlement revenues generated by CLS and reduce the trade intermediation profits of the largest FX dealing banks.

There are, therefore, solid grounds for regulators to apply basic antitrust principles to the clearing and settlement businesses in order to ensure that market access is not being unduly restricted by membership or ownership limitations that cannot be justified on safety and soundness grounds.

Second, some types of derivatives contracts do not lend themselves to centralized clearing as well as others. Customized contracts or contracts which are functionally equivalent to insurance contracts on rare events are examples. Since it can be difficult for policy makers or regulators to determine definitively whether given contracts, new types of which are being created all the time, are well suited for central clearing, it is appropriate to put in place certain basic trading regulations in the OTC markets that will serve both to make such trading less likely to produce another AIG disaster and to encourage the movement of trading in suitable products onto central clearinghouses. Two such measures would be to apply higher regulatory capital requirements for noncleared trades in consequence of the higher counterparty risk implied by such trades and to mandate trade registration and collateral management by a regulated third party, such as an exchange.

In establishing the regulatory standards for the clearing of derivatives transactions, it is imperative for lawmakers and regulators to be fully conscious of the fact that the derivatives market is effectively international rather than national and that it is exceptionally easy for market participants to change the legal domicile of their trading activities with a keystroke or a simple change of trading algorithm.

In this regard, I would highlight two important areas of concern. First, the three major world authorities controlling the structure of the derivatives clearing business—the SEC, the CFTC, and the European Commission—each take a very different view of the matter. Historically, the SEC has applied what I would term the utility model to the industry. The CFTC has applied what I would term the silo model. And the European Commission has applied what I would term the spaghetti model.

The SEC's utility model favors institutions operated outside the individual exchanges, in particular the DTC and the equities markets and the OCC and the options markets. This approach has generally performed well in terms of safety and soundness and in encouraging competition among exchanges. It performs poorly, however, in terms of encouraging innovation in clearing and settlement services.

The CFTC's silo model allows the individual exchanges to control their own clearinghouses. This approach has also performed well in terms of safety and soundness. The CFTC's model also encourages innovation in product development in a way in which the SEC's model does not. This is because CFTC-regulated futures exchanges can capture the benefits of product innovation in terms of generating trading volumes, whereas SEC-regulated options exchanges risk seeing trading volumes in new products migrate to other exchanges, all of which use clearing services provided by the OCC. On balance, I believe the CFTC's model is the more appropriate for the derivatives industry.

The second point I would like to make regarding the global nature of the derivatives trading industry is that certain measures to curb speculative activity being debated here in Washington are likely to push trading activity off-exchange, precisely the opposite of Congress' intent. For example, a so-called Tobin tax on futures transactions at the level being discussed last year, two basis points

or 0.02 percent, would be equivalent to over 400 times the CME transaction fee on Euro-dollar futures. It should go without saying that a tax this large relative to the current transaction fee on the underlying contract would push all of this activity into alternative jurisdictions.

Likewise, commodity market position limits, if not harmonized with UK and other national authorities, will merely push such trading outside the CFTC's jurisdiction. There is already an active regulatory arbitrage on oil and natural gas futures between the CME's NYMEX exchange, which trades such contracts under CFTC regulation, and the Intercontinental Exchange, which trades such contracts under FSA regulation in London. In short, we must be extraordinarily cautious not to undermine Congress' worthy goal of bringing more derivatives trading under the purview of U.S.-regulated exchanges and clearinghouses by inadvertently providing major market participants incentives to do precisely the opposite.

Thank you, Mr. Chairman.

Chairman REED. Thank you.

Dr. Spatt, please.

STATEMENT OF CHESTER S. SPATT, PAMELA R. AND KENNETH B. DUNN PROFESSOR OF FINANCE, TEPPER SCHOOL OF BUSINESS, CARNEGIE MELLON UNIVERSITY

Mr. SPATT. Thank you, Chairman Reed and Ranking Member Crapo. I am pleased and honored to have an opportunity to present my views to the Senate Subcommittee this morning. As Senator Toomey's introduction indicated, I am a chaired professor at the Tepper School of Business at Carnegie Mellon University in Pittsburgh and I also served as Chief Economist of the U.S. Securities and Exchange Commission from July 2004 to July 2007. My expertise as a faculty member include such areas as trading mechanisms, derivative securities, asset valuation, financial regulation, and the financial crisis.

I think the focus on clearing through central counterparties is a natural one and one in which I am sympathetic, potentially both to reduce contagion associated with counterparty risk and to make the structure of risk more transparent. However, it is unclear to me whether the extent of use of clearinghouses, especially the extent of mandatory clearing currently envisioned, will lead ultimately to a reduction in systemic risk in the event of a future crisis. I think it is very important to manage carefully the risk within the clearinghouse. I also think it is important that fees for holding uncleared derivatives reflect economic costs and not be punitive to avoid creating artificial concentration of risk within the clearinghouse.

The clearinghouse is subject to considerable moral hazard and systemic risk, because (a) there is a strong incentive for market participants to trade with weak counterparties, (b) concentration of risk in the central clearinghouse, and (c) margining would likely need to ratchet up in the context of a crisis. I believe that central clearing could potentially raise systemic risk substantially.

In fact, Federal Reserve Chairman Ben Bernanke attributed the lack of failure of a clearinghouse during the financial crisis to "good luck" in an important speech that he presented at the Atlanta Fed-

eral Reserve conference in April. In fact, he quoted a Mark Twain character as emphasizing the theme, that "if you put all your eggs in one basket, you had better watch that basket." I think that is the core of the issue involving clearinghouses.

Now, I think everyone agrees that it is important that clearinghouses not receive "too big to fail" types of guarantees. In fact, Chairman Gensler testified before the full Committee to that effect in mid-April. But I think that emphasizes the importance of having strong risk management. I think strong risk management is absolutely essential to the potential success of the clearinghouse model. And indeed, while it is a delicate balance, I would emphasize the importance of strong risk management, even at the expense of other values.

The governance of the clearinghouse should reflect strong incentives to control risk. It is important that the leadership and the governance of the clearinghouse reflect strong incentives, and in particular, I think artificial requirements that most of the directors be independent directors are a push in the wrong direction. It is important that governance, including board governance and risk committee composition, reflect incentives. Much of the commentary of regulators has focused upon more abstract notions of "conflict of interest."

Incentives are very important. Proposals to absolve small members of the clearinghouse of their duties or to allow them to outsource their duties, are illustrative of some of the incentive problems that I would envision potentially in terms of the operation of the clearinghouse. Incentives are absolutely crucial.

Analogously, regulators are focused upon access to the clearinghouse by investing firms. Indeed, I think access is an important issue but I would resolve tradeoffs in favor of strong risk management. It is actually interesting that in the equity context, the SEC actually adopted last fall a role basically eliminating direct unfettered customer access because of the importance in the equity context of managing risk and making sure orders were properly vetted by member firms; I view that as an analogous type of issue to those in the clearinghouse space.

There are strong analogies, as well, with respect to the payments system. My Carnegie Mellon colleague Marvin Goodfriend, for example, points out how both in the private clearinghouse system before the creation of the Federal Reserve and then in the Federal Reserve System itself, direct access is not allowed to the payments system essentially as a mechanism to protect the integrity of the system.

Finally, my underlying view on these issues is also strongly informed by the relevance of economic principles for the structuring of the clearinghouse, and I do think it is important that we be sensitive to the economic consequences of these contemplated rulemakings as we move forward on these important issues.

Chairman REED. Thank you very much, Doctor.

Mr. Lewis, please.

STATEMENT OF CLIFFORD LEWIS, EXECUTIVE VICE PRESIDENT, STATE STREET GLOBAL MARKETS

Mr. LEWIS. Thank you, Senator. Chairman Reed, Ranking Member Crapo, other Members of the Committee, thank you for the opportunity to testify today. Let me also express my appreciation for the work that has been done by your staff and yourselves and Congress, the CFTC, and the SEC on the Dodd-Frank implementation.

State Street is one of the world's largest custodial banks. We administer over $21 trillion—that is trillion with a "t"—dollars of other people's money. That makes us one of the world's largest processors of derivative transactions today and it is why we are very interested in the topic you all are working on.

Now, let me say at the outset that we at State Street support the Dodd-Frank mandates for both derivatives clearing and execution. We believe that if the rules are properly implemented, these changes will bring big benefits to our customers who are investors, investors like pension funds, endowments, and mutual funds. At the same time, we have to report that our investor clients are extremely concerned by current regulatory uncertainty and the potentially significant incremental costs that may result from the new rules.

Now, let me also emphasize that in relation to central clearing, the key issue for State Street is effective implementation of Dodd-Frank's requirement that clearinghouses, and I quote, "permit fair and open access." A couple specific comments.

First, we support the CFTC's participant eligibility rules as proposed. Specifically, we are very concerned that some clearinghouses could try to carry forward their current restrictive membership requirements that bear no relationship to risk reduction, in direct contradiction of Dodd-Frank.

Second, clearing members obviously need the financial and operational resources to execute their duties to customers and the clearinghouse. But strong capital rules should be risk-based rather than arbitrary. Senator Toomey rightfully emphasized that the current model of futures markets clearinghouses worked well during the crisis. The successful wind-down of Lehman as well as other such disasters indicates that that model, which includes participation in the liquidation process of an open auction system, not limited to one subset of market participants, is unsurprisingly the most successful and reliable.

Third, both the clearing and execution mandates, we believe, should go into effect at the same time. Clearing is most value adding and, frankly, safest only when tied to execution. We do not really see how a safe central clearinghouse exists independent of liquid and transparent markets.

Fourth, regulations governing clearinghouse memberships obviously have to be coordinated globally. A number of you have already recognized the fact that there are a tremendous amount of U.S. jobs at stake. There is also the fact that regulatory arbitrage would completely undermine and perhaps, in fact, worsen the current risk situation.

Finally, we would make an operational point as sort of plumbers in the financial market, which is that at least 6 months is going to be required—at least 6 months is going to be required—once the

rules are completely finalized for our customers to be ready to actually implement them, and I say at least 6 months.

In conclusion, let me just emphasize that we at State Street stand ready to help Congress, the Administration, and the regulators as the process of rule writing and implementation goes forward. And let me also point out that State Street, and obviously we are not alone in that, is spending very, very large amounts of money to prepare for the implementation of Dodd-Frank and that we are investing this way because we believe these rules, again, if properly implemented, will bring major benefits to our investor clients.

Thank you.

Chairman REED. Thank you very much.

Mr. Thompson.

STATEMENT OF DON THOMPSON, MANAGING DIRECTOR AND ASSOCIATE GENERAL COUNSEL, JPMORGAN CHASE & CO.

Mr. THOMPSON. Chairman Reed, Ranking Member Crapo, and Members of the Subcommittee, my name is Don Thompson. Thank you for inviting me to testify today.

JPMorgan has been an active participant in the development and management of clearinghouses. We have direct membership in 77 clearinghouses covering a variety of markets, such as listed and over-the-counter OTC derivatives and equity and fixed-income securities. We are committed to clearing over-the-counter derivatives transactions, have been clearing dealer-to-dealer OTC transactions for over a decade. Today, we clear over 90 percent of the eligibility interdealer interest rate and CDS transactions that we execute. At the same time, we have also made significant investments in our client clearing franchise, which we expect to grow as requirements of clearing under Title VII become implemented.

While there are a number of critical issues to consider in determining the appropriate market structure and governance for clearinghouses, the most critical is guarding against systemic risk. Questions of membership criteria, risk committee structure and governance all implicate safety and soundness, so it is essential that the regulations carefully weigh those considerations, and I commend the Committee for holding this hearing to ensure that these proposals are well considered.

As you are aware, the migration of products that were once traded and managed bilaterally to CCPs will concentrate the risk for those transactions at clearinghouses. Clearinghouses do not eliminate credit and market risk arising from over-the-counter derivatives. They simply concentrate it in a single venue in significant volume. This concentration of risk, combined with an increase in aggregate credit and operational risk at clearinghouses, will result in these institutions becoming systemically important.

Since these institutions are private for-profit entities, it is critical that regulations guard against an outcome that would privatize profits but potentially socialize losses. Attempts to increase clearing member access or lower clearing member capital requirement can be responsibly implemented only if they are coupled with requirements for sound risk management practices, including appropriate limits on the types of transactions subject to the clearing

mandate, requirements for members of clearinghouses to have capital contributions proportional to the risk that they bring into the clearinghouses, elimination of uncapped liability of clearing members, and requirements for clearing members to be able to risk manage transactions they bring into clearinghouses.

We strongly support open access to clearinghouse membership and believe it can be achieved without compromising risk management standards. Two critical controls must be in place at each clearinghouse to support open access, a clear liability framework that caps member exposure and risk limits that are real time and proportional to each member's capital.

The approach we advocate here is consistent with the approach taken by the FSA in their recent comment letter to the CFTC. The foundation we are proposing would allow clearing membership to be prudently expanded to firms with modest levels of capital, including the $50 million minimum requirement proposed by the CFTC.

Absent proper oversight, clearinghouses are at greater risk of failure, which could have significant systemic impact. Failure could result for a number of factors, such as lack of proper risk management on the part of members from clearing complex products that cannot be properly valued by the clearinghouse or for from competitive actions resulting from a race to the bottom among for-profit CCPs.

Given these risks, we believe that as long as CCPs are structured as for-profit entities, the primary regulatory focus should be to ensure that proper risk management, governance, regulatory oversight, and incentive structures are in place.

It is also worth noting that because derivatives trading and clearing is a global business, in order to prevent regulatory arbitrage, rigorous regulatory standards should be applied consistently in each of the major global markets, including uniform operating principles and consistent on-the-ground supervisory approach.

We believe that no institution, including clearing members and clearinghouses, should be too big to fail. The policy objectives of the Act would be well served by promoting systemic stability and ensuring safety and soundness of clearinghouses and by requiring that these institutions have adequate capital to absorb losses and sufficient liquidity to safeguard the system.

JPMorgan is committed to working with Congress, regulators, and industry participants to ensure that Title VII is implemented appropriately and effectively. I appreciate the opportunity to testify before the Subcommittee and look forward to answering any questions you may have.

Chairman REED. Thank you, Mr. Thompson.

Mr. Cawley, please.

STATEMENT OF JAMES CAWLEY, COFOUNDER, SWAPS AND DERIVATIVES MARKET ASSOCIATION

Mr. CAWLEY. Thank you, Mr. Chairman. Chairman Reed, Ranking Member Crapo, Members of the Subcommittee, my name is James Cawley. I am CEO of Javelin Capital Markets, an electronic trading venue of OTC derivatives that will register as a SEF, or Swap Execution Facility, under the Dodd-Frank Act. I am also here

to represent the interests of the Swaps and Derivatives Market Association, which is comprised of multiple independent derivatives dealers and clearing brokers, some of whom are the largest in the world.

To ensure that the U.S. taxpayer is never again required to bail out Wall Street, we must move away from "too interconnected to fail," where one bank pulls another three with it in the event of its failure. Equally important, we must remove the systemic sting currently associated with each bilateral derivatives contract and that connects financial firms to each other and thus compel these contracts into clearing.

In order to have safe and successful central clearing of OTC derivatives, certain remaining impediments must be removed such that clearinghouses ensure that they have truly representative governance structures, offer objective and proportionate risk models, provide open access to properly qualified and noncorrelated clearing members, and accept trades on a real-time and execution-blind basis such that systemic risk is mitigated while transparency and market liquidity are increased.

With regard to clearinghouse governance, we support CFTC core principles O, P, and Q, that require that governance arrangements be transparent, fair, and representative of the marketplace. Such governance bodies should represent the interests of the market as a whole and not just the interests of a few.

Importantly, clearinghouse membership requirements should be objective, publicly disclosed, and permit fair and open access, as Dodd-Frank requires. This is important, because clearing members act as gatekeepers to clearing, and without open access to clearing, you will not have universal clearing adoption, increased transparency, and less than systemic risk. Clearinghouses should seek to be inclusive and not exclusive in their membership criteria.

We should dispense with the myth that swaps are somehow different from other cleared markets and we should not ignore the vast experience from those markets, that they have to offer. Importantly, clearinghouses should learn from their own experience in the listed derivative space of futures and options. In those markets, central clearing has operated successfully since the days of post-Civil War reconstruction in this country, nearly 150 years ago, long before spreadsheets and risk models. In those markets, counterparty risk is spread over 100 disparate and noncorrelated clearing firms. It works well, and no customer has ever lost money due to a clearing member failure.

To complement broad participation, clearinghouses should not have unreasonable capital requirements. Capital should be a function of the risk a member contributes to the system. Simply put, the more you or your customers trade, the more capital you should contribute.

The SDMA supports the CFTC's call for clearing broker capital requirements to be proportionate in scale relative to the risk introduced to the system. We support the CFTC's call that a clearing firm's minimum capital be closer to $50 million rather than closer to the $5 billion or $1 billion threshold that certain clearinghouses have originally suggested.

Certain clearinghouse operational requirements for membership that have no bearing on capital or capability should be seen for what they are, transparent attempts to limit competition. Specifically, clearing members should not be required to operate swap dealer desks just so that they can meet their obligation in the default management process. These requirements can easily be met contractually through arrangements with third-party firms or other dealers.

With regard to trade acceptance, clearinghouses and their constituent clearing member firms should accept trades on an execution-blind basis. Clearing firms and their constituent FCMs should be prevented from discriminating against certain customer trades simply because they dislike the manner in which they have been executed or the fact that they may be anonymous. Certain trade counterparties should be precluded from exploiting current market position to impose documentary barriers to entry that restrict customer choice of execution venue, execution method, and dealer choice. Regulators should remain vigilant to such restrictions on trade and ensure that they do not manifest themselves in a post-Dodd-Frank world.

The SDMA joins the MFA and supports the CFTC requirement that trades be accepted into clearing immediately upon execution. Regulators should be mindful not to allow clearinghouse workflows to increase and not decrease trade latency. Such workflows are nothing more than clear attempts to stifle successful OTC derivative clearing.

In conclusion, the CFTC and the SEC should be commended for their excellent work. Both agencies have been transparent and accessible through the entire process and they have adapted to the industry's suggestion where appropriate. We must move away from "too interconnected to fail," and as an industry, we must work together to ensure that OTC derivatives clearing is a success and that Wall Street never again has to come to Main Street for another bailout.

Thank you for your time.

Chairman REED. Thank you very much, gentlemen, for excellent testimony.

We will proceed with our first round, and if appropriate, since we have a large panel, we will entertain a second round if there are additional questions, but let me begin.

Dr. Steil, one of the recurring themes of all the witnesses has been the globalization of these markets. From your perspective at the Council on Foreign Relations, I presume you spend a lot of time looking at overseas markets, as well as U.S. markets. How would you sort of rate what is going on overseas relative to what Dodd-Frank is trying to create here in the United States at this time?

Mr. STEIL. I used to be on the board of a European exchange, so I got to see some of that firsthand. I would describe the situation in most of the European Union as being confusion. First of all, there are contradictions across national jurisdictions. For example, the UK is taking very different approaches on certain issues, such as bank capital requirements, from the rest of the European Union.

Second of all, there were regulatory approaches that were put in place before the financial crisis that are widely seen now as being

inappropriate, but are still being pushed forward by inertia. I had referred briefly in my testimony, for example, to the European Commission's spaghetti model approach for clearinghouses. Prior to the financial crisis, the European Commission wanted to see clearinghouses compete more against each other and they felt that the way to do that was to compel them to provide interoperability, technological linkages, one to another.

My concern is that that could produce enormous operational risk that could spread from one institution to another and could lead to a situation where the clearinghouses compete by lowering their margin requirements and other prudential requirements and could undermine their ability to make sure that we have a safe and sound securities trading system.

So I think we are more advanced over here right now in terms of having a coherent approach, and although I have differences on some approaches, I think the thrust is going in the right direction and it is a matter of refining individual details.

Chairman REED. Let me just follow up and ask perhaps the same question a different way, and also ask Dr. Spatt to comment. There is a real issue here of, going forward, are we advantaged by these reforms or disadvantaged, particularly with the competition with the European Community and with some of our Asian financial centers. And so your sense going forward, then I will ask Dr. Spatt.

Mr. STEIL. It depends on the individual issue. Let us take the issue of clearing certain contracts that are traded in multiple jurisdictions. I mentioned briefly in my testimony natural gas and oil futures contracts. These contracts are traded both by the NYMEX exchange, which is owned by the CME, which is regulated by the CFTC, and by the Intercontinental Exchange, which interestingly enough, although it is an American exchange, trades certain of these contracts out of London, so to speak. Of course, this is a keystroke that determines jurisdiction——

Chairman REED. Right.

Mr. STEIL. ——under FSA regulations. Margin requirements can differ on contracts that are traded in different jurisdictions.

And in terms of the current debate, for example on position limits on certain commodities, you have seen in the markets evidence that any time it looks like position limits may be instituted in the U.S. markets, say in natural gas and oil contracts, open interest shifts from NYMEX to ICE. I do not think this is coincidental. There is great concern in the markets here that if position limits are implemented here and not overseas, institutions will be forced to liquidate positions in order to get under those requirements, and so they start increasing their open interest overseas, and I think that is the sort of regulatory arbitrage we need to be concerned about.

Chairman REED. Dr. Spatt, your comments, and then there will definitely be a second round because I have questions for the other panelists, but I want to give my colleagues a chance. Dr. Spatt?

Mr. SPATT. Thank you, Senator Reed. I share the concerns about the competitiveness issues. I am certainly struck by the discussion today about how little movement there has been in Europe and certainly in Asia on these issues. Even the language of the G20 has certainly used a much more extended window than is present in

the Dodd-Frank legislation, and there does not seem to be much movement by Europe and Asia even relative to the longer window used by the G20.

This whole issue reminds me of a strong parallel that I observed when I was Chief Economist at the SEC. At the time, there was a lot of concern about the consequences of Sarbanes-Oxley for listings and lots of interest on the part of European companies to deregister from the U.S. environment and a lot of discussion and debate about that. To the extent that we get it wrong—and I have fears that we may be getting it wrong—to the extent that we get it wrong, the concern is basically that a lot of the business will flow overseas, that the complications in trading overseas are tiny. There are obviously major market centers in London and Hong Kong and it is relatively easy for most sophisticated traders to redirect their orders to what they consider to be a more appropriate environment.

Chairman REED. I thank you.

Just before I recognize Senator Crapo, I cannot help but think this is somewhat ironic, because, of course, AIG's financial products were located in London so that they could avoid the "onerous," quote-unquote, regulation and they began—they were sort of the self-destructive aspect of the company.

Mr. SPATT. Well, I do think, to the extent that the Administration views the G20 as an important group, I think it is important that there be alignment, that does not necessarily mean to simply match the current form of Dodd-Frank, but I think it is important that there be regulatory alignment between the framework in the U.S. and the framework overseas, and that may involve movement in both directions.

Chairman REED. Thank you, Doctor.

Senator Crapo.

Senator CRAPO. Thank you, Senator Reed.

Mr. Thompson, I would like to return to the end user issues that I discussed with the first panel a little bit and ask you if you could explain how the margin requirements on uncleared groups or swaps will impact end users.

Mr. THOMPSON. Thank you for that, Senator Crapo. I would love to be able to do that. The impediment to doing that is as many times as I have read the regulations, I still do not entirely understand them because there seems to be an internal inconsistency in the regulations themselves.

They seem to say, on the one hand, we will not require the collection of margin from end users by swap dealers. On the other hand, it says that swap dealers are required to negotiate agreements with end users which will provide for the mechanics of transfer of margin with respect to their liabilities under uncleared swaps.

It seems to me difficult to square those two statements, and the regulations, as many times as I have read them, do not square the circle there, so I remain a little confused about exactly what they require in terms of requiring swap dealers to collect margin from end users on uncleared swaps.

Senator CRAPO. And is this a conflict between the approach of the SEC and the CFTC versus the approach of the banking regulators?

Mr. THOMPSON. I believe that that issue is present both in the margin release from the banking regulators as well as the margin release from the CFTC. Both of them require this concept of swap dealers establishing what they call thresholds, presumably which will govern the requirement to collect margin once you get above the threshold. There is very little, virtually no discussion of how those thresholds are set, whether they are done in accordance with banks' ordinary and customary credit practices, whether they will be imposed by regulators, whether they can be changed by regulators in a financial crisis. There is a whole level of detail around that question which is lacking in both releases.

Senator CRAPO. From my perspective, and I do not propose that I am anywhere close to the expert that you or the others on the panel are to these regulations, but it seems to me from what I am hearing that—it appears that although there is the confusion you described, that there seems to be an understanding that there will be somehow an increased margin requirement imposed either as a margin requirement or as some kind of other fee on end users. Is that a fair assumption?

Mr. THOMPSON. I think it is natural when you have that kind of ambiguity in otherwise very long and comprehensive regulatory releases that people who would be affected by that, most significantly the end user community, would be naturally suspicious that there is not going to be some requirement imposed in some form or fashion in connection with their liabilities under uncleared swaps. So, yes, I think I agree with you.

Senator CRAPO. And if that is the case, I believe, and I do not want to speak for him, but I believe Mr. Edmonds in the first panel indicated that that increased margin requirement would be a cost on end user transactions that would not necessarily be justified by any appropriate increase in safety and soundness. He may or may not have intended that. That is what I heard him say. But what do you think about that? Do you think that the increased margin costs that would come from what we have been discussing would be justified in an improvement of safety and soundness?

Mr. THOMPSON. Well, when I think about that question, which is an excellent question, I go back to the statute which authorizes and directs the prudential regulators to set margin requirements for uncleared swaps, and in that requirement under Section 731, there is a requirement that it be appropriate for the risk.

When you think about end users, your typical corporate nonfinancial entities, there is no evidence that they contributed in any significant way to the financial crisis. Their use of over-the-counter derivatives is almost invariably risk reducing hedging transactions.

Furthermore, unlike financial firms, which tend to be very highly correlated, such that when Lehman Brothers gets in trouble, people start to get the sweats about other financial entities, when you think about the end user world, it is a whole host of entities whose credit risk has very low correlation.

So in my mind, that means that imposing onerous margin requirements on those types of entities gets you very, very little reduction in systemic risk and, I would argue, is not appropriate for the risk.

Senator CRAPO. Well, thank you. As I see it, to put it my way, it seems to me like we are raising the cost of capital and reducing the availability of capital for very little benefit.

Mr. THOMPSON. That is certainly what we are hearing from our clients.

Senator CRAPO. Thank you.

Chairman REED. Senator Merkley.

Senator MERKLEY. Thank you, Mr. Chair.

Mr. Lewis, I wanted to understand a little bit better the exchanges that have been set up, CME and ICE. An article from December in the *New York Times* noted that State Street has not yet gained full entry into the derivatives trading club, and it mentioned other groups like the Bank of New York, MF Global, Newedge. Is that still pretty much the case, or have things changed in the course of the last few months?

Mr. LEWIS. It varies, and we are talking to the clearinghouses. I mean, existing clearinghouses, there was no problem when State Street decided to enter. The new clearinghouses, many of which that were set up with relatively limited membership that consisted of the major swap dealers today, who, as Dr. Steil said, make about $40 billion a year from market making activities, curiously did not have membership requirements that would allow State Street to participate, notwithstanding the fact that our capital ratios are better than any of the other top 20 banks in the United States.

Senator MERKLEY. Right. So I am trying to get a sense, then, of how does State Street respond. Do you end up utilizing those exchanges but having to do the deals through those that are members, or do you simply operate through the other exchanges?

Mr. LEWIS. This is a prospective problem, really, more now. We find ourselves in the ironic situation of handling the back-office processing for some of our clients, sort of test trades at clearinghouses that we were not allowed to join. I think CME and ICE have got proposals in place, with help from some of the existing members, including JP, that would let us participate. I think we still have a continuing problem with SwapClear at LCH, which apparently has a different model.

Senator MERKLEY. And so, Mr. Thompson, you do not see any systemic issues or problems with State Street participating?

Mr. THOMPSON. Generally speaking, we are supportive of open access. I am not intimately familiar with the State Street legal entity which is seeking to join ICE and CME, but I would just reiterate what I said in my opening statement, which is as long as clearinghouse membership is proportional to the risk that clearing members bring into the clearinghouse and as long as clearing members have demonstrated risk management capabilities such that they can assist actively in the management of a clearing member default, we would have no problem with an entity like that becoming a clearing member of a clearinghouse that we are a clearing member of.

Senator MERKLEY. There is a fair amount of discussion of the question as to whether risk management arguments are being used really out of proportion to keep other players out of the exchanges. Do you see kind of an evolution in that argument or kind of a

movement toward risk assumptions that are reasonable in terms of other folks participating?

Mr. THOMPSON. Well, what I see in that is, on the part of many market participants, a recognition, much of which came out of the experience we had with Lehman Brothers' default and how the risk management process worked in the LCH, that having the ability to independently manage risk contributed to a very successful resolution of the Lehman Brothers bankruptcy with respect to the $9 trillion of derivatives that it had in LCH.

The LCH mechanic requires all clearing members to be active bidders for portions of the portfolio of a defaulting clearing member, which is what Lehman was, and in the LCH Lehman situation, we were able to reallocate their portfolio among existing clearing members without going through the first level in the default waterfall, which is the initial margin posted by Lehman, thus not putting any member guarantee fund contributions at risk, and most critically, not imperiling the solvency of the clearinghouse. So we think risk management is a very important feature of the landscape.

Senator MERKLEY. Mr. Lewis, I am going to turn back to you on this. I mean, one issue is membership in the exchange. Another is membership in the Risk Committees. The Risk Committees have a key role in deciding what gets traded on the exchange, in other words, how broadly, what kind of swaps derivatives are there.

In terms of the other exchanges that you are members of, do you also have a role in the Risk Committee, being able to kind of help shape what gets traded on the exchange?

Mr. LEWIS. Yes, and we are most concerned not only for ourselves, but for the buy-side customers that need to participate in this who ultimately are at risk in pension funds and mutual funds need to be represented in these.

I think there is a very complicated aspect as to how to run the worst-case situation, which is the default of a clearing member, and that is where there is a distinction between the practice in the U.S., which worked very successfully, and the practice which Mr. Thompson just alluded to in LCH in London. In the U.S., it is essentially an open auction, and indeed, in the U.S., the majority of the Lehman positions, not surprisingly, were bought by nonclearing firms. We would argue that the most open auction, most market-oriented process for handling a liquidation makes sense. We would also think that, occasionally, some of these restrictions have less to do with safety and more to do with limiting profit opportunity.

Senator MERKLEY. Thank you very much. Thank you, both of you.

Chairman REED. Well, thank you, Senator Merkley.

Let me just address a general question. I will start with Mr. Thompson, but I wish to call in Mr. Lewis, also, and this might be terribly unsophisticated, but it strikes me that in an over-the-counter derivative arrangement, there are substantial fees charged by the broker-dealer, and part of those fees are equivalent to margin. They are an attempt to price the risk in every transaction as risk.

And so when we talk about the end user being assessed a margin requirement or not assessed a margin requirement, is it not the re-

ality that there is a built-in risk premium or something like margin in there, and the question really is, if there is a requirement under these rules to have a formal margin or even a contingent margin, the question is really, is that paid for by the issuing broker-dealer or is it paid for by the customer, and in these situations where there are no competitive market, it could be fully passed on to the customer. Is that more of the question we are dealing with here, who pays rather than who is covering the risk?

Mr. THOMPSON. I think there are a couple of levels to that, so let me just address each of those in turn.

Chairman REED. Sure.

Mr. THOMPSON. First of all, the term "fees" is often used, but it is really misleading in the over-the-counter business, which is not what we call an agency business, where I sell you a security issued by another. We call it a principal-to-principal business, where you and I enter into transactions. And so if we are entering into an interest rate swap, what we are really—what you are paying is the rate on the fixed rate that you want to pay on your interest rate swap, for example. So if you are in open competition with other dealers, you would select the dealer who requires you to pay the lowest fixed rate.

Now, embedded in that fixed rate, as you correctly identify, for transactions that do not involve margin, is something that we call a credit spread, compensation to the dealer for the possibility that you may default, and in the derivatives markets, those credit spreads are risk based. If you are a hedge fund, you would pay a higher credit spread than if you are a AAA corporate. That is essentially how it works.

Now, when people talk about the cost of margining transactions, that is not a cost which is embedded in the fixed rate of the transaction. What people are referring to there is the cost to you of coming up with $10 million or $20 million or whatever the margin requirement is in order for you to be able to fund the margin requirement that I am going to impose on you. I hope that clears it up.

Chairman REED. I think I am going to ask Mr. Cawley to help clear it up and Mr. Lewis to help clear it up. I think it is an excellent answer, but your comments, please.

Mr. CAWLEY. It would be my pleasure, Mr. Chairman, to clear it up. There are essentially two types of fees that the end user is charged, some of which are not transparent and some of which are. There are—and there has been—Senator Toomey and Senator Crapo correctly discussed the clearing fees, the margin or, indeed, the capital fees that get held aside for each individual trade, whether it be within a clearinghouse where it is an objective fee that is dictated by the risk model of that clearinghouse or whether it be a subjective fee set by the broker-dealer that extends a credit relationship to that entity.

And it is, indeed, the subjectivity of that fee relationship that got us into trouble in 2008, because dealers, incumbent dealers essentially extended open fee relationships to entities such as AIG and then requested the bailout.

But, you know, from the end user standpoint, from what I have heard from Chairman Gensler, as we participated in roundtables and had meetings with him and read his public comments, it is our

understanding that there is an exemption for end users vis-a-vis margin. That said, end users still have to pay their own way. They do not get a free ride on every trade that they do. They have to set aside the appropriate amount of capital for each trade, and that is only fair, and appropriate within the marketplace.

The argument against that, then, is, well, you know, is capital formation. Well, is this not going to take money off our balance sheets if we really had nothing to do with AIG? And we would say this. Well, you are trading derivatives, so you have to come in the same way as everybody else.

What you should also look, though, is at the benefits of the lessened execution fees that can occur. For example, if you take a standard credit default 5-year trade, if I want to buy default protection on GECC and I get charged five basis points in the bid-offer spread for a five million round lot trade, that is $21,000 per trade. Now, likewise, in the futures world, the execution fees are ten, maybe $10, $15, $20. So you can see the contrast between a transparent liquid marketplace and the lack of transparency in the CDS and the interest rate swap markets.

Now, the way to benefit, then, is to bring these markets into a transparent, open, competitive marketplace such that that $21,000 fee, as one of the gentlemen on the panel correctly surmised that it is about $40 or $50 billion of execution fees, you go after—you create competition. You bring transparency into the marketplace. You bring multiple dealers, not just five or six or ten dealers, but 30 or 40 or 50 dealers in to compete. And you open up clearinghouses away not just from five or six or ten constituent clearing members who also have execution desks, as well, so there may or may not be a conflict of interest there, but what you do focus on is the benefit of taking that $50 billion worth of execution fees and driving it downwards to ten, leaving the resultant $40 billion on the balance sheets of corporate America so they can go out and, indeed, hire people and invest in their respective companies and industries.

Chairman REED. Thank you. And, Mr. Lewis, I want your perspective.

Mr. LEWIS. Just very briefly, we talk about end users, as I say, that are financial institutions that are in this. I think, by and large, they view this, unfortunately, as completely an incremental cost. And what I think has been lost is the genius of the approach, which is really the genius of futures that has proven this for 100 years, lots of academic research, which is that a more transparent market is a more efficient market. The biggest beneficiary of that are the price takers, the noncorrelated flow, the investors, if you will. The savings of America are better off if you have a transparent market.

And that is one of the reasons we emphasize so much that you have to see both sides of the coin between clearing and the exchange piece, or SEFs, as it is called in this case. I think the measure of success will be that improved efficiency. The more rapidly that the clients see that efficiency, the less political problems there will be. The more obvious the benefits will be. And I think that it is a win–win.

Alternatively, frankly, if there is not a big improvement in efficiency, then probably some of these risk products may not become as important as they are. In fact, some may disappear.

And the final point I would just observe is that I think the least likely outcome and a very uncertain outcome is that the market and the products are going to look like they look like today. The effect of this is going to be to change things fundamentally, and I think if you hold to your guns, change things for the better.

Chairman REED. Thank you.

Mr. THOMPSON. Senator Reed, if I might just close with one additional observation——

Chairman REED. Sure, and then Professor Spatt. Absolutely.

Mr. THOMPSON. Yes. When people talk about transparency in the context of clearing, I think they are confusing things because you are confusing the clearing side of it, which is how trades settle and clear, with the execution side of it. And I think it is worth, on the execution side, to keep in mind that Dodd-Frank implements a full pretrade transparency for execution and post-trade transparency for both SEF-executed as well as non-SEF-executed transactions.

So I think from a public policy perspective, the transparency argument has been had and decided in favor of full market transparency. That is a conclusion that we are totally comfortable with. And so I do not see how changing the clearing model really can add to the transparency debate which has already been resolved in favor of full transparency as required by the statute.

Chairman REED. Professor Spatt.

Mr. SPATT. Yes, so on two points. First, on the issue of the SEFs and the CCPs, to the extent that the statute is obviously requiring post-trade transparency but not universal exchange trading, the prices from post-trade transparency can clearly inform collateral issues vis-a-vis the CCP, and those do not even have to be real time. That is a separate issue from whether it is real-time disclosure. Those prices could be disclosed a day later if real-time disclosure is a severe impediment with respect to liquidity. It seems to me those are separate.

There is one other point I also wanted to make with respect to access. The issue of access is not a unique issue with respect to the derivatives market. In other contexts, there have been concerns about unfettered access. The SEC late last year promulgated a rule barring unfettered access by customers that do not go through intermediaries because of concerns that that would impose systemic risk on the system, if those orders were not vetted but had basic kinds of errors. Analogously, in the history of payment system clearinghouses, both the private clearinghouse systems prior to the Federal Reserve and the Federal Reserve, also control access because of issues associated with default.

Chairman REED. Thank you.

Dr. Steil, you have a comment. You will get the last word.

Mr. STEIL. Two brief observations on end users. First, generally speaking, I do not like the approach of taking a certain class of market participants, carving that class out and saying that exemptions apply there, because traditionally, when that has been used in other markets, it has produced a regulatory arbitrage that has itself produced significant complications and inefficiencies.

Just very briefly, for example, in the UK markets, you have stamp duty on equity trading and you have a carve-out for market makers. They do not pay it. So the market makers trade the stocks, but other sophisticated investors trade substitutes for the stocks called CFDs, or Contracts for Differences, and this has led to endless debate about corporate governance. For example, how do we deal with entities that have significant CFD exposures to a given company? So I do not like that general approach.

Second, I think a lot of these end users are either overstating or misstating their cases in some cases. FMC Corporation, an end user, testified before your parent Committee back in April, and I would like to read just one sentence that the Treasurer said. He said, "Our banks do not require FMC to post cash margin to secure mark-to-market fluctuations in the value of derivatives, but instead price the overall transaction to take this risk into account."

Now, this means there is no free lunch. First of all, if you post margin, you get paid interest on it, so it is not uncompensated.

Second of all, as you yourself pointed out, if you do not post margin, you expect the bank to take account of this risk and, therefore, build it into its price, the bid-ask spread. And in an untransparent market, you do not know exactly what that price is.

From my experience with the mutual fund industry, many traders on the buy side did not like when NASDAQ shifted from an opaque dealer market structure in the 1990s to a transparent electronic market structure because then trading cost analysis was able to distinguish between good traders and bad traders. And it is my perception that a lot of corporate treasurers do not want to be subjected to that sort of scrutiny which would naturally emerge in a more transparent marketplace.

Chairman REED. Well, thank you very much, gentlemen. This has been very thoughtful and excellent testimony which will help us, and it will not be, I am sad to say, the last word on this topic, but these were all very, very thoughtful words and I thank you very much.

With that, I would just simply say, some of my colleagues may have written questions that they would like to submit. One week from today will be the deadline for my colleagues. We would ask you, if you do receive written questions, to respond as quickly as possible.

And again, thank you, and with that, I will adjourn the hearing. The hearing is adjourned.

[Whereupon, at 11:27 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF CHRISTOPHER EDMONDS

PRESIDENT, ICE TRUST

MAY 25, 2011

Chairman Reed, Ranking Member Crapo, I am Chris Edmonds, President of ICE Trust, a limited purpose New York bank that operates as a clearinghouse for credit default swaps. I very much appreciate the opportunity to appear before you today to testify on clearing OTC derivatives.

Background

ICE has a long, successful, and innovative history in clearing, including clearing previously "unclearable" over-the-counter (OTC) derivatives such as energy and credit default swaps. ICE owns and operates five derivatives clearinghouses: ICE Clear US, a Derivatives Clearing Organization (DCO) under the Commodity Exchange Act, located in New York and serving the markets of ICE Clear US; ICE Clear Europe, a Recognized Clearing House located in London that clears ICE Futures Europe, ICE's OTC energy markets and European credit default swaps (CDS); The Clearing Corporation, a DCO and ICE Clear Canada, a recognized clearinghouse located in Winnipeg, Manitoba, that serves the markets of ICE Futures Canada. ICE Trust serves as the leading United States clearinghouse for CDS, having cleared approximately $11 trillion in gross notional value since it launched on March 9, 2009. Globally, ICE has cleared more than $18 trillion in credit default swap volume since the financial crisis.

Clearing is the cornerstone of U.S. and global regulators' financial reform efforts. Clearing greatly reduces counterparty and systemic risk in the derivatives markets for standardized contracts. As an example, since our service came to market we have reduced the outstanding risk exposure by greater than 90 percent for the products we offer. In addition, clearing brings transparency, and transparency is a prerequisite for efficient markets and effective regulation. Increased liquidity from clearing results in lower transaction costs and tighter bid/ask spreads, reducing the cost of hedging price risk and lowering operating costs for businesses. Companies operating DCOs, like ICE, have led this effort and have been very successful in their efforts to clear OTC derivatives.

Clearing Over the Counter Derivatives

ICE's experience in energy and credit derivatives demonstrates that when clearing is offered to a market, the market overwhelmingly chooses to clear its products. While convincing market participants of the advantages of clearing is easy, however, the process of clearing an OTC derivative is difficult. For example, in order to clear an OTC derivative, the clearinghouse must be able to properly price the contract for an accurate mark to market. Marking-to-market is a process common to clearinghouses whereby a clearing participant's position is priced (marked) on at least a daily basis, and to the extent that the clearing participant has incurred a loss, the clearing participant must pay the clearinghouse the amount of the loss. The daily making-to-market of positions, and the commensurate daily collection of any loss (known as variation margin), is a unique discipline of clearinghouses that reduces systemic risk by eliminating the accumulation of losses. In addition, a clearinghouse must determine the correct size and type of contract that it will clear, balancing the risk management objectives of the clearinghouse with the needs of market participants. Finally, the clearinghouse must model risk for the market in order to determine how to properly set margin rates. We do this by working in concert with our clearing firms, who are required to provide accurate pricing information for OTC products.

For Credit Default Swaps (CDS), which we have cleared since March 2009, we require clearing members to provide accurate and reliable prices on a daily basis. If a clearing member submits a price that is out of line with the prices submitted by other clearing members, the clearing member is subject to being required to enter into a transaction at the out of line price. Requiring clearing members to submit to "executable" prices compels clearing members to carefully price the CDS contract. Furthermore, requiring clearing members to submit accurate and reliable prices limits risk to the clearinghouse by ensuring that one clearing member can assume another's position in the event of default. Over the past 10 years, ICE has gained extensive experience with the clearing process—allowing ICE to grow its business and reduce system risk by finding new markets and product to clear.

Over the next few months, the mandatory clearing and trading provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) should take effect, and market participants will be forced to clear OTC derivatives as a matter of law. ICE respectfully submits that the regulators responsible for deter-

mining which contracts must be cleared should consider any mandate very carefully. Many contracts not cleared now are not cleared for good reasons. Some markets have structural issues where illiquidity makes the contracts difficult to price. Other markets have regulatory hurdles where two or more regulators have different ideas on how the market should operate.

ICE generally supports the clearing principles of Dodd-Frank. ICE believes, however, that the best path to meet this goal is to allow clearinghouses and market participants to find the best way to clear markets within defined principles, as opposed to promulgating prescriptive rules for clearinghouses. Many of the proposed rules attempt to design a perfect market. Attempts at such market design are not very likely to work and may delay implementation of clearing services. At the very worst, these efforts may destroy liquidity in certain markets. The best way to quickly achieve the clearing objectives of Dodd-Frank is to make sure those unnecessary regulatory hurdles and other impediments are removed and to give clearinghouses and market participants the freedom to create cleared OTC markets.

For example, one key regulatory hurdle to clearing is cooperation between regulators. Many OTC derivatives, like CDS, have characteristics of securities and commodities. Close regulatory cooperation between the CFTC and SEC is necessary, and required by law, in order to make sure that market participants have legal certainty. This is particularly important in regards to portfolio margining—allowing security-based and commodity-based derivatives to be held in the same account and margined together. Historically, the CFTC and SEC have had little success creating portfolio margining. After the implementation of Dodd-Frank, the absence of a clear and economical portfolio margining regime will discourage CDS clearing.

Regulation of Clearinghouses

Appropriate regulation of clearinghouses is of utmost importance to the financial system. Pursuant to Dodd-Frank, clearinghouses will be a key part of the efforts to decrease systemic risk in the derivatives markets. In order to accomplish this important mission, clearinghouses must be open and transparent, while exercising proper risk management controls. However, given the scope, complexity and importance of the OTC derivatives, "one-size-fits-all" regulation will not work. Flexibility is important, because regulators must be able to anticipate and respond to future problems—and not just yesterday's crises. Prescriptive laws and regulations will hamper flexibility and create regulatory gaps. To be flexible, regulators must be prudential, understanding their markets and tailoring regulation to ensure market integrity and consumer protection.

Regulators need clear lines of jurisdiction. Regulators need to provide certainty that they have the power to take actions to uphold the public good. Likewise, market participants need the certainty that their business transactions will not be held to conflicting standards of conduct. Further, regulatory certainty reduces the possibility of regulatory arbitrage, or long-term damage to the U.S. financial sector in a highly competitive global environment.

The need for certainty extends beyond U.S. borders. It is vital to recognize that the OTC derivatives markets are global: most large companies in the developed world use derivatives, and they conduct these transactions with U.S. counterparties. Thus, U.S. regulators must work with international regulators from a common set of regulatory principles. Right now, Dodd-Frank has created significant uncertainty over whether a transaction will be subject to U.S. regulation or foreign regulation. This lack of clarity may begin to have an impact on markets, drying up liquidity and hampering regulatory reform efforts because market participants are unsure which laws apply. Therefore, harmonizing regulatory systems across countries and giving market participants is of utmost importance.

Timing of Implementation

Earlier this month, the CFTC and SEC held a roundtable to hear views on the implementation of Dodd-Frank. Dodd-Frank's effective date is July 16th or at least 60 days after a final rulemaking, if one is required. As the CFTC and SEC have come to realize, the legislation cannot (effectively or practically) take effect all at once.

ICE believes that regulators should pursue an aggressive timetable to implement most sections of Dodd-Frank as soon as possible. While Dodd-Frank requires an enormous effort from both market participants and regulators, the cost of uncertainty is much higher. ICE has suggested to regulators that they pursue a three-phase implementation plan. Phase 1 would implement transparency initiatives, including the important swap reporting and swap data repository regulations. Phase 2 would implement the mandatory clearing and trading requirements, building on the transparency created by Phase 1. Phase 3 include everything else, such as non

spot month-position limits, which could constrain the mandatory trading and clearing requirements. This timeline is similar to what other organizations are suggesting, such as the Managed Fund Association.

Flexibility is central to meeting these implementation goals. Regulators have an immense burden to implement Dodd-Frank. Creating a one-size-fits-all prescriptive system of regulations will only increase that burden, as regulators will be required to continually consider exemptions for markets that do not quite fit the regulator's model. Likewise, market participants will have an easier time meeting implementation goals if they have the freedom to meet the goals of Dodd-Frank without radically changing their operations to meet prescriptive rules.

Conclusion

ICE has always been and continues to be a strong proponent of open and competitive markets, and of appropriate regulatory oversight of those markets. As an operator of global futures and OTC markets, and as a publicly held company, ICE understands the importance of ensuring the utmost confidence in its markets. To that end, we have continuously worked with regulatory bodies in the U.S. and abroad in order to ensure that they have access to all relevant information available to ICE regarding trading and clearing activity on our markets. We have also worked closely with Congress and regulators at home and abroad to address the evolving regulatory challenges presented by derivatives markets and will continue to work cooperatively for solutions that promote the best marketplace possible.

Mr. Chairman, thank you for the opportunity to share our views with you. I would be happy to answer any questions you may have.

PREPARED STATEMENT OF TERRENCE A. DUFFY

EXECUTIVE CHAIRMAN, CME GROUP INC.

MAY 25, 2011

Chairman Reed, Ranking Member Crapo, Members of the Subcommittee, thank you for the opportunity to respond to the Subcommittee's questions respecting clearing of swap contracts. I am Terry Duffy, Executive Chairman of CME Group ("CME Group" or "CME"), which is the world's largest and most diverse derivatives marketplace. CME Group includes four separate exchanges—Chicago Mercantile Exchange Inc., the Board of Trade of the City of Chicago, Inc., the New York Mercantile Exchange, Inc., and the Commodity Exchange, Inc. (together "CME Group Exchanges"). The CME Group Exchanges offer the widest range of benchmark products available across all major asset classes, including futures and options based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products. CME also includes CME Clearing, a derivatives clearing organization (DCO) and one of the largest central counterparty clearing services in the world; it provides clearing and settlement services for exchange-traded contracts, as well as for over-the-counter (OTC) derivatives transactions through CME Clearing and CME ClearPort®.

The CME Group Exchanges serve the hedging, risk management and trading needs of our global customer base by facilitating transactions through the CME Globex® electronic trading platform, our open outcry trading facilities in New York and Chicago, as well as through privately negotiated transactions executed in compliance with the applicable Exchange rules and cleared by CME's clearinghouse. In addition, CME Group distributes real-time pricing and volume data through a global distribution network of approximately 500 directly connected vendor firms serving approximately 400,000 price display subscribers and hundreds of thousands of additional order entry system users. CME's proven high reliability, high availability platform coupled with robust administrative systems represent vast expertise and performance in managing market center data offerings.

The financial crisis focused well-warranted attention on the lack of regulation of OTC financial markets. We learned a number of important lessons and Congress crafted legislation designed to reduce the likelihood of a repetition of that disaster. However, it is important to emphasize that regulated futures markets and futures clearinghouses operated flawlessly. Futures markets performed all of their essential functions without interruption and, despite failures of significant financial firms, our clearinghouse experienced no default and no customers on the futures side lost their collateral or were unable to immediately transfer positions and continue managing risk. Dodd-Frank was adopted to impose a new regulatory structure on a previously opaque and unregulated market—the OTC swaps market. It was not intended to engineer a new regulatory regime for the already robustly regulated futures markets.

For example, while Congress granted the Commodity Futures Trading Commission (CFTC or Commission) the authority to adopt rules respecting Core Principles, it did not direct it to eliminate principles-based regulation. Yet the Commission has proposed specific requirements for multiple Core Principles—almost all Core Principles in the case of designated contract markets (DCMs) and DCOs—which would eviscerate the principles-based regime that has fostered the ability of CFTC-regulated entities to effectively manage risk for the past decade.

We support the overarching goals of DFA to reduce systemic risk through central clearing and exchange trading of derivatives, to increase data transparency and price discovery, and to prevent fraud and market manipulation. Unfortunately, DFA left many important issues to be resolved by regulators with little or ambiguous direction and set unnecessarily tight deadlines on rulemakings by the agencies charged with implementation of the Act. We have concerns about many of these proposed rulemakings, about which we have previously provided written testimony to the Senate Banking Committee and other committees of this Congress. For purposes of this hearing, we will focus on the following five questions posed to us by this Subcommittee:

1. What issues may affect the safety and soundness of clearinghouses, and how should those issues be mitigated?
2. What are the similarities and differences with other cleared products that should be considered when establishing clearinghouses for swaps?
3. Are there unique attributes of certain asset classes that should be highlighted when considering adopting a clearing paradigm? How about unique attributes of certain market participants?
4. What best practices should be considered regarding ownership, governance, or control of derivatives clearinghouses?
5. What structural and economic barriers affect access to swap clearing? What must be done to eliminate or reduce those barriers?

Question 1. What issues may affect the safety and soundness of clearinghouses, and how should those issues be mitigated?

The safety and soundness of clearinghouses is a major focus of Dodd-Frank. The Core Principles for derivative clearinghouses compel DCOs to have adequate financial resources, comprehensive risk management procedures and safeguards against system failures. In addition, Dodd-Frank includes eight additional Core Principles dealing with the safety and soundness of derivative clearinghouses. Moreover, the CFTC has been granted increased power to force a derivative clearinghouse to alter a procedure or implement a new procedure if it is not in compliance with the Core Principles, without the procedural steps previously required. The rigid rules being proposed by the CFTC with respect to risk management are unnecessary and destructive of innovation and competition. Such a prescriptive set of requirements will force clearinghouses into a rigid methodology for managing risk and inhibit the ability of individuals best positioned to adapt risk management methodologies to changing circumstances. The end result of this would be to increase, rather than reduce risk.

CME Group appreciates the importance to the broader financial system of a regulatory regime designed to ensure that every DCO can perform its role as a central counterparty, including performance of its financial obligations during periods of market stress. In that regard, the Commission's DCO Core Principles have functioned admirably and effectively over the years, including during the 2008 financial crisis. CME Group can support regulations that enhance the Commission's existing core principle system, if they strike a responsible balance between establishing general prudential standards and prescriptive requirements.

On March 21, 2011, CME Group, by its CEO Craig Donohue, filed a detailed 17-page letter commenting on an additional set of CFTC risk management requirements for clearinghouses. The letter, which will not be repeated here, may be accessed at *http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=31993&SearchText=*. CME's position on this issue can be summarized as follows:

> The Commission's Notice of Proposed Rulemaking addresses the critically important topic of risk management practices at DCOs. Greater use of DCOs for OTC derivatives heightens the importance of ensuring that risk management at every DCO is robust and comprehensive. The unique risk characteristics of OTC derivatives products and markets underscore the importance of DCOs retaining reasonable discretion and flexibility to adapt risk management practices as products and markets develop over time.

> Risk management is not an assembly line type of process that can be commoditized, codified and deployed in such a way as to ensure that risk management regimes of DCOs remain prudent and agile. Indeed, very few aspects of risk management can be standardized across all cleared markets to such an extent that a rules-based regime can describe each potential condition that can arise and the necessary actions that can and should be taken to mitigate risk. CME Group is therefore very concerned that certain provisions in the proposed regulations would diminish CME Clearing's ability to effectively manage risk by requiring each DCO to employ the same rigid, standardized risk management procedures.
>
> Consistent with the CFTC's approach in a number of other rulemakings, regulations proposed in the NPR further the CFTC's retraction of the highly successful principles-based regime that has permitted U.S. futures markets to prosper as an engine of economic growth for this Nation, to a restrictive, rules-based regime that will stifle growth, innovation, and flexibility in risk management. As we have noted in comment letters in response to other proposals, Congress not only preserved principles-based regulation in the Dodd-Frank Act, it reinforced the vitality of that regime by expanding the list of core principles applicable to DCOs. Although DFA granted the CFTC the authority to adopt regulations with respect to core principles, it did not direct the CFTC to eliminate principles-based regulation. Rather, DFA made clear that DCOs were granted reasonable discretion in establishing the manner in which they comply with the Core Principles.
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> Furthermore, certain of the proposed prescriptive regulations would impose significant costs not only on DCOs and their clearing members, but on the CFTC, with little or no corresponding regulatory benefit. In that regard, CME Group is very concerned that the CFTC has not performed the required cost/benefit analyses with respect to the rulemaking proposals in the NPR. Aside from certain information provided in connection with recordkeeping and reporting requirements, the "cost/benefit analysis" with regard to the regulations proposed in connection with the Core Principles consists of little more than the following two assertions: (1) "With respect to costs, the Commission has determined that the costs to market participants and the public if these regulations are not adopted are substantial"; and (2) "With respect to benefits, the Commission has determined that the benefits of the proposed rules are many and substantial". In requiring the CFTC to consider costs and benefits of its proposed actions, Congress requires an actual and concrete estimate of costs of agency action. The mere uncertainty of cost estimates does not excuse the CFTC from issuing such an estimate.
>
> The performance of actual and concrete cost/benefit analyses is particularly important for any regulator proposing to adopt regulations that would increase the costs of central clearing of OTC derivatives.

One of the CFTC proposals which causes us great concern is the CFTC's proposal to establish lower financial resource requirements for nonsystemically important DCOs, an approach we believe will exacerbate rather than ameliorate systemic risk. The CFTC relies on Title VIII of Dodd-Frank in proposing Regulation 39.29, which would require a DCO that is deemed systemically important (a SIDCO) to comply with substantially different and higher financial resources requirements than any DCO that the Financial Stability Oversight Council does not designate as systemically important. As proposed, Regulation 39.29 would: (1) require a SIDCO to maintain financial resources sufficient to meet its financial obligations notwithstanding a default by the two clearing members creating its largest financial exposures; (2) limit a SIDCO's use of assessment powers to cover financial resources requirements relating to a default by the clearing member creating its second largest financial exposure; and (c) for purposes of valuing its assessment powers, require a SIDCO to apply the same 30-percent haircut and 20-percent post-haircut cap on assessments as proposed for nonsystemically important DCOs in Regulation 39.11(d).

Any regulation should subject all DCOs to the same substantive financial resources requirements, and subject systemically important DCOs to more frequent stress testing and reporting requirements. We believe this approach is better designed to achieve Dodd-Franks' objectives of promoting robust risk management, promoting safety and soundness, reducing systemic risk and supporting the broader financial system.

Setting a lower bar for nonsystemically important DCOs with regard to financial resources requirements (and, presumably, for certain other DCO core principles, including Core Principle D regarding risk management) would allow those DCOs to offer lower guaranty fund and margin requirements. In addition to putting SIDCOs

at an unfair competitive disadvantage, this approach would likely attract additional volume to at least some nonsystemically important DCOs and transform them into *de facto* SIDCOs. However, until such time as they were designated SIDCOs by the Council and given sufficient time to come into compliance with the higher requirements for SIDCOs, they would be operating under the lower and less costly standards for nonsystemically important DCOs. This would contravene Title VIII's stated objectives of promoting robust risk management, promoting safety and soundness, reducing systemic risk and supporting the broader financial system.

CME Group therefore urges that all DCOs be subject to the same substantive financial resources requirements. We suggest that, rather than adopting Regulation 39.29 as proposed, the Commission should adopt a regulation that subjects SIDCOs to more frequent stress testing and reporting requirements than any DCOs the Council does not designate as systemically important. For example, a SIDCO might be required to conduct bi-monthly stress tests of its ability to cover its default obligations (rather than monthly stress testing, as proposed for all DCOs), and to submit to the Commission the reports required under proposed Regulation 39.11(f) on a monthly basis (rather than a quarterly basis, as proposed for all DCOs). This alternative approach comports with the Council's recent statement that systemically important financial market utilities should be "subject to enhanced examination, supervision, enforcement and reporting standards and requirements."

CME Group is a staunch supporter of robust and comprehensive risk management practices throughout the cleared derivatives markets. As further explained below, we are supportive of those aspects of the proposed regulations that seek to implement appropriate and cost-effective measures to build upon the principles-based regime the CFTC has overseen in recent years and that performed admirably during the recent financial crisis. It is that regime that should be extended to the cleared swaps markets, and not an untested rules-based regime that, at least in part, appears to be based upon arbitrary assumptions and rigid concepts about how DCOs should manage risk.

Question 2. What are the similarities and differences with other cleared products that should be considered when establishing clearinghouses for swaps?

If a swap contract and a futures contract have similar volatility and trade in a mature, liquid market, which should be the case for the major plain vanilla swaps, the considerations for clearing the contracts are identical. Thinly traded swaps present more difficult management processes, which our clearinghouse aims to overcome through its admission and risk management processes.

This similarity between swaps and futures for a large part of the OTC market counsels in favor of adopting the clearing rules that have worked so successfully in futures markets. Indeed, a focus of Dodd-Frank is to bring the OTC swaps market into a regulatory scheme similar to that which allowed the futures markets to function flawlessly throughout the financial crisis. If the CFTC and the SEC are to meet the goals of Dodd-Frank to transition from the world of unregulated, uncleared OTC trading to a world more nearly approximating the highly successful futures model clearing, they should adhere to the principles which have already proven effective in the management of risk. Instead, the proposed clearing rules require a significant, untested, and costly revision of an approach that has proved successful in the futures model and require that this new model be implemented in an impossibly short time frame.

For example, it does not make sense to impose an entirely new regime for segregation of customer assets for swap clearing, which will impose significant costs on participants and undermine efficient risk mitigation, when the existing model of futures clearing has provided 100 percent protection against loss due to customer default. In its Advanced Notice of Proposed Rulemaking (ANPR), however, regarding segregation of customer funds, the Commission notes that it is considering imposing an "individual segregation" model for customer funds belonging to swaps customers. A Notice of Proposed Rulemaking on this subject is forthcoming and appears to impose a form of "individual segregation" model for swaps clearing but not for futures clearing. Such a model would impose unnecessary costs on derivatives clearing organizations (DCOs) and customers alike. As noted in the ANPR, DCOs have long followed a model (the "baseline model") for segregation of collateral posted by customers to secure contracts cleared by a DCO whereby the collateral of multiple futures customers of a futures commission merchant (FCM) is held together in an omnibus account. If the FCM defaults to the DCO because of the failure of a customer to meet its obligations to the FCM, the DCO is permitted (but not required), in accordance with the DCO's rules and CFTC regulations, to use the collateral of the FCM's other futures customers in the omnibus account to satisfy the FCM's net cus-

tomer futures obligation to the DCO. Under the baseline model, customer collateral is kept separate from the property of FCMs and may be used exclusively to "purchase, margin, guarantee, secure, transfer, adjust or settle trades, contracts or commodity option transactions of commodity or option customers." A DCO may not use customer collateral to satisfy obligations related to an FCM's proprietary account.

In its ANPR, the Commission suggests the possibility of applying a different customer segregation model to collateral posted by swaps customers, proposing three separate models, each of which requires some form of "individual segregation" for customer cleared-swap accounts. Each of these models would severely limit the availability of other customer funds to a DCO to cure a default by an FCM based on the failure of a customer to meet its obligations to the DCO. The imposition of any of these alternative models first, is outside of the Commission's authority under DFA and second, will result in significant and unnecessary costs to DCOs as well as to customers—the very individuals such models are allegedly proposed to protect.

CME Group recognizes that effective protection of customer funds is critical to participation in the futures and swaps markets. This fact does not, however, call for a new segregation regime. The baseline model has performed this function admirably over the years, with no futures customers suffering a loss as a result of an FCM's bankruptcy or default. There is no reason to believe it will not operate as well in the swaps market. DFA did nothing to change this segregation regime as applied to futures, and as noted above, a focus of DFA is to bring the OTC swaps market into a regulatory scheme similar to that which allowed the futures markets to function flawlessly throughout the financial crisis. To this end, it is unreasonable to believe that Congress would intend to require a different scheme of segregation of customer funds and as a result, a different margining and default model than that currently used in the futures markets. Imposing such a conflicting model would complicate the function of DCOs intending to clear both futures and swaps. Indeed, the statutory language adopted in Section 724 of DFA does nothing to compel such a result.

The imposition of a different customer segregation system could undermine the intent behind DFA by imposing significantly higher costs on customers, clearing members, and DCOs intending to clear swaps and injecting moral hazard into a system at the customer and FCM levels. A change from the baseline model would interfere with marketplace and capital efficiency as DCOs may be required to increase security deposits from clearing members. That is, depending on the exact methodology employed, DCOs may be forced to ask for more capital from clearing members. Based on CME Group's initial assessments, these increases in capital requirements would be substantial. For example, CME Group's guarantee fund would need to double in size. Aside from these monetary costs, adoption of a segregation model would create moral hazard concerns at the FCM level. That is, the use of the new proposed models could create a disincentive for an FCM to offer the highest level of risk management to its customers (if the oversight and management of individual customer risk was shifted to the clearinghouse) and continue to carry the amount of excess capital they do today.

Imposition of the suggested systems could increase costs and decrease participation in the CFTC-regulated cleared-swaps market because customers may be unable or unwilling to satisfy resultant substantially increased margin requirements. FCMs would face a variety of increased indirect costs, such as staffing costs, new systems and compliance and legal costs and direct costs such as banking and custodial fees. FCMs would likely, in turn, pass these costs on to customers. Additionally, smaller FCMs may be forced out of business, larger FCMs may not have incentive to stay in business, and firms otherwise qualified to act as FCMs may be unwilling to do so due to the risk and cost imposed upon the FCM model by individualized segregation. This could lead to a larger concentration of customer exposures at fewer FCMs, further increases to margin and guarantee fund requirements, and further increased costs to customers. All of these consequences would lead to decreased participation in U.S. futures and swaps exchanges and result in loss of jobs in the United States.

Question 3. Are there unique attributes of certain asset classes that should be highlighted when considering adopting a clearing paradigm? How about unique attributes of certain market participants?

As noted above, a thorough understanding of the liquidity and other characteristics of the market for a swap in normal and stressed circumstances is the key to safety and soundness in clearing. Different swaps with different liquidity and other varied characteristics, put simply, carry with them different risks. Interest rate swaps based on U.S., UK, and EU instruments should be easy to liquidate in the event of a default as are futures on U.S. debt or Eurodollars. Single name credit

default swaps are expected to require an elaborate preset process and direct participation for clearing members.

These differences in swaps, as well as the simple fact that Dodd-Frank imposes a brand new clearing regime on the OTC swaps market, counsels in favor of a slow phasing-in of swap clearing. The Commission's proposed rules for mandatory clearing and trading of swaps should be revised to stage the transition from the existing market structure so that the participants may make the technical and documentary changes necessary to avoid technological and legal risks. We believe that the following template will make the transition to clearing swaps under DFA the quickest, least costly and most complete and effective.

Stage 1: Continued Voluntary Clearing.

- The Commission's first action must be to avoid impairment of the current successful clearing process for swaps and swaps converted to futures.
- The Commission should promptly make the requisite finding, pursuant to Section 5c(b), that a DCO, which is clearing swaps as of the effective date of DFA, will be permitted to continue clearing swaps of the same class and will also be permitted to clear any swap that is economically equivalent to any futures contract that it was clearing prior to the DFA effective date.
- The Commission should approve the collateral and risk management practices and procedures that were in place as of the DFA effective date pending further notice. This means that the traditional form of customer segregation must continue and any of the proposed alternatives to limit or eliminate fellow-customer risk must be delayed until all of the remaining stages for implementing mandatory clearing have been approved. DCOs must be permitted to operate pursuant to the Core Principles, as amended by DFA, during this period.
- The CFTC should also demonstrate that it will abide by its commitment to preserve the cross margining benefits currently available to the users of ClearPort. The Commission should adopt a regulation that treats any ClearPort product that is cleared as a future as of the DFA effective date, but which is subsequently cleared as a swap, as entitled to be carried in a 4d account with customer futures contracts.

Stage 2: Mandatory Clearing of Certain Dollar Denominated Swaps.

- Promptly after the effective date of DFA, the Commission should make an initial determination, pursuant to CEA section 2(h)(2)(A)(i), that all U.S. dollar denominated swaps that are structurally and economically equivalent to swaps that are being cleared by a DCO or ICE Trust as of the DFA effective date are subject to the mandatory clearing requirement. This determination, if it becomes final, will subject more than 60 percent of the swaps market—that has not been exempted from the defined term by the Department of Treasury—to mandatory clearing. Next, "the Commission shall provide at least a 30-day public comment period regarding any determination made under clause (i)." Section 2(h)(2)(A)(ii)
- At this point, section 2(h) provides a clear path for anyone who objects to the finding to make its views known and to invoke an additional review process by the Commission, taking into account the factors described in section 2(h). The review process should be staged so that final determinations are made first for the highest volume swaps.
- The Commission should not adopt differing start dates for different classes of traders for mandatory clearing of particular types of swaps.
- This proposal will (i) preserve customer choice in clearing, (ii) bring the largest volume of swaps into clearinghouses as soon as possible, and (iii) allocate the Commission's resources in an efficient manner.

Stage 3: Reconsider and Repropose Regulations Respecting the Operation of DCOs.

- Do not deviate from the Core Principles regulatory regime without cause.
- Do not change the method of customer segregation without cause (as further discussed above).

Stage 4: Registration of SEFs.

- Finalize rules respecting the structure and operation of SEFs.
- Allow an adequate number of days for SEFs to become operational and to test connections to DCOs, SDRs, and customers.
- Implement mandatory trading requirement.

Stage 5: Mandatory Clearing of Dollar Denominated Swaps Listed for Clearing Post DFA Effective Date.

Stage 6: Mandatory Clearing of Swaps Denominated in G7 Currencies.

Question 4. What best practices should be considered regarding ownership, governance, and control of derivatives clearinghouses?

The extensive rules proposed by the CFTC respecting ownership, governance and control of derivative clearinghouses can and should wait until there is evidence that the specific limitations in Dodd-Frank do not adequately control the potential problem. The Core Principles for derivative clearinghouses are clear, comprehensive and easily shaped and enforced by the Commission on an as necessary basis. Section 5b of the CEA specifically insures: fairness respecting participant and product eligibility, appropriate governance fitness standards, prevention of conflicts of interest and appropriate composition of governing boards. The CFTC drafted these provisions. In the event that Dodd-Frank does prove insufficient, which is highly unlikely, the Commission could consider drafting "best practices" or safe harbors for ownership, governance, and control rather than extremely prescriptive measures like those in the proposed rules.

The Commission's proposed rules regarding the mitigation of conflicts of interest in DCOs, DCMs and SEFs (Regulated Entities) exceed its rulemaking authority under DFA and impose constraints on governance that are unrelated to the purposes of DFA or the CEA. Section 726 conditions the Commission's right to adopt rules mitigating conflicts of interest to circumstances where the Commission has made a finding that the rule is "necessary and appropriate" to "improve the governance of, or to mitigate systemic risk, promote competition, or mitigate conflicts of interest in connection with a swap dealer or major swap participant's conduct of business with, a [Regulated Entity] that clears or posts swaps or makes swaps available for trading and in which such swap dealer or major swap participant has a material debt or equity investment." The "necessary and appropriate" requirement constrains the Commission to enact rules that are narrowly tailored to minimize their burden on the industry. The proposed rules are not narrowly tailored but rather overbroad, outside of the authority granted to it by DFA and needlessly burdensome.

The Commission proposed governance rules and ownership limitations that affect all Regulated Entities, including those in which no swap dealer has a material debt or equity investment and those that do not even trade or clear swaps. Moreover, the governance rules proposed have nothing to do with conflicts of interest, as that term is understood in the context of corporate governance. Instead, the Commission has created a concept of "structural conflicts," which has no recognized meaning outside of the Commission's own declarations and is unrelated to "conflict of interest" as used in the CEA. The Commission proposed rules to regulate the ownership of voting interests in Regulated Entities by any member of those Regulated Entities, including members whose interests are unrelated or even contrary to the interests of the defined "enumerated entities." In addition, the Commission is attempting to impose membership condition requirements for a broad range of committees that are unrelated to the decision making to which Section 726 was directed.

The Commission's proposed rules are most notably overbroad in that they address not only ownership issues but the internal structure of public corporations governed by State law and listing requirements of SEC regulated national securities exchanges. More specifically, the proposed regulations set requirements for the composition of corporate boards, require Regulated Entities to have certain internal committees of specified compositions and even propose a new definition for a "public director." Such rules in no way relate to the conflict of interest Congress sought to address through Section 726. Moreover, these proposed rules improperly intrude into an area of traditional State sovereignty. It is well established that matters of internal corporate governance are regulated by the States, specifically the State of incorporation. Regulators may not enact rules that intrude into traditional areas of State sovereignty unless Federal law compels such an intrusion. Here, Section 726 provides no such authorization.

Perhaps most importantly, the proposed structural governance requirements cannot be "necessary and appropriate," as required by DFA, because applicable State law renders them completely unnecessary. State law imposes fiduciary duties on directors of corporations that mandate that they act in the best interests of the corporation and its shareholders—not in their own best interests or the best interests of other entities with whom they may have a relationship. As such, regardless of how a board or committee is composed, the members must act in the best interest of the exchange or clearinghouse. The Commission's concerns—that members, enumerated entities or other individuals not meeting its definition of "public director"

will act in their own interests—and its proposed structural requirements are wholly unnecessary and impose additional costs on the industry—not to mention additional enforcement costs—completely needlessly.

Question 5. What structural and economic barriers affect access to swap clearing? What must be done to eliminate or reduce those barriers?

An end user of swaps with sufficient credit and resources to enter into a swap will experience no barrier to clearing under Dodd-Frank. A firm that seeks to act as a clearing member of a swaps clearinghouse must meet the operational and financial requirements of that clearinghouse, which should be set sufficiently high to meet the clearinghouse's obligations under Dodd-Frank's Core Principles for DCOs. Dodd-Frank's requirements regarding safety and soundness modify a clearinghouse's obligation to grant open access to any potential clearing member. The issues of managing a default involving an immature or illiquid swap contract require higher admission standards than for a futures clearinghouse.

The Commission's proposed rules regarding submissions by DCOs seeking approval to clear swaps may, however, provide a barrier to access to clearing simply because they impose extreme difficulty and expense on a DCO seeking to clear a given swap. The proposed regulations treat an application by a DCO to list a particular swap for clearing as obliging that DCO to perform due diligence and analysis for the Commission respecting a broad swath of swaps, as to which the DCO has no information and no interest in clearing. In effect, a DCO that wishes to list a new swap would be saddled with the obligation to collect and analyze significant amounts of information to enable the Commission to determine whether the swap that is the subject of the application and any other swap that is within the same "group, category, type, or class" should be subject to the mandatory clearing requirement.

The proposed regulation eliminates the possibility of a simple, speedy decision on whether a particular swap transaction can be cleared—a decision that the DFA surely intended should be made quickly in the interests of customers who seek the benefits of clearing—and forces a DCO to participate in an unwieldy, unstructured, and time-consuming process to determine whether mandatory clearing is required. Regulation Section 39.5(b)(5) starkly illustrates this outcome. No application is deemed complete until all of the information that the Commission needs to make the mandatory clearing decision has been received. Completion is determined in the sole discretion of the Commission. This proposed regulation is one among several proposals that imposes costs and obligations whose effect and impact are contrary to the purposes of Title VII of DFA. The costs in terms of time and effort to secure and present the information required by the proposed regulation would be a significant disincentive to DCOs to voluntarily undertake to clear a "new" swap. This process to enable an exchange to list a swap for clearing is clearly contrary to the purposes of DFA.

Thank you for allowing us to respond to these important questions.

PREPARED STATEMENT OF BENN STEIL

SENIOR FELLOW AND DIRECTOR OF INTERNATIONAL ECONOMICS, COUNCIL ON FOREIGN RELATIONS

MAY 25, 2011

Thank you Chairman Reed, Ranking Member Crapo, and Members of the Subcommittee for the opportunity to present to you this morning my views on the important subject of derivatives clearing.

The collapse of Lehman Brothers and AIG in September of 2008 highlighted the importance of regulatory reforms that go beyond trying to prevent individual financial institutions from failing. We need reforms that act to make our markets more resilient in the face of such failures—what engineers and risk managers call "safe-fail" approaches to risk management. Well capitalized and regulated central derivatives clearinghouses to track exposures, to net trades and to novate them, to collect proper margin on a timely basis, and to absorb default risk have historically provided the best example of successful "safe-fail" risk management in the derivatives industry.

Compare the collapse of the large hedge fund Amaranth in 2006 with the collapse of AIG in 2008. Both were laid low by derivatives exposures. Yet whereas the failure of Amaranth caused barely a ripple in the markets, owing to its exposures having been in centrally cleared exchange-traded natural gas futures contracts, the failure of AIG precipitated justifiable concerns of widespread market contagion that ultimately required a massive and enormously controversial Government intervention

and bailout to contain. Had AIG been building derivatives exposures on-exchange rather than in the OTC markets, its reckless speculation would have been brought to a halt much earlier owing to minute-by-minute exposure tracking in the clearinghouse and unambiguous mark-to-market and margining rules. The long, drawn-out wrangling between AIG and Goldman Sachs over the collateral required to cover AIG's deteriorating derivatives positions would never have been possible had a clearinghouse stood between the two. Furthermore, AIG's net exposures in the marketplace would not have been the subject of rumor or surmise, but a simple matter of record at the clearinghouse.

Encouraging a shift in derivatives trading from OTC markets without central clearing to organized, Government-regulated markets with central clearing is challenging, however, for two major reasons.

First, the dealers that dominate the OTC derivatives business have no incentive to accommodate such a shift. Dealers earn approximately $55 billion in annual revenues from OTC derivatives trading. Some of the largest earn up to 16 percent of their revenues from such trading. The movement of such trading onto exchanges and central clearinghouses has the potential to widen market participation significantly, to increase the transparency of prices, to reduce trading costs through the netting of transactions, and in consequence to reduce the trading profits of the largest dealers materially. It is natural, therefore, that dealers should resist a movement in trading activity onto exchanges and clearinghouses. Where compelled by regulation to accommodate it, dealers can also be expected to take measures to control the structure of, and limit direct access to, the clearing operations. The use of measures such as unnecessarily high capital requirements in order to keep smaller competitors or buy-side institutions from participating directly as clearinghouse members are to be expected.

Indeed, trading infrastructure providers organized as exclusive mutual societies of major banks or dealers have a long history of restricting market access. For example, in the foreign exchange markets, the bank-controlled CLS settlement system has long resisted initiatives by exchanges and other trading service providers to prenet trades through a third-party clearing system prior to settlement. Such netting would significantly reduce FX trading costs for many market participants, but would also reduce the settlement revenues generated by CLS and reduce the trade intermediation profits of the largest FX dealing banks. Other settlement service providers such as DTCC have no incentive to offer competition to CLS, as they are owned by the very same banks. There are therefore solid grounds for regulators to apply basic antitrust principles to the clearing and settlement businesses in order to ensure that market access is not being unduly restricted by membership or ownership limitations that cannot be justified on safety and soundness grounds.

Second, some types of derivatives contracts do not lend themselves to centralized clearing as well as others. Customized contracts, or contracts which are functionally equivalent to insurance contracts on rare events, are examples. Since it can be difficult for policy makers or regulators to determine definitively whether given contracts—new types of which are being created all the time—are well suited for central clearing, it is appropriate to put in place certain basic trading regulations in the OTC markets that will serve both to make such trading less likely to produce another AIG disaster and to encourage the movement of trading in suitable products onto central clearinghouses. Two such measures would be to apply higher regulatory capital requirements for noncleared trades, in consequence of the higher counterparty risk implied by such trades, and to mandate trade registration and collateral management by a regulated third party, such as an exchange.

In establishing the regulatory standards for the clearing of derivatives transactions, it is imperative for lawmakers and regulators to be fully conscious of the fact that the derivatives market is effectively international, rather than national, and that it is exceptionally easy for market participants to change the legal domicile of their trading activities with a keystroke or a simple change of trading algorithm. In this regard, I would highlight two important areas of concern.

First, the three major world authorities controlling the structure of the derivatives clearing business—the SEC, the CFTC, and the European Commission—each take a very different view of the matter. Historically, the SEC has applied what I would term the "utility" model to the industry, the CFTC has applied what I would term the "silo" model, and the European Commission has applied what I would term the "spaghetti" model. The broad benefits of each are depicted in the matrix below.

Clearing Regulation Model	Promotes Safety	Promotes Competition	Promotes Innovation
SEC	✓	✓	
CFTC	✓		✓
EU		✓	

The SEC's utility model favors institutions operated outside the individual exchanges; in particular the DTCC in the equity markets and the OCC in the options markets. This approach has generally performed well in terms of safety and soundness, and in encouraging competition among exchanges. It performs poorly, however, in terms of encouraging innovation in clearing and settlement services.

The CFTC's silo model allows the individual exchanges to control their own clearinghouses. This approach has also performed well in terms of safety and soundness. The recent decision of the CME to raise margin requirements on silver trading is evidence of the model working well, in terms of the exchange placing a premium on the integrity and solvency of its clearing operations rather than trying to maximize short-term speculative trading volumes. The CFTC's model also encourages innovation in product development in a way in which the SEC's model does not. This is because CFTC-regulated futures exchanges can capture the benefits of product innovation in terms of generating trading volumes, whereas SEC-regulated options exchanges risk seeing trading volumes in new products migrate to other exchanges, all of which use clearing services provided by the OCC. The CFTC model, in consequence, does not promote competition from new trading venues in the same way that the SEC model does. It does, however, promote wider direct market participation in clearing systems, as demutualized exchanges have a commercial interest in expanding such access to buy-side institutions that dealers normally want to exclude. This reduces trading costs and expands market liquidity.

The European Commission's spaghetti model, enshrined in its so-called "Code of Conduct" for the industry, compels the EU's clearinghouses to interoperate with each other. It also encourages both exchanges and clearinghouses to compete against each other. Like the SEC's model, however, it can be expected to dampen incentives for product innovation, as clearing competition makes it more difficult for exchanges that own clearinghouses to maximize their trading and clearing revenue returns on new product development. More importantly, this model, I believe, is not conducive to ensuring safety and soundness, as it encourages clearinghouses to cut margin requirements and other prudential measures as a way to attract business from, or prevent business from moving to, other clearinghouses. It also injects a major element of operational risk into the business, in consequence of each clearinghouse being vulnerable to failures of technology or risk management in others.

On balance, I believe that the CFTC's model is the most appropriate for the derivatives industry, and I believe that the unworkability of the European Commission's spaghetti approach will ultimately oblige it to move back in the CFTC's direction. Although the CFTC's approach does not promote interexchange competition as directly as the SEC's model, it is important to note that new competitors are, in fact, entering into the futures business. ELX, founded in 2009, and NYPC, a recent joint venture between the NYSE and the DTCC which facilitates cross-margining of multiple products, are now competing with the CME in the financial futures space.

The second point I would like to make regarding the global nature of the derivatives trading industry is that certain measures to curb speculative activity being debated here in Washington are highly likely to push trading activity "off exchange"—precisely the opposite of Congress' intent. For example, a so-called Tobin Tax on futures transactions at the level being discussed last year, 2 basis points (0.02 percent), would be equivalent to over 400 times the CME transaction fee on Eurodollar futures. It should go without saying that a tax this large, relative to the current transaction fee on the underlying contract, would push all of this trading off the CME and into alternative jurisdictions.

Likewise, commodity market position limits, if not harmonized with UK and other national authorities, will merely push such trading outside the CFTC's jurisdiction. There is already an active regulatory arbitrage on oil and natural gas futures between the CME's NYMEX exchange, which trades such contracts under CFTC regulation, and the Intercontinental Exchange (ICE), which trades such contracts under FSA regulation in London. We have seen indications of movement in trading from NYMEX to ICE in line with market perceptions of the likelihood of such limits being imposed in the United States. In short, we must be extraordinarily cautious not to undermine Congress' worthy goal of bringing more derivatives trading under the purview of U.S.-regulated exchanges and clearinghouses by inadvertently providing major market participants incentives to do precisely the opposite.

Thank you, Mr. Chairman, for the opportunity to present my views today on this important issue.

PREPARED STATEMENT OF CHESTER S. SPATT

PAMELA R. AND KENNETH B. DUNN PROFESSOR OF FINANCE, TEPPER SCHOOL OF BUSINESS, CARNEGIE MELLON UNIVERSITY

MAY 25, 2011

I am pleased and honored to have the opportunity to present my views to the Senate Subcommittee on Securities, Insurance, and Investment at its hearing today on "Derivatives Clearinghouse: Opportunities and Challenges." I am the Pamela R. and Kenneth B. Dunn Professor of Finance at the Tepper School of Business at Carnegie Mellon University, where I have been a faculty member since 1979. I also served as the Chief Economist of the U.S. Securities and Exchange Commission in Washington, DC, from July 2004 until July 2007. My expertise as a faculty member includes such areas as trading mechanisms, derivative securities, asset valuation, financial regulation, and the financial crisis. In addition to my faculty position my current affiliations include serving as a Research Associate of the National Bureau of Economic Research, Senior Economic Advisor to Kalorama Partners, and a member of both the Shadow Financial Regulatory Committee and Financial Economists Roundtable. I also was one of the founders and the second Executive Editor of the *Review of Financial Studies,* which quickly emerged as one of the preeminent journals in financial economics, as well as a Past President and Program Chair of the Western Finance Association.

The changes in how our financial markets trade and clear derivative securities and swaps that now are being implemented are fundamental to the design of these markets. In the aftermath of the financial crisis the focus on migrating standardized swaps and derivatives to clear through central counterparties (CCPs) is a natural one and one to which I am sympathetic as an attempt to reduce the contagion associated with counterparty risk and make the structure of risk much more transparent. However, it is unclear whether the extent of use of clearinghouses will ultimately lead to a reduction in systemic risk in the event of a future crisis. Additionally, it will be crucial to manage carefully the risks within the clearinghouses. To the extent that risks or the fees of the clearinghouse are lower compared to uncleared derivatives, market participants could choose to increase their risk exposures. Of course, it is important that the fees for holding uncleared derivatives reflect economic costs and not be punitive to create artificial concentration of risk within the clearinghouse and also that the clearinghouse be sensitive to the incentives to dump transactions into it that are not marked properly.

The clearinghouse structure is potentially subject to considerable moral hazard as there is a strong incentive for market participants to trade with weak counterparties (who may offer more favorable pricing), subject to their eligibility to clear through a centralized counterparty (CCP). However, at some point a CCP may not be willing to clear contracts from a weak counterparty because of the risk associated with the counterparty being unable to deliver on its dynamic margin obligations on a going forward basis. Then the CCP would be subject to serious counterparty risk.

In situations where trading with weak counterparties (and effectively with the CCP) is especially attractive to other market participants, there is a greater risk exposure to the overall economy. For this reason and also because of the concentration of risk in the CCP, it is easy to anticipate that central clearing actually could raise systemic risk substantially in the event of a financial crisis.

A number of observers have emphasized the absence of clearinghouse failures in the United States during the recent financial crisis. Of course, not every potential financial crisis is the same with respect to its causes, scale or transmission. Consequently, in my judgment we can only take limited comfort for the future from the absence of failure of a clearinghouse during the recent financial crisis. Indeed, Federal Reserve Chairman Ben Bernanke attributed the lack of failure of a clearinghouse during the financial crisis to "good luck"[1] in a speech at the recent Atlanta Federal Reserve Bank conference. Of course, many institutions that were previously thought to be essentially impervious and under various forms of Federal oversight either did collapse or would have collapsed without massive Federal guarantees (including Fannie Mae, Freddie Mac, AIG, Lehman Brothers, Bear Stearns, Citigroup and Bank of America). It is generally recognized that clearinghouses can fail,[2] and indeed, a recent editorial in the *Wall Street Journal*[3] cited such relatively recent failures as those in France in 1974, Kuala Lumpur (Malaysia) in 1984 and Hong Kong in 1987. The regulatory and supervisory system will require much more of clearinghouses in the future than during the recent financial crisis, potentially amplifying their vulnerability. In his Atlanta Federal Reserve speech Chairman Bernanke summarized this point as follows, "As Mark Twain's character Pudd'nhead Wilson once opined, if you put all your eggs in one basket, you better watch that basket." Of course, this not only highlights the potential importance of regulatory supervision of the clearinghouse, but also that clearinghouses should be properly designed to limit their risk exposure.

One of the challenges confronting the supervisor of the clearinghouse is whether the clearinghouse could require the possibility of a "bailout" to ward off failure. At hearings of the Senate Banking Committee in mid-April CFTC Chairman Gary Gensler agreed that the clearinghouses would not receive "too big to fail" guarantees or subsidies. Arguably, this is reflective of a political environment, which is now quite unsympathetic to the use of such guarantees. But this highlights the crucial importance of strong risk management of the central counterparty to avoid the potential collapse of a major clearinghouse in a financial crisis. While it's a delicate balance, the importance of strong risk management potentially could be even at the expense of other values, such as promoting more competitive pricing of clearinghouse services.

A key role of the clearinghouse is to make trading entities informationally insensitive to their specific counterparties. At the same time, there is a danger of a potentially large increase in systemic risk unless the risk is well managed by the clearinghouse, because the clearinghouse is a risk management platform that concentrates the risk in the economy. Thus, the governance of a clearinghouse must reflect a strong incentive to control risk and internalize the costs and benefits associated with alternative collateral standards. Limiting greatly the role of trading firms in the governance and promoting "independent directors" (who would lack the incentives to focus on managing and minimizing the risk and perhaps in some instances relevant experience) would create significant challenges and even reluctance by trading firms to allocate capital to the clearinghouse and back-stop the risks of the clearinghouse. Mutualization of risk is essential to the success of a clearinghouse model and affording protection against the ultimate risks being borne by society in the form of "too big to fail" guarantees. Yet the commentary of regulators focuses upon the more abstract notion of "conflicts of interest" in governance, without explicit focus on the incentives to control the underlying risks that would arise in the clearinghouse model. In light of this it is crucial that the governance of the clearinghouse, including the composition of the Board and especially the Risk Committee, reflect the importance that the broader society places on the elimination of "too big to fail" guarantees. To the extent policy makers choose to concentrate risk within a clearinghouse, it is crucial that the risk management of the clearinghouse mitigate the underlying systemic risk, including a strong risk management structure and governance aligned with that goal.

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[1] Speech at the Federal Reserve Bank of Atlanta conference on April 4, 2011.

[2] Roe, M., "Derivatives Clearinghouses Are No Magic Bullet", *Wall Street Journal,* May 6, 2010.

[3] "Pudd'nhead Wilson in Washington", *Wall Street Journal* editorial, April 23–24, 2011, p. A14.

Incentives are crucial to ensure that there is a reasonable attempt to align the incentives of various parties. For example, in the event of a crisis clearing members would potentially contribute financial and human capital to the CCP. It would create incentive problems to absolve smaller members of these duties (except for the limits related to their underlying capital contribution) or to allow them to outsource these to third parties whose incentives would not be aligned. It also is important to ensure that in the event of a crisis that the clearing members have funding available for their contingent capital obligations—to the extent that individual CCPs are unable to monitor their clearing members along such lines, it may be important for the regulator to supervise this to avoid a default cascade that would jeopardize the clearinghouse through a sequence of defaults. In fact, it's important for the regulator to be sensitive to the complications that arise from the incentives of a set of profit-maximizing clearinghouses.

Analogously, regulators are focused upon "access" to the clearinghouse by investing firms—but it is important to recognize that this is not a traditional trading platform, but an organization in which mutualization of risks by the membership is fundamental. Indeed, members should be required to have appropriately high capital pledged to protect the organization in that they are counterparties whose risk is being accepted by the clearinghouse and indeed, the members become the ultimate guarantors through the mutualization of risk.

The issue of "direct access" surfaces in a number of different forms across markets—for example, requiring that orders be presented through intermediaries would be a way to protect markets against obvious errors in order presentation. Indeed, because of concerns about "direct access" in equity trading the SEC adopted a rule late last year eliminating direct unfiltered customer access in the order transmission process due to the systemic risk that would create for our system of equity clearance and settlement.[4]

Another crucial policy choice is whether the clearinghouse would likely be a recipient of a bailout in the event of a failure in its risk management. The strong political consensus against the possibility of a bailout emphasizes the importance of strong risk management by the clearinghouse and a governance system, including restrictions on access through nonmembers and a board structure that makes risk management the central priority. From an economist's perspective this highlights how restricting direct access is a partial substitute for "too big to fail."[5] Using governance and access (as compared to other governmental regulatory tools) to enhance the competitiveness of pricing of clearinghouse services comes at the cost of making a bailout of the clearinghouse more likely.

The analogy between risk management for a swaps clearinghouse and that for the clearinghouse for a payments system is striking. In the payment systems context my colleague Marvin Goodfriend [1990] writes,[6] "[I]t was efficient for private clearinghouses before the Fed to limit their membership to a relatively exclusive core of banks, allowing other banks access to the clearing system through agent-member banks. This suggests that it is efficient for the Fed to restrict direct access to its national clearing system as well, both to protect Fed lending generated in the payments systems and to protect the interbank credit market." Goodfriend [1990] also observes that it is valuable "to restrict direct access to its national clearing system as well, to protect Fed daylight overdrafts and the interbank credit market." In the context of a derivatives and swaps clearinghouse restriction on direct access by nonmembers leads to a system in which the clearinghouse members are responsible to protect the integrity of the clearinghouse. In that sense restrictions on direct access help assure financial stability and protect society against bearing greater costs from implicit "too big to fail" guarantees for the clearinghouse. If the clearinghouse member has strong incentives to monitor its customers, by imposing much of the risk created by customer losses on the introducing member, then a strong compatible risk management system will result.

The absence of failures of clearinghouses in the financial crisis has been viewed by some as offering reassurance about the inherent stability of the clearinghouse model. Indeed, the clearinghouse model has a number of attractive features, such

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[4] "SEC Adopts New Rule Preventing Unfiltered Market Access", Press Release 2010-210, November 3, 2010. *http://www.sec.gov/news/press/2010/2010-210.htm; Also see,* discussion in J. Angel, L. Harris, and C. Spatt, 2011, "Equity Trading in the 21st Century", *Quarterly Journal of Finance,* 1, 1–53.

[5] Analogously, allowing the composition of directors to focus on risk management incentives and expertise also is a substitute for "too big to fail."

[6] M. Goodfriend, 1990, "Money, Credit, Banking, and Payments System Policy", in *U.S. Payments System: Efficiency, Risk, and the Role of the Federal Reserve,* edited by David B. Humphrey, Kluwer Academic Publishers; also reprinted in *Federal Reserve Bank of Richmond Economic Review,* January/February 1991, pp. 7–23.

as, netting of exposures and greater transparency of risks. At the same time, this model presents greater sources of vulnerability due to concentration of risk and greater moral hazard at the customer level because there is no pricing differential or penalty imposed on weak counterparties as long as they are acceptable to the clearinghouse. In addition, to the extent that financial services firms believe they have essentially fully transferred various risks to the clearinghouse they likely will bear additional risks (systemic and otherwise) because of their enhanced risk-bearing capacity. It is extremely important to recognize and acknowledge the implications of the endogeneity of risk. Improvements in the management of collective risk potentially will incentivize financial services firms to take on more risk at the margin. For example, decisions about leverage will emerge endogenously. It is important to bring considerable caution and skepticism to discussions about risk management in the clearinghouses, especially in light of their broader contemplated role.[7]

My underlying view on the relevance of economic principles to the structuring of clearinghouses also highlights the broader point that in restructuring the derivatives and swaps markets it is important to be sensitive to the economic consequences of contemplated rulemakings and undertake cost-benefit analyses that will identify these consequences and help to inform rule proposals.

PREPARED STATEMENT OF CLIFFORD LEWIS

EXECUTIVE VICE PRESIDENT, STATE STREET GLOBAL MARKETS

MAY 25, 2011

Chairman Reed, Ranking Member Crapo, and Members of the Subcommittee, thank you for the opportunity to testify today regarding the clearing-related provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

As an initial comment, I commend the CFTC for their efforts to date on Dodd-Frank implementation, where they are working on a broad range of highly complex issues, on a very aggressive timeframe.

State Street is one of the world's largest custodial banks and processors of derivatives transactions, and we support regulations which will benefit our customer base of large, buy-side, institutional investors, such as pension funds, mutual funds, and endowments. We support the Dodd-Frank mandates for both derivatives clearing and execution, which we believe will reduce global systemic risk, and, properly implemented, benefit our institutional investor customer base.

Like most market participants, our buy-side clients are concerned by the current regulatory uncertainty and the potentially significant cost and market liquidity impacts that may result from the new rules. At State Street, we are well positioned to provide our clients with full-service clearing and other services that can help them realize the benefits of the new derivatives regime, through enhanced transparency, more open execution platforms, and central clearing.

In relation to central clearing, the key issue for State Street is effective implementation of the Dodd-Frank Act's requirement that clearinghouse membership requirements "permit fair and open access." Open access will reduce systemic risk by avoiding concentration of clearing activity with a small number of existing "dealer" members, and benefit the buy-side by allowing netting across dealers on swaps that clear through the same clearinghouse.

State Street intends to pursue membership in a variety of derivatives clearinghouses, and the Dodd-Frank requirement for open access is an important element in our ability to increase competition in the clearing services marketplace.

I'd like to make a few specific recommendations:

First, we support the CFTC's participant eligibility rules as proposed, but note these rules will require vigilant oversight by the CFTC. The proposed rules recognize the critical importance of strong clearinghouse risk management practices, while, at the same time, permit broader clearinghouse membership, reducing systemic risk and allowing buy-side market participants to benefit from alternative clearing member business models. As we noted in our comment letter to the CFTC, we are concerned that some clearinghouses will carry forward their current restrictive membership requirements, in direct contradiction of the spirit and intent of Dodd-Frank.

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[7] For example, *see,* "Derivatives, Clearing and Exchange-Trading", Statement No. 293 of the Shadow Financial Regulatory Committee, April 26, 2010, *http://fic.wharton.upenn.edu/fic/policy percent20page/Statement%20No.%20293-%20Derivatives,%20Clearing%20and%20Exchange%20Trading.pdf.*

Second, clearing members must be required to demonstrate the necessary financial and operational resources to execute their duties to customers and the clearinghouse. Strong capital rules are important, but should be risk-based rather than arbitrary dollar amounts. We have suggested linking capital requirements to other risk-based clearinghouse measures, such as a multiple of default fund contributions. Other arbitrary requirements linked to a dealer-specific business model, such as a minimum swap book, are not risk-based and will prohibit membership by nondealer firms. Outsourcing of certain functions should be allowed, provided that the execution risk associated with such outsourcing rests with the member firm and not the clearinghouse. By way of example, the current model of the futures markets showed itself well structured to handle such crises, as the successful wind-down of Lehman's futures positions by nonmembers demonstrated at the time of its bankruptcy.

Third, both the clearing and the execution mandates should go into effect at the same time.

Clearing is most effective when tied to execution, providing market participants with greater transparency, tighter spreads and cost reduction. Phasing-in the clearing requirement in advance of the execution requirement would burden market participants with increased costs while denying them the corresponding benefits. If some form of phasing is deemed necessary by the CFTC, it should be done by instrument and require that as each new instrument is folded under the regulatory regime, both the clearing and execution requirements attach simultaneously.

Fourth, to the extent possible, regulations governing clearinghouse membership rules should be coordinated globally, to avoid regulatory arbitrage that could frustrate the Dodd-Frank requirements for open access.

Finally, in order to allow the markets and participants to adjust to new ways of doing business, we suggest that a 6-month transition period be given between finalization of the mandatory clearing and execution rules and mandatory compliance. The final rules will provide certainty to the markets as to what the new regulatory demands are, and only then will businesses be in a position to plan and adapt accordingly.

Again, State Street strongly believes in the importance of the clearing and execution mandates as spelled out in Dodd-Frank, and we stand ready to help Congress, the Administration and the regulators as the process of rule writing and implementation goes forward.

Thank you for the invitation to testify before you today. I will be happy to take your questions.

PREPARED STATEMENT OF DON THOMPSON

MANAGING DIRECTOR AND ASSOCIATE GENERAL COUNSEL, JPMORGAN CHASE & CO.

MAY 25, 2011

Chairman Reed, Ranking Member Crapo, and Members of the Committee, my name is Don Thompson, and I am a Managing Director and Associate General Counsel at JPMorgan Chase & Co (JPMC). I head our derivatives legal group and have been actively involved in implementation of Title VII of the Wall Street Reform and Consumer Protection Act (the "Act"). Thank you for inviting me to testify today on the opportunities and challenges of derivatives clearinghouses (CCPs).

JPMC has been an active participant in the development and management of clearinghouses with direct membership in 77 clearinghouses for a variety of markets including listed and over-the-counter (OTC) derivatives, equity and fixed income securities. We are committed to clearing OTC derivatives transactions and have been clearing dealer-to-dealer OTC transactions for a decade. Today major swap dealers clear over 90 percent of eligible interdealer interest rate and CDS transactions. At the same time, we have also made significant investments in our client clearing franchise, which we expect to grow as the requirements of clearing under Title VII become implemented.

While there are a number of critical issues to consider in determining the appropriate market structure and governance for clearinghouses, the most critical is guarding against systemic risk. Questions of membership criteria, risk committee structure and governance all implicate safety and soundness, so it is essential that regulations carefully weigh these considerations.

As the Committee is aware, the migration of products that were once traded and managed bilaterally to clearinghouses will concentrate the risk from these transactions at CCPs. CCPs do not eliminate credit and market risk arising from derivatives; they simply concentrate it in a single location in significant volume. This con-

centration of risk combined with an increase in aggregated credit and operational risks at CCPs will result in these institutions becoming systemically important.

Since these institutions are private, for-profit entities, it is critical that regulations guard against an outcome that would privatize profits but potentially socialize losses. Attempts to increase clearing member access or lower clearing member capital requirements can be responsibly implemented only if they are coupled with requirements for sound risk management practices. These practices should include appropriate limits on the types of transactions that are subject to the clearing mandate, requirements for members of clearinghouses to have capital contributions proportional to the risk they introduce to the CCP, elimination of uncapped liability of clearing members and requirements for clearing members to be able to risk manage the transactions they bring to the CCP. We strongly support open access to clearinghouse membership, and believe it can be achieved without compromising risk management standards. Two critical controls must be in place at each clearinghouse to support open access: a clear liability framework that caps each member's exposure, and risk limits that are real-time and proportional to each member's capital. With this foundation, the clearing membership can be prudently expanded to firms with modest levels of capital, including the $50 million minimum proposed by the CFTC.

Absent proper oversight, CCPs are at greater risk of failure, which could have significant systemic implications. Failure could result from a number of factors, such as a member's lack of proper risk management, from clearing complex products that cannot be properly valued by the CCP, or from actions resulting from a "race to the bottom" among for-profit CCPs.

Given these risks, we believe that as long as CCPs are structured as for-profit entities, the primary regulatory focus should be to ensure that proper risk management, governance, regulatory oversight and incentive structures are in place, as discussed in greater detail below.

It is also worth noting that because derivatives trading and clearing is a global business, in order to prevent arbitrage, rigorous regulatory standards should be applied consistently in each of the major global markets, including uniform operating principles and a consistent on-the-ground supervisory approach.

Safety and Soundness of Clearinghouses

In considering clearinghouse membership requirements and their impact on clearinghouse safety and soundness, it is important for policy makers to keep in mind the nature of a clearinghouse. A clearinghouse is structured to provide for mutual sharing of counterparty risk among members. Each clearing member is exposed to the counterparty credit risk of all other members and, by extension, all clients clearing trades via other members. Clearinghouses themselves provide a very small portion of the capital which backs the performance of the clearinghouse, and the vast majority of the financial resources of a clearinghouse is provided by the members through their contributions to the guaranty fund as well as collateral posted by the clearing members. To the extent of their liability, each member is delegating risk management of its capital to the clearinghouse, which in many cases is a private, for profit entity. Each member is also exposed to the capital, liquidity and operational capabilities of other members, to the client risk introduced by every other member as well as the risk management processes put in place by those members and by the clearinghouse. A clearinghouse that is prudently managed must have adequate margin and guarantee fund resources and must refresh its calculations daily and intraday to adjust its resources to changing market conditions.

There are additional measures that should be considered in order to enhance the safety and soundness of clearinghouses:

1. Clearinghouses should have a credible resolution plan, given their interconnectedness to the financial markets and the associated systemic risk implications. Such resolution plans should be tested regularly and reviewed by regulators.
2. On-site inspections by regulators should be conducted at regular and frequent intervals. The sufficiency of clearinghouse financial safeguards should be regularly evaluated against the results of such tests, and adjusted as appropriate.
3. The liability of clearing members to the clearinghouse should be clearly ascertainable and capped. Unlimited liability of members towards the clearinghouse to absorb clearinghouse losses has the effect of maintaining the solvency of the clearinghouse at the expense of its participants, a trade-off that likely would lead to systemic risk concentration, not mitigation. Unlimited liability is the worst of all worlds: large financial institutions will be interconnected, but will have no idea of their exposure to any other particular institution, and neither the incentive nor the means to mitigate the risk.

4. In determining the appropriateness of a clearinghouse financial safeguards package there should also be an appropriate balance between initial margin and guarantee fund contributions. This balance should not be allowed to vary significantly across clearinghouses. If initial margin is set too low, there will be an incentive to push risky and unbalanced positions through the clearinghouse as participants recognize that the risk introduced in the clearinghouse will be subsidized by other clearing members through guaranty fund contributions. The amount of initial margin customers are required to post, together with the degree of protection afforded such margin, may adversely affect the incentives of customers to select prudently managed clearinghouses, contributing to moral hazard and instigating a race to the bottom.

Clearinghouse Access

We strongly support regulation aimed at mitigating conflicts of interest. We also support full implementation of the open access core principles set out by Congress in the Act with a risk-based framework that allows clearing members to clear client and house activity in proportion to their capital. We note that the Lynch amendment, which would have restricted equity ownership of interests in clearinghouses and swap execution facilities by swap dealers, was not part of the final text of the Act passed by Congress and signed by the President; however, proposed rules include such restrictions.

We believe that all clearinghouses should provide open access to whoever meets certain minimum objective criteria. In our view, the fact that a clearinghouse relies almost exclusively on the capital of its members places a great emphasis on the ability of a member to absorb any losses resulting from: (a) the house and client risk that a clearing member introduces into the clearinghouse; and (b) mutualization of the risks introduced by every other clearing member and those clearing members' clients. Given the loss mutualization feature of clearinghouses, we believe that the financial stability of clearinghouses depends on the requirements that must be satisfied for a member to qualify as a clearing member. Those criteria, however defined, should require clearing members to hold a minimum amount of capital. In addition, it is our view that the way to provide open access to new clearing members while promoting the safety and soundness of clearinghouses would be to provide clearing members with the ability to clear house and client risk in proportion to the amount of capital available to them as well as to funded margin and guarantee fund contributions. We do not support any exclusionary practices.

Interaction of Corporate Governance and Risk Management

We support regulations requiring the creation of a risk committee at all clearinghouses. In addition, we believe it would be appropriate to provide for the separation of the corporate governance function (Board of Directors) from the risk management function (Risk Committee) within a clearinghouse.

Risk Committee

We believe that the Risk Committee should be comprised of a majority of clearing member representatives, with the remainder open to clearinghouse and client participation. We support a requirement for at least 10 percent of the Risk Committee to be composed of client representatives with relevant expertise, and the balance to be open to participation by independent representatives. We believe that the main focus of the Risk Committee should be the preservation of the guarantee fund that is utilized to safeguard the clearinghouse and its members against defaults, taking into account prudent risk management standards, including mitigation of systemic risk. The main focus of the Board would be to promote the commercial interests of the clearinghouse. We expect that in most cases the Risk Committee and the Board would be able to achieve a productive balance between those two interests. We support a requirement for the Board to consult with the appropriate regulator prior to rejecting a recommendation by the Risk Committee on matters of risk. In our view all matters relating to risk would fall within the purview of the Risk Committee. This would include all matters related to margin and the sizing of the guarantee fund, membership criteria and membership application, and the enumeration of products eligible for clearing. Regulators have identified sound risk management standards as well as open access as key factors that must be addressed in determining whether a particular type of swap is suitable for clearing.

Board of Directors

With respect to the corporate governance function of SEFs, exchanges, and clearinghouses, we support encouraging a balance of views being represented on the Board of Directors. We think that a 35 percent requirement for independent directors will be problematic to implement in practice because it will be difficult to iden-

tify a sufficient number of individuals who are not already involved in the industry and who have an appropriate level of practical market experience. In our view the desired balance between different interests can be achieved by identifying different classes of interested parties and encouraging a diverse representation of those interests in the Board of Directors. This would be done by requiring that no single class of interested parties achieves more than 65 percent of the seats on the Board. Each SEF, exchange and clearinghouse should be able to determine how to fill the remainder of the seats. Regulators would monitor compliance with the letter and the spirit of this provision. In our opinion, the different classes of interested parties vary depending on the type of entity: In the case of clearinghouses the classes would be: (a) clearing members whose capital is at risk if another clearing member or one of its clients fails; (b) end users, who have an interest in protecting their collateral and in keeping clearing costs low; and (c) other investors and infrastructure providers (*e.g.,* technology providers, SEFs, exchanges, and clearinghouses), who have an interest in increasing profitability.

In the case of SEFs, the classes would be: (a) liquidity providers; (b) liquidity takers; and (c) other investors and infrastructure providers (*e.g.*, technology providers, exchanges, and clearinghouses), who have an interest in increasing profitability.

In the case of exchanges, the classes would be: (a) liquidity providers; (b) liquidity takers; and (c) other investors and infrastructure providers (*e.g.,* technology providers, SEFs, and clearinghouses), who have an interest in increasing profitability.

These limitations would have the added benefit of promoting competition and discouraging vertical integration of exchanges, SEFs, and clearinghouses.

All those who bring risk into the clearinghouse or profit from the operations of the clearinghouse should have "skin in the game"

We think it is essential to the development of a sound clearing infrastructure that those whose capital is at risk can participate in the risk management of clearinghouses. Clearinghouses rely almost exclusively on the margin and guarantee fund contribution of clearing members to manage systemic risk and counterparty risk.

In a vertically integrated model, shareholders in a holding company that owns clearinghouses and exchanges (and in the future may also own SEFs) are exposed to a fraction of the risk that clearing members are exposed to through loss mutualization. There is no current requirement for clearinghouses to provide a first loss piece to the financial waterfall package and in most structures the clearinghouse "skin in the game" contribution is minimal compared with the overall size of the guarantee fund. For this reason the large majority of the capital at risk of a clearinghouse is composed of the margin and guarantee fund contributed by clearing members.

In addition to the financial resources required to satisfy the financial safeguards core principles set out in the Act we support introducing a requirement for clearinghouses to carry a first-loss risk component as well as a mezzanine risk component in the waterfall of financial safeguards. This would establish a direct link between the earnings that a clearinghouse derives from cleared activity and the contribution of that clearinghouse to its own financial safeguards package. We would support regulations that require a clearinghouse to retain in a segregated deposit account, on a rolling basis, 50 percent of the earnings from the previous four years. We observe that this amount would represent approximately 10 percent of the clearinghouse enterprise value, therefore achieving a reasonable balance between risk and reward for clearinghouse shareholders. In addition, it would be appropriate for at least 50 percent of the retained earnings to have a first loss position in the financial waterfall. This solution would accomplish the goal of greater systemic stability, and would scale over time the contribution by the clearinghouse to its own financial safeguards package without large decreases or increases at any one resizing date. We recommend that the clearinghouse contribution be subject to a minimum floor of $50 million, to provide adequate protection and provide increased confidence in the markets while market participants ramp up access to clearing services. In our view this would incentivize clearinghouses to manage risk in a prudent manner. We would also support limits on the ability of clearinghouses to upstream dividends resulting from clearing fees to their holding companies when a clearing member defaults. The introduction of a first loss position and the introduction on limits on the upstreaming of dividends for clearinghouses would result in significant benefits from a systemic stability point of view.

Limitations on Voting Rights

The best way to promote a successful implementation of the clearing requirement of the Act is to ensure that clearinghouses are fully equipped to manage risk in a prudent manner, while providing open access to clients and clearing members. In

order to achieve this purpose, clearinghouses should be able to attract financial and intellectual capital from those who have experience in the products that the clearinghouse intends to clear, as well as from new participants into the market.

We note that the OTC derivatives market is sufficiently diversified at present. A market survey published by ISDA on October 25, 2010, shows that the five largest U.S.-based dealers hold 37 percent of the outstanding derivatives market (equity, rates, credit). In our view this data is more representative of the global nature of the OTC derivatives market than other data that has been quoted out of context in the debate regarding conflict of interest. That data was focused exclusively on a restricted number of U.S. institutions and was not intended to represent a survey of the OTC market, which is global. To assume that dealers would acquire shareholdings in a clearinghouse or otherwise gain influence over a clearinghouse with a view to impede or narrow the implementation of the clearing requirement would be inconsistent with the reality of today's markets. On the contrary some participants in the OTC markets have made significant investments into the capital of clearinghouses well in advance of a legal requirement to clear being introduced or proposed in the U.S. or in Europe.

At this point in the development of market infrastructure, it is essential to promote competition between clearinghouses, exchanges, and SEFs. With respect to clearinghouses, we note that in today's markets there are a maximum of three clearinghouses per asset class that are able to clear OTC derivatives. In some asset classes there is no clearinghouse currently clearing. There is no specific reason to apply limits only to those who have the expertise and the funds to finance a clearinghouse and who are exposed to losses if the risk management of the clearinghouse fails. We believe that preventing those whose capital is at risk from acquiring the right to vote on the governance of the entities that perform a key role in the OTC markets is not necessary to achieve the policy objectives set out by Congress in the Act. For this reason we support a limit on voting rights that would apply to each class of market participants irrespective of whether they are clearing members, SEFs, exchanges, enumerated entities, or other types of entities or individuals. This would promote open access and greater competition among clearinghouses.

Given that preference shares and other types of nonvoting shares are a way to provide liquidity into the clearinghouse and have no effect on corporate governance, we believe that it would not be appropriate to apply limitations on the ownership of nonvoting shares.

No Free Riding—Clearing Member Resources

We do not believe that there should be a two-tiered approach to membership, where some clearing members are subject to loss mutualization and others are not. A clearinghouse will rely on the financial resources waterfall set out in CFTC proposed §39.11. This includes funded guarantee fund contributions by a clearing member. CFTC proposed §39.11 also contemplates the ability of a clearing organization to assess a clearing member for additional default fund contributions. We believe that it is important to make sure that a clearing member will have sufficient liquid capital to fund additional guarantee fund assessments, in proportion to house and client business cleared by that clearing member.

We believe it would be appropriate to require that clearing members have the ability to provide daily executable binding quotation for all points in the curve for all products cleared. Clearinghouses must be able to mark to market all positions at the end of each trading day. Clearing members must provide daily prices for all points of the maturity curve rather than relying on whether the cleared product trades on an exchange or a SEF on that day.

In our view it is essential to require that clearing members have the operational ability to sustain the flow of client and house positions into the clearinghouse, including porting books of liquid and illiquid positions at times of market distress. In times of market stress or crisis, it is imperative that clearing members be able to act quickly in order to address the risk management aspects of defaults. By way of example, if a clearing member fails, the clearinghouse will conduct an auction to absorb the losses caused by that clearing member failure. The provision of liquidity by surviving members during that auction is key to the survival of a clearinghouse that deals in OTC instruments.

Default management is not a responsibility that can be outsourced without introducing new risks to the stability of the clearinghouse. We think third-party pricing and outsourced default management services can disappear quickly in a crisis, as the provider of the service may have to focus their resources on their own survival. For this reason we believe it is preferable that clearing members or their affiliates be able to participate in the default management process. In the alternative, we would support a structure that would allow a clearing member to outsource pricing

and default management services to another provider so long as the third-party provider of pricing and default management services is not allowed to undertake the provision of those services to more than one clearing member (including for itself or an affiliate).

To ensure the correct incentives are in place during an auction of a failed member's portfolio, we recommend that any loss incurred by the clearinghouse as a result of the auction be absorbed first by the guarantee fund contributions of those members that fail to submit a bid. Any remaining loss should be distributed among the bidding clearing members in reverse proportion to the strength and size of their bid. This mechanism will ensure that all members are treated equally going in to an auction, and that appropriate financial incentives exist to provide exit liquidity to the clearinghouse. In addition, we believe this mechanism creates a fair outcome for all members by subordinating the guarantee fund capital of any bidder that is subject to a failed outsourcing arrangement.

Guarantee fund assessments ensure members have appropriate liquidity to meet potential capital calls in a crisis

We support the CFTC proposal requiring clearinghouses to haircut the value of unfunded assessment and to cap the percentage of the financial resources package that can be met by the value of assessments.

We note that CFTC proposed §39.11 also refers to the own capital contribution of a clearinghouse as a component of the financial resources package. We believe that it would be appropriate for the Commission's regulations to provide greater granularity and require that if a clearinghouse enumerates its own capital as part of the waterfall, that clearinghouse must provide sufficient assurances that its capital will be available to meet those obligations and will not be reallocated to serve other purposes at the discretion of that clearinghouse.

It should be noted that a clearing member may have committed to additional assessments at more than one clearinghouse. We believe it would be appropriate for regulators to adopt a risk-based analysis to determine the likelihood that a clearing member will be able to meet its assessment obligations across all clearinghouses.

Systemically Important Clearing Houses

We believe that in the new market structure landscape, that no entity should be too big to fail. In our view, this principle applies equally to clearing members, clearinghouses, and clients. Given the loss mutualization feature of clearing, it is only by requiring each participant to have skin in the game that we can ensure all the parties involved in bringing risk into the system have an incentive to act in a manner that is prudent, safe, and sound. We believe it is appropriate for members, clients and clearinghouse shareholders to have skin in the game. This principle is of particular relevance for those entities that are deemed systemically important by the Financial Stability Oversight Council pursuant to Title VIII of the Act.

Regulatory Coordination

In our view, coordination between regulators who have authority over clearinghouses will be a key component of systemic stability. One significant element will be the ability of regulators to look across clients, clearing members, exchanges, SEFs, and clearinghouses for any factors that could increase systemic risks. We think it is appropriate to monitor the activity of clients, clearing members exchanges, SEFs, and clearinghouses for undue concentration with a view to identify those that pose a systemic risk and take action to mitigate problematic situations before they exert a significant impact on the financial systems.

Conclusion

We believe that no institution, including clearing members and clearinghouses, should be too big to fail. The policy objectives of the Act would be well served by promoting systemic stability and ensuring safety and soundness of exchanges, SEFs, and clearinghouses, and by requiring that these institutions have adequate capital to absorb losses and sufficient liquidity to safeguard the system. JPMC is committed to working with Congress, regulators, and industry participants to ensure that Title VII is implemented appropriately and effectively. I appreciate the opportunity to testify before this Committee and look forward to answering any questions you may have.

PREPARED STATEMENT OF JAMES CAWLEY

COFOUNDER, SWAPS AND DERIVATIVES MARKET ASSOCIATION

MAY 25, 2011

Chairman Reed, Ranking Member Crapo, and Members of the Subcommittee, my name is James Cawley. I am CEO of Javelin Capital Markets, an electronic execution venue of OTC derivatives that expects to register as a SEF (or "Swaps Execution Facility") under the Dodd Frank Act.

I am also here to represent the interests of the Swaps & Derivatives Market Association or "SDMA," which is comprised of multiple independent derivatives dealers and clearing brokers, some of whom are the largest in the world.

Thank you for inviting me to testify today.

To ensure that the U.S. taxpayer is never again required to bail out Wall Street, we must move away from "too inter connected to fail" where one bank pulls another three with it—in the event of its failure. Equally important, we must remove the systemic "sting" currently associated with each bilateral derivatives swap contract that connects financial firms to each other and thus compel these swaps contracts into clearinghouses as mandated under the Dodd-Frank Act.

In order to have safe and successful central clearing of OTC derivatives, certain remaining impediments must be removed such that clearinghouses ensure that they have truly representative governance structures, offer objective and proportionate risk models, provide open access to properly qualified and noncorrelated clearing members and accept trades on a "real time" and "execution blind" basis such that systemic risk is mitigated while transparency and market liquidity are increased.

Clearinghouse Governance and Membership

With regard to clearinghouse governance, we support CFTC Core Principles O, P, and Q, that require that governance arrangements be transparent, fair and representative of the marketplace. Such governance bodies should represent the interests of the market as a whole and not just the interests of the few.

Importantly, clearinghouse membership requirements should be objective, publicly disclosed and permit fair and open access; as Dodd-Frank requires.

This is important because clearing members act as the "gatekeepers" to clearing. Without open access to clearing, you will not have universal clearing adoption, increased transparency, and lessened systemic risk.

Clearinghouses should seek to be inclusive, not exclusive in their membership criteria.

We should dispense with the myth that swaps are somehow different from other cleared markets and thus the vast experience from those markets should be ignored.

Instead, clearinghouses should learn from their own experience in the listed derivatives space—of futures and options.

In those markets, central clearing has operated successfully since the days of post Civil War Reconstruction nearly 150 years ago; long before spreadsheets and risk models. In those markets, counterparty risk is spread over a hundred disparate and noncorrelated clearing firms. It works well. No customer has ever lost money due to a clearing member failure.

To complement broad participation, clearinghouses should not have unreasonable capital requirements. Capital should be a function of the risk a member contributes to the system; simply put, the more you or customers trade, the more capital you contribute.

The SDMA supports the CFTC's call for clearing broker capital requirements to be proportionate and scale relative to the risk introduced to the system. We support the CFTC's call that a clearing firm's minimum capital be closer to $50 million, rather than closer to the $5 billion or $1 billion threshold as certain clearinghouses have originally suggested.

Certain clearinghouse operational requirements for membership that have no bearing on capital or capability should be seen for what they are—transparent attempts to limit competition.

Specifically, clearing members should not be required to operate swap dealer desks just so they can meet their obligation in the default management process. These requirements can easily be met contractually through agreements with third party firms or dealers.

With regard to conflicts of interest within a clearing member, Dodd-Frank is clear; dealer desks should not be allowed to influence their clearing member colleagues and strict Chinese walls should exist.

Derivatives Trade Integrity

With regard to trade acceptance, clearinghouses and their constituent clearing member firms should accept trades on an "execution blind" basis. Clearing firms should be prevented from discriminating against certain customer trades, simply because they dislike the manner in which they have been executed or the fact that they may be anonymous.

Certain trade counterparties should be precluded from exploiting current market position to impose documentary barriers to entry that restrict customer choice of execution venue, execution method, or dealer choice. Regulators should remain vigilant to ensure that such restrictions on trade do not manifest themselves in a post Dodd-Frank world.

With regard to trade integrity, execution venues, clearing members and clearinghouses should, as the regulators require, work together to ensure that executed trades settle or are accepted into clearing as quickly as possible.

The SDMA, joins with the MFA, and supports the CFTC requirement that trades be accepted into clearing immediately upon execution or trade submission. Regulators should be mindful not to allow clearinghouse workflows that seek to increase and not decrease trade latency. Such workflows should be seen for what they are—clear attempts to stifle successful OTC derivative clearing.

Conclusion

In conclusion, the CFTC and the SEC should be commended for their excellent work. Both agencies have been transparent and accessible throughout the entire process. They have adapted to industry suggestion when appropriate.

We must move away from "too interconnected to fail." As an industry, we must work together to ensure that OTC derivatives clearing is a success such that Wall Street never again has to come to Main street for another bail out.

Thank you.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN REED FROM CHRISTOPHER EDMONDS

Q.1. Does your swaps clearinghouse have minimum capital requirements as part of your ownership and governance standards?

A.1. Yes.

Q.2. If so, what are they?

A.2. ICE Clear Credit's Rule 201(b)(ii), in relevant part, currently provides that " . . . no applicant shall be admitted or permitted to remain, as applicable, as a Participant unless, in ICE Clear Credit's sole determination:

> (1) if it is an FCM or a Broker-Dealer, (A) it has a minimum of $100 million of Adjusted Net Capital and (B) it has Excess Net Capital that is greater than 5 percent of the Participant's Required Segregated Customer Funds; or (2) if it is not an FCM or a Broker Dealer, it has a minimum of $5 billion in Tangible Net Equity (provided that in the case of (1) or (2), this requirement may, at the discretion of ICE Clear Credit, be met by a Parent if such Parent provides a guarantee pursuant to Rule 205);
>
> For purposes of this clause (ii):
>
> "Adjusted Net Capital" for a Participant that is an FCM, shall be as defined in CFTC Rule 1.17 and as reported on its Form 1-FR-FCM or FOCUS Report or as otherwise reported to the CFTC under CFTC Rule 1.12, and for a Participant that is not an FCM but is a Broker-Dealer, shall be its "net capital" as defined in SEC Rule 15c3-1 and as reported on its FOCUS Report;
>
> "Excess Net Capital" for a Participant that is an FCM or a Broker-Dealer shall equal its "excess net capital" as reported on its Form 1-FR-FCM or FOCUS Report or as otherwise reported to the CFTC under CFTC Rule 1.12;
>
> "Participant's Required Segregated Customer Funds" shall equal (i) the total amount required to be maintained by such Participant on deposit in segregated accounts for the benefit of customers pursuant to Sections 4d(a) and 4d(f) of the CEA and the regulations thereunder and (without duplication) pursuant to the rules of relevant clearing organizations for positions carried on behalf of customers in the cleared OTC derivative account class plus (ii) the total amount required to be set aside for customers trading on non-United States markets pursuant to CFTC Rule 30.7.
>
> "Tangible Net Equity" shall be computed in accordance with the Federal Reserve Board's definition of "Tier 1 capital" as contained in Federal Reserve Regulation Y Part 225 Appendix A (or any successor regulation thereto), in the case of a bank or other Participant subject to such regulation, or otherwise shall be the Participant's equity less goodwill and other intangible assets, as computed under generally accepted accounting principles.

Q.3. What role do these capital requirements play in managing clearinghouse and counterparty risk?

A.3. The role of capital is secondary to the initial margin and guaranty fund collateral that a clearinghouse collects from its clearing participants, nevertheless, capital requirements are a fundamental and important component of a clearinghouse risk management regime. Capital requirements are a measurement of a clearing participant's ability to meet its financial obligations to the clearinghouse.

Section 725(c) of Dodd-Frank entitled Core Principles for Derivatives Clearing Organizations provides in relevant part that each derivatives clearing organization shall establish appropriate admission and continuing eligibility standards including sufficient financial resources to meet obligations arising from participation in the derivatives clearing organization.

The Bank for International Settlements in its Recommendations for Central Counterparties (CCP) (Recommendation 2: Participant requirements 4.2.2) states in relevant part "to reduce the likelihood of a participant's default and to ensure timely performance by the participant, a CCP should establish rigorous financial requirements for participation. Participants are typically required to meet minimum capital standards. Some CCPs impose more stringent capital requirements if exposures of or carried by a participant are large or if the participant is a clearing participant. Capital requirements for participation may also take account of the types of products cleared by a CCP . . . ."

Q.4. How would reducing these capital requirements impact the risk profile of the clearinghouse, as well as the ability of new potential clearing members to join the clearinghouse?

A.4. As indicated above, the clearinghouse model relies, in part, on having adequately capitalized clearing participants in order to manage its counterparty risk. There is a direct correlation between the level of an entities regulatory capital and its ability to meet its counterparty obligations to a clearinghouse.

Q.5. How is your clearinghouse risk committee constituted? How many members are there?

A.5. Pursuant to ICE Clear Credit rule 503(a), the composition of the Risk Committee shall be as follows:

> (i) The Risk Committee shall consist of twelve members.
>
> (ii) Each member of the Risk Committee shall have risk management experience and expertise and shall be subject to the approval of the Board, such approval not to be unreasonably withheld, conditioned or delayed.
>
> (iii) Three of the members of the Risk Committee shall be comprised of (A) a member of the Board who is independent in accordance with the requirements of each of the New York Stock Exchange listing standards, the U.S. Securities Exchange Act of 1934, as amended, and IntercontinentalExchange, Inc.'s Board of Director Governance Principles (such requirements, the "Independence Requirements" and such member, the "Independent ICE Manager") and (B) two officers of ICE Clear Credit from among the Chief Executive Officer, President, Chief Financial Officer and Chief Risk Officer, each appointed by ICE

US Holding Company L.P. (including any successor, the "ICE Parent"), a Cayman Islands exempted limited partnership, by written notice to the Board;

(iv) The other nine members of the Risk Committee will be appointed as specified below (the "Participant Appointees");

(v) The nine Participant Appointees will include one member appointed by each Participant Group that includes or is Affiliated with one of the following: Bank of America, N.A.; Barclays Bank PLC; Citibank, N.A.; Credit Suisse Securities (USA) LLC; Deutsche Bank AG; Goldman Sachs International; JPMorgan Chase Bank, N.A.; Morgan Stanley Capital Services, Inc.; and UBS AG. "Participant Group" means a Participant and its Affiliates, if any, such that, if two or more Participants are Affiliates, collectively they shall constitute a Participant Group.

(vi) The composition of the Participant Appointees shall be reconstituted on March 14, 2012, and each one year anniversary thereafter (or if any such day is not an ICE Business Day, the next ICE Business Day) as follows (each such anniversary, a "Risk Committee Reconstitution Date," and the twelve full consecutive calendar months (including March through February) ending at the calendar month-end prior to a Risk Committee Reconstitution Date, an "Eligibility Determination Period") (subject to paragraph (ii) above):

(A) among those Participant Groups that have an incumbent member on the Risk Committee, those Participant Groups that have the six highest Participant Activities for the immediately preceding Eligibility Determination Period (each, a "Top Six Incumbent Participant Group") shall have the right to retain such member on the Risk Committee until the next Risk Committee Reconstitution Date;

(B) among the Participant Groups that are not Top Six Incumbent Participant Groups, the Participant Groups that have the three highest Participant Activities for the immediately preceding Eligibility Determination Period (each, an "Eligible Participant Group") shall have the right to appoint or retain, as applicable, a member on the Risk Committee until the next Risk Committee Reconstitution Date;

(C) each Participant Group that has an incumbent member on the Risk Committee but is not entitled to retain such member as provided above shall cause its Risk Committee member to resign or otherwise remove such member from the Risk Committee effective as of the applicable Risk Committee Reconstitution Date; and

(D) each Participant Group that has the right to appoint a member to the Risk Committee as provided above and that does not have an incumbent member on the Risk Committee shall notify the Board in writing on or prior to the applicable Risk Committee Reconstitution Date of the individual appointed by such Participant Group to the Risk Committee; provided, however, that the failure to

provide such notice shall not result in the loss of the right of such Participant Group to appoint a member to the Risk Committee.

(E) "Participant Activity" means, for a specified Eligibility Determination Period and with respect to a particular Participant Group, the aggregate volume of Trades during such time submitted to, and accepted for clearing by, ICE Clear Credit by members of such Participant Group, which such volume shall be measured in terms of aggregate notional amount of Trades so submitted and accepted. In the event that a Combination of Participants occurs prior to the applicable Risk Committee Reconstitution Date, all Participant Activity of such Participants (and their Affiliates) shall be aggregated together for purposes of determining the Participant Activity of the resulting Participant Group for the corresponding Eligibility Determination Period.

(F) "Combination" means any event in which a Participant (or its Affiliate) obtains Control of another Participant that was previously not an Affiliate of such Participant (or any Person that Controls such other Participant) or a Participant (or any Person that Controls such Participant) is merged with another Participant that was previously not an Affiliate of such Participant (or any Person that Controls such other Participant).

(vii) Intentionally omitted in Rules for formatting.

(viii) Notwithstanding anything to the contrary herein, if at any time on or after the DCO/SCA Conversion Date but prior to the first Risk Committee Reconstitution Date, there is a Combination involving Participants where more than one of the relevant Participant Groups had the right to appoint a member of the Risk Committee, then, as of the date of consummation of such Combination, (A) such Participant Groups shall, collectively, have the right to appoint only one member of the Risk Committee and the Participant Group resulting from such Combination shall take all actions necessary to remove all but one of their previously appointed members effective as of the date of consummation of the Combination and (B) the vacanc(ies) of the Risk Committee will be filled by the Participant Group(s) that had the highest Participant Activit(ies) (over the 12-month period from and including March 2010 to and including February 2011) among those Participants that, as of the date of consummation of such Combination, did not have the right to appoint a member to the Risk Committee (in order of the level of such Participant Activity, from highest to lowest) effective as of the date of consummation of such Combination.

(ix) Notwithstanding anything to the contrary herein, if at any time on or after the first Risk Committee Reconstitution Date, there is a Combination involving Participants where more than one of the relevant Participant Groups had the right to appoint a member of the Risk Committee,

then, as of the date of consummation of such Combination, (A) such Participant Groups shall, collectively, have the right to appoint only one member of the Risk Committee and the Participant Group resulting from such Combination shall take all actions necessary to remove all but one of their previously appointed members effective as of the date of consummation of the Combination and (B) the vacanc(ies) of the Risk Committee will be filled by Participant Group(s) that had the highest Participant Activit(ies) (over the immediately preceding Eligibility Determination Period) among those Participants that, as of the date of consummation of such Combination, did not have the right to appoint a member to the Risk Committee (in order of the level of such Participant Activity, from highest to lowest) effective as of the date of consummation of such Combination.

(x) Notwithstanding anything to the contrary herein, if at any time all Participants in a Participant Group with the right to appoint a member of the Risk Committee are in Default or have had their status as Participant terminated as a result of being a Retiring Participant, (A) such Participant Group shall immediately lose the right to appoint a member to the Risk Committee and (B) at the date of such Default or termination, the Participant Group that had the highest Participant Activity (over the period from and including March 2010 to and including February 2011 or, if on or after the first Risk Committee Reconstitution Date, over the immediately preceding Eligibility Determination Period) among those Participants that, as of the date of such Default or termination, did not have the right to appoint a member to the Risk Committee, shall have the right to appoint a member to the Risk Committee effective as of the date of such Default or termination.

(xi) A Participant Group may appoint an individual to be a member of the Risk Committee only if such individual is an employee of one of the Participants in such Participant Group or an Affiliate thereof. Any member of the Risk Committee may be removed at any time, with or without cause, by the Participant Group that appointed such member pursuant to this Rule 503. In the event a vacancy occurs on the Risk Committee as a result of the retirement, removal, resignation, or death of a member thereof, such vacancy shall be filled by an individual designated by the relevant Participant Group.

(xii) Within five ICE Business Days of the end of each Eligibility Determination Period, ICE Clear Credit shall, based on its books and records, deliver to each Participant Group a good faith determination of the identity of (A) the Top Six Incumbent Participant Groups and (B) the Eligible Participant Groups, and shall inform each of the Top Six Incumbent Participant Groups and the Eligible Participant Groups of its right to appoint a member to the Risk Committee as of the next Risk Committee Reconstitution Date

pursuant to this Rule; provided, however, that ICE Clear Credit and its Affiliates, Board and officers shall have no liability with respect to the delivery of such good faith determination. For the sake of clarity, such good faith determination shall identify only the Participant Groups mentioned above, and shall not set forth the Participant Activity levels of such Participant Groups. In the event any Participant Group disputes in good faith ICE Clear Credit's good faith determination of the Top Six Incumbent Participant Groups or the Eligible Participant Groups, the disputing Participant Group and the Risk Committee shall submit such dispute for resolution to PricewaterhouseCoopers LLP (or, if such firm shall decline or is unable to act or is not, at the time of such submission, independent of ICE Clear Credit, the disputing Participant Group or any member of the Risk Committee, to another independent accounting firm of international reputation mutually acceptable to the disputing Participant Group and the Risk Committee) (such firm, the "Independent Accounting Firm"), which shall, within 30 ICE Business Days after such submission, determine and report to ICE Clear Credit, the disputing Participant Group and the Risk Committee, and such report shall be final, conclusive and binding on the disputing Participant Group, the Risk Committee and ICE Clear Credit. The disputing Participant Group shall be solely responsible for the fees and disbursements of the Independent Accounting Firm. ICE Clear Credit and its Affiliates, Board and officers shall have no liability in connection with the determination of the Independent Accounting Firm.

(xiii) If, by written agreement of the Risk Committee and the Board, ICE Clear Credit is determined to have established multiple risk pools (each, a "Risk Pool"), ICE Clear Credit will create a new and separate risk committee for each such Risk Pool. In such event, (A) each such new risk committee will have, with respect to its Risk Pool, the same rights, responsibilities and operational procedures as the Risk Committee has under this Chapter, and (B) to the extent practicable, the composition of such other risk committee will be determined on the same basis as the Risk Committee is determined hereunder (taking into account, instead, the applicable volume or usage metric with respect to such Risk Pool as determined by the Risk Committee), with the rules for such composition being determined by the Board, in consultation with the Risk Committee

Q.6. What role do they have in controlling access to the clearinghouse?

A.6. Both the Risk Management Committee and the newly established Risk Management Subcommittee, described below, are consultative committees and have no authority to accept or deny clearing participants.

Importantly, the authority to accept or deny clearing participants vests solely with the ICE Clear Credit Board of Managers.

Nevertheless, in anticipation of proposed CFTC regulations relating to the mitigation of conflicts of interest being promulgated, ICE Clear Credit recently adopted the following Rules 510 and 511 to establish a Risk Management Subcommittee that will be consulted prior to determining the standards and requirements for initial and continuing clearing participant eligibility and prior to approving or denying clearing participant applications.

510. Subcommittee Specified Actions.

ICE Clear Credit shall not take nor permit to be taken any of the following actions without prior consultation with the Risk Management Subcommittee ("Subcommittee Specified Actions"):

(a) Determine products eligible for clearing;

(b) Determine the standards and requirements for initial and continuing Participant eligibility;

(c) Approve or deny (or review approvals or denials of) Participant applications described in Rule 202 (or any successor Rule thereto) or the other ICE Provisions;

(d) Modify this Chapter of the Rules or Modify any of the responsibilities, rights or operations of the Risk Management Subcommittee or the manner in which the Risk Management Subcommittee is constituted as set forth in the Rules.

511. Composition of the Risk Management Subcommittee; Confidentiality.

(a) The composition of the Risk Management Subcommittee shall be as follows:

(i) The Risk Management Subcommittee shall consist of five members.

(ii) Each member of the Risk Management Subcommittee shall have risk management experience and expertise and shall be subject to the approval of the Board, such approval not to be unreasonably withheld, conditioned or delayed.

(iii) Two of the members of the Risk Management Subcommittee shall be public directors as defined in CFTC Rule 1.3(ccc) ("Independent Public Directors") appointed by ICE Clear Credit. The Board must make such finding upon the appointment of the member and as often as necessary in light of all circumstances relevant to such member, but in no case less than annually.

(iv) One member of the Risk Management Subcommittee shall be a Non-Participant Party. Such member will be nominated by the buy-side Advisory Committee of ICE Clear Credit.

(v) Two of the members of the Risk Management Subcommittee shall be composed of representatives of Participants who are members of the Risk Committee. Such members shall be nominated by the Risk Committee.

(vi) No member of the Risk Management Subcommittee may be subject to statutory disqualification under CEA Section 8a(2) or Section 3(a)(39) of the Securities Exchange Act, or other applicable CFTC or SEC regulations.

Q.7. How is ICE Clear Credit planning to satisfy the open access provisions in the Dodd-Frank Act?

A.7. Since its inception, ICE Trust, now known as ICE Clear Credit, has supported open access and will continue to do so pursuant to Dodd-Frank. (It should be noted that from a business model perspective, it is generally in ICE Clear Credit's interest to receive more transactions to clear.)

Specifically, ICE Trust Rule 314 (Open Access for Execution Venues and Trade Process Platforms) previously provided:

> ICE Trust shall ensure that there shall be open access to the clearing system operated by ICE Trust pursuant to these Rules for all execution venues (including, without limitation, designated contract markets, national securities exchanges, swap execution facilities and security-based swap execution facilities) and trade processing platforms. ICE Trust may impose (a) reasonable criteria to determine whether an execution venue has the capability to deliver the necessary quality of service to be granted access to ICE Trust, (b) reasonable criteria to determine whether a trade processing platform has the capability to deliver the necessary quality of service to be granted access to ICE Trust and connected through the ICE Trust application programming interface, (c) reasonable requirements as to risk filters and other credit risk management standards with respect to transactions to be submitted to ICE Trust for clearing, and (d) reasonable costs on such execution venues and trade processing platforms and Participants that use such venues and platforms; provided that in each case such criteria or costs shall not unreasonably inhibit such open access and shall comply with applicable law.

ICE Clear Credit Rule 314 was recently amended slightly to read as follows:

> ICE Clear Credit shall ensure that, consistent with the requirements of CEA Section 2(h)(1)(B) and Securities Exchange Act Section 3C(a)(2), there shall be open access to the clearing system operated by ICE Clear Credit pursuant to these Rules for all execution venues (including, without limitation, designated contract markets, national securities exchanges, swap execution facilities and security-based swap execution facilities) and trade processing platforms. ICE Clear Credit may impose (a) reasonable criteria to determine whether an execution venue has the capability to deliver the necessary quality of service to be granted access to ICE Clear Credit, (b) reasonable criteria to determine whether a trade processing platform has the capability to deliver the necessary quality of service to be granted access to ICE Clear Credit and connected through the ICE Clear Credit application programming interface,

(c) reasonable requirements as to risk filters and other credit risk management standards with respect to transactions to be submitted to ICE Clear Credit for clearing, and (d) reasonable costs on such execution venues and trade processing platforms and Participants that use such venues and platforms; provided that in each case such criteria or costs shall not unreasonably inhibit such open access and shall comply with applicable law.

Q.8. How would you expect the open access provisions to impact your business model, as well as the overall role of clearinghouses in the swaps market worldwide?

A.8. As indicated above, ICE Trust, now known as ICE Clear Credit, has always supported open access. ICE Clear Credit is agnostic with respect to the execution venue provided that the execution venue meets ICE Clear Credit's reasonable eligibility standards and submits transactions to ICE Clear Credit on behalf of ICE Clear Credit's authorized clearing participants.

Q.9. Given the policy objective of Title VII to increase the clearing of swaps, how would you structure the implementation of the new Dodd-Frank clearing requirements to provide the greatest incentives for market participants to clear their trades?

A.9. Specifically, clearing participants will be incented to clear if the Dodd-Frank provisions calling for the CFTC and SEC to approve portfolio margining between correlated commodity-based swaps and security-based swaps are implemented. ICE Clear Credit has submitted to the CFTC and SEC its draft request for portfolio margin treatment with respect to the commodity-based swaps (CDS indices) and security-based swaps (single name CDS) that ICE Clear Credit clears.

More generally, centralized clearing fundamentally reduces counterparty risk and provides financial stability as a result of sound and transparent risk management practices. All clearing participants are required to post collateral in the form of initial margin and all clearing participants' cleared positions are marketed-to-market on a daily basis. In addition, clearing participants are required to contribute to the clearinghouse's guaranty fund which serves as a mutualized financial backstop in the event that a clearing participant should default on its obligations. The implementation of new Dodd-Frank requirements should be structured in a manner that promotes the fundamental safety and soundness principles of centralized clearing.

Q.10. Are there certain entities or asset classes that should be cleared before others?

A.10. Generally, the more standardized and liquid swaps are more appropriately cleared.

Q.11. Could you describe the current policies and procedures used by your clearinghouse to prevent conflicts of interest in decision making about clearing swap trades?

A.11. See responses to Question 2 above.

Q.12. How do you expect the provisions of the Dodd-Frank Act that seek to minimize conflicts of interest to impact the governance and voting composition of your Boards of Directors?

A.12. The provisions of Dodd-Frank relating to conflicts are unlikely to impact ICE Clear Credit given its corporate governance structure. The majority of ICE Clear Credit's Board of Managers are independent (6/11). Three of the remaining Board members are representatives of ICE management. The remaining two Board members are representatives of the clearing participants.

Q.13. How do you ensure that neither a single shareholder nor a small group of shareholders can dominate the clearinghouse and determine its policies?

A.13. Technically, ICE Clear Credit has a single shareholder—ICE Inc. ICE U.S. Holding Company L.P. is the sole member of ICE Clear Credit. ICE Inc. (a public company) wholly owns the company that serves as the General Partner (GP) of ICE U.S. Holding Company L.P. None of the Limited Partners have the right to elect the Board of Managers of ICE Clear Credit. The GP of ICE U.S. Holding Company L.P. elects the Board of Managers of ICE Clear Credit. The Limited Partners of ICE U.S. Holding (that include the former owners of The Clearing Corporation) merely maintain a limited economic interest in the profits of ICE Clear Credit.

Q.14. One concern is that members could restrict access either directly or indirectly by controlling the ability to enter into correspondent clearing arrangements. What are the best approaches to ensuring fair and open access?

A.14. As noted above, the ICE Clear Credit clearing participants do not govern ICE Clear Credit. Instead, the ICE Clear Credit Board of Managers, a majority of whom are independent, govern ICE Clear Credit. Moreover, as noted above, ICE Clear Credit has an open access policy as codified in its Rules.

Q.15. Some have argued that members could actually lower risk controls and be incentivized to take on greater risk positions in a clearinghouse environment. How does the clearinghouse management team evaluate the risk controls?

A.15. The clearing participants of a clearinghouse mutualize the risk of all of the clearing participants as a result of contributing to the clearinghouse's guaranty fund. Since each clearing participant's capital is exposed to the risk of other clearing participants, the clearing participants are financially incented to ensure that risk controls are appropriate and are not lowered. In addition, as noted above, the ICE Clear Credit Board of Mangers is vested with the sole authority to determine the risk controls of ICE Clear Credit.

Q.16. What incentives exist to ensure risks are properly evaluated and not exposed to influence from members?

A.16. See above response. It is in the economic interest of clearing members who serve on the Risk Committee to ensure that risks are properly evaluated. Nevertheless, at ICE Clear Credit, the Risk Committee has no authority and is merely a consultative com-

mittee. As noted above, only the ICE Clear Credit Board of Managers has authority to make risk-related decisions.

Q.17. It was recently reported that ICE Clear Credit is reducing its minimum adjusted net capital for members from $1 billion to $50 million (plus $20 million in one-time guarantee fund contributions and a variable rate on how much the member exposes the clearinghouse). How does this change balance access with safety and soundness?

A.17. See response to Question 1 above that references ICE Clear Credit's current minimum adjusted net capital requirements. The $50 million number comes from the CFTC's proposed minimum adjusted net capital requirement. ICE Clear Credit has not considered lowering its adjusted net capital requirement to $50 million.

Q.18. Both the U.S. Department of Justice and the European Commission have become concerned about the possibility of anticompetitive practices in credit derivatives clearing. In your opinion, what factors give rise to these concerns?

A.18. ICE Clear Credit does not know and will not speculate regarding any factors that might give rise to concerns of the U.S. Department of Justice. ICE Clear Credit respectfully refers the Committee to the European Commission's press release dated April 29, 2011.

Q.19. Do those same factors extend to the clearing of other products? And how should we address those factors?

A.19. Again, ICE Clear Credit does not know and will not speculate regarding any factors that might give rise to concerns of the U.S. Department of Justice.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN REED FROM JAMES CAWLEY

Q.1. What are your perspectives on the current rules proposed by the CFTC and SEC on the ownership and governance of clearinghouses? How would reducing minimum capital requirements for clearinghouse membership impact the risk profiles of clearinghouses as well as the ability of new potential clearing members to join clearinghouses?

A.1. Please see the attached SDMA comment regarding Implementation of Conflicts of Interest Policies and Procedures, dated June 3, 2011 (hereafter "Conflicts Letter").

Q.2. How do you anticipate clearinghouses will coordinate with exchanges and swap execution facilities (SEF) on the clearing and trading of swaps? What would be the positive and negative impacts of a vertically integrated clearinghouse-SEF model when compared with more independent role for clearing and execution venues?

A.2. Please see the attached SDMA comment regarding OTC Derivative Market Integrity and Real-Time Trade Processing Requirements, dated June 3, 2011.

Q.3. Both the U.S. Department of Justice and the European Commission have become concerned about the possibility of anticompetitive practices in credit derivatives clearing. What factors

give rise to these concerns? Do those same factors extend to the clearing of other products? And how should we address those factors?

A.3. There are two key factors that indicate anticompetitive practices. The first factor is that all or most of the sales for a particular product or service are provided by a small number of sellers. This high concentration of market share is known as "market power." The second factor is high barriers to entry into the market. Barriers to entry are anything that prevents a potential competitor's ability to enter the market and include high capital costs, control of resources and intellectual property.

All of these factors give rise to concerns in the clearing of credit derivatives and extend to the clearing of other products. The clearinghouses that clear credit derivatives have market power. It is well established that 80 percent of the market is controlled by 10 dealers. These dealers and the clearinghouse they control are an oligopoly (*i.e.,* a small group of firms that exert monopoly like control over the market). They have sought to maintain their market power through restrictive clearinghouse participant eligibility standards.

For further detail on these restrictive standards, and our thoughts on how to address these issues, please see the Conflicts Letter.

Q.4. Should there be restrictions on the ownership of clearinghouses by major swaps dealers? Why or why not?

A.4. Please see the attached SDMA comment regarding Implementation of Conflicts of Interest Policies and Procedures, dated June 3, 2011.

Q.5. Is the clearing function a natural monopoly? Why or why not?

A.5. The clearing function is not a natural monopoly. A natural monopoly exists in a market where barriers to entry are substantial costs or the use of infrastructure that cannot be reasonably duplicated by a competitor. Two examples of this type of infrastructure are electrical grids and railroad bridges.

This is not the case in clearing function. Clearing does not rely upon infrastructure that cannot be reasonably duplicated. It relies upon capital. There is no limit in the amount of capital that can be used. Please see the Conflicts Letter for a discussion of how the use of capital should be applied to clearing risk.

Q.6. While the benefits of encouraging clearing are widely acknowledged, increased clearing brings some risks of its own. What steps would you recommend our regulators take to reduce and contain systemic risk at clearinghouses?

A.6. Since their inception clearinghouses have played a vital role in the market by managing the default risk of counterparties and spreading that risk over the members of the clearinghouse. This system is most effective when the 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 clearinghouses are monopolies controlled by a handful of highly correlated firms. In the event of clearing member default where there are a small number of cor-

related clearing members there is a greater chance that other clearing members may also default.

In order to reduce systemic risk the regulators must require that clearinghouses have a large, noncorrelated group of clearing members. This can only be accomplished through clearing membership standards that are based upon fair and open access. Please see the Conflicts Letter for a further discussion of this topic.

Q.7. How should regulators properly oversee the dynamic risk management process in a real-time manner?

A.7. To oversee the dynamic risk management process in real-time the regulators must have adequate technology resources. Without adequate technology there can be no real-time monitoring of any function. Adequate technology has three components. The first component is technology infrastructure that meets current industry standards. Second, the regulators must have direct connectivity to the clearinghouses. Third, the regulators must have software that can perform real time monitoring of risk management functions. The software can either be provided by the clearinghouses to the regulators or a program developed by the regulators.

ADDENDUM 1

SDMA SWAPS & DERIVATIVES MARKET ASSOCIATION

June 3, 2011

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

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

Re: Implementation of Conflicts of Interest Policies and Procedures by Futures Commission Merchants and Introducing Brokers (17 CFR Part 1) and Implementation of Conflicts of Interest Policies and Procedures by Swap Dealers and Major Swap Participants (17 CFR Part 23) (RIN 3038-AC96)

Dear Sir/Madam Secretaries,

The Swaps & Derivatives Market Association ("SDMA") appreciates the opportunity to provide additional comment on the (a) Implementation of Conflicts of Interest Policies and Procedures for Futures Commission Merchants ("FCM") and Introducing Brokers ("IB"), and (b) Implementation of Conflicts of Interest Policies and Procedures by Swap Dealers ("SD") and Major Swap Participants ("MSP"). These rules implement the structural and institutional safeguards mandated by sections 731, 732 and 764 of Title VII of the Dodd Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank Act") and are among the most important of all the rulemakings proposed by the Commodity Futures Trading Commission (the "CFTC" or "Commission"), because they ensure the independence of clearing members that is essential to nondiscriminatory, open access to clearing. The SDMA supports proposed rules (a) 1.71 *Implementation of Conflicts of Interest Policies and Procedures by Futures Commission Merchants and Introducing Brokers* and (b) 23.605 *Implementation of Conflicts of Interest Policies and Procedures.* The SDMA urges the Commission to move forward the proposed rules as written and not make any

revisions that dilute their effectiveness. This letter supersedes our January 24, 2011 letter regarding these proposed rules.

The SDMA is a non-profit financial trade group formed in 2010 to support the goals of the Dodd Frank Act. It believes that systemic risk of OTC derivatives can be mitigated through their regulation, the creation of central clearing, and by ensuring open and transparent access to ensure greater competition, lower transaction costs and greater liquidity. The SDMA is comprised of many US and internationally based broker-dealers, investment banks, futures commission merchants and asset managers participating in all segments of the exchange-traded and over-the-counter derivatives and securities markets.

The SDMA supports Title VII of the Dodd-Frank Law and commends the diligent, thoughtful, and exhaustive work that the teams at both the CFTC and the SEC continue to do with regard to promulgating rules necessary for the OTC derivatives market place to comply with the Act.

I. Introduction

Sections 731, 732 and 764 of the Dodd Frank Act correctly recognize the potential for conflicts of interest that arise from a dealer bank and its clearing subsidiary's business role to enhance shareholder value on one hand, and its prudential role, to ensure sound clearing practices as a clearing member, on the other. In the OTC derivatives markets, dealer banks may provide two types of services: execution and clearing. Execution services are provided by the dealer's trading desk, which provides liquidity to the markets as a "market maker". The dealer bank may also provide clearing services through its FCM or clearing member subsidiary. As a member of a clearinghouse, the clearing subsidiary typically submits customer derivatives trades for clearing in return for fees. To be sure, the dealer bank and its clearing member subsidiary have a fiduciary obligation to enhance shareholder value. To this end the dealer bank is always seeking to increase the profitability of its business.

Important to the broader market, the clearing subsidiary of the dealer bank also serves a more prudential role as a member of the clearing house. As a clearing member, the dealer's clearing subsidiary must ensure that customer trades are properly capitalized or "margined" subject to clearing house rules and relative to the risk that each trade adds to the system. In essence, the clearing member acts as a "gatekeeper" to the system. It keeps out bad trades or bad counterparties that might otherwise threaten

the clearing house systemically. In so doing, the clearing house's integrity is upheld and systemic risk to the financial markets is reduced.

It is these competing interests: (1) the dealer bank's obligation to enhance shareholder value (by both execution and clearing), and (2) the dealer bank's broader responsibility to provide open and fair market access to clearing, through its clearing member that creates a clear conflict. It is the tension between these two forces, where the dealer's clearing member may be required to provide access to models or firms that directly compete with its execution desk that is central to this paper's discussion and the success of clearing in the OTC derivatives market.

Such a conflict arises from potential profits. It is important to note that more profits lie in execution than clearing for the dealer bank. It was recently noted by the industry that, whereas revenues from OTC derivatives clearing was expected to generate an estimated $300 to $500 million in profits annually, dealer revenues from OTC derivatives market making currently generated a sizable $40 to $60 billion in annual profits.[1]

The Dodd Frank Act and the Commissions correctly notice that such conflicts of interest at dealer banks have the propensity to exist. Sections 731 and 732 of the Dodd Frank Act require that separation of trading and clearing exist at SD's, MSPs, IB's & FCMs. To comply with sections 731 and 732, FCMs, IBs, SDs and MSPs must establish "structural and institutional safeguards", similar to firewalls, to limit communication and interaction between their clearing and trade units. The SDMA believes that the firewalls are critical to reducing potential conflicts between the trading unit of an FCM, IB, SD or MSP and their clearing unit.

The following discussion considers examples of how conflicts of interest may have manifested themselves already in: (a) clearinghouse participant eligibility for membership, (b) clearinghouse governance, (c) customer eligibility for clearing services, (d) clearinghouse product eligibility for clearing, (e) clearing workflow, and (f) clearing documentation requirements.

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[1] See CFTC SEC Governance Roundtable Transcript (Page 33, August 20, 2010).

II. Clearinghouse Membership Requirements: Participant Eligibility

Participant eligibility for clearinghouse membership is the first situation where conflicts of interest may have arisen. The Dodd Frank Act correctly recognizes the potential for such conflicts and prohibits restrictive participant eligibility rules. Specifically, section 725 of the Dodd Frank Act amends section 5b(c) of the Commodity Exchange Act to create core principles for Derivative Clearing Organizations. Core Principle C: *Participant and Product Eligibility* requires that a clearinghouse shall establish "... appropriate admission and continuing eligibility standards ..." and that those requirements are objective, publically disclosed and permit fair and open access. This Core Principle addresses the concern that a clearinghouse may not use unreasonable capital or "sophistication" requirements to limit access to clearinghouse membership.

Since their inception, clearinghouses 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. For over a hundred years, the listed derivatives marketplace has enjoyed considerable safety and soundness because its clearing membership constituency has been both large in number and diverse. It is well established in these markets, that no customer has ever lost money due to a clearing house or clearing member failure. From experience, it is fair to say that systemic risk is has been properly mitigated when the clearing member constituency is large and uncorrelated.

By contrast, systemic risk is increased where a clearinghouse may be composed of a handful of dangerously correlated firms. In this instance, when one clearing member defaults there may be a greater chance that another member will default. In order to reduce systemic risk, the clearinghouse should be encouraged to 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.

A. Minimum Capital Requirements

Some clearinghouses have attempted to impose minimum capital requirements of $1 billion. This requirement is unreasonable and is clearly aimed at restricting participant eligibility to clearinghouse membership. Moreover, a $1 billion capital requirement is no guarantee that a clearing member can meet their financial obligations. 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. In fact, prior to the financial crisis AIG, Bear Sterns and Lehman Brothers would have met the proposed $1 billion capital requirement.

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 amount of risk the clearing member brings to the market must be calculated per trade, and by the total value of the customer portfolios that it clears.

As the Commission correctly states in proposed rule 39.12(a)(2)(ii), capital requirements should be "...based upon objective, transparent, and commonly accepted standards that appropriately match capital to risk". Proposed rule 39.12(a)(2)(iii), provides that a clearinghouse "...shall not set a minimum capital requirement of more than $50 million for any person that seeks to become a clearing member in order to clear swaps." The SDMA agrees with CFTC Chairman Gensler's statement that the "proposed participant eligibility requirements will promote fair and open access to clearing." (Statement in Support of Dodd-Frank Rulemaking of Chairman Gary Gensler, Statement for the record regarding the proposed rules on Risk Management Requirements for Derivatives Clearing Organizations, made on December 16, 2010).

Proponents of such high capital thresholds fail to offer any empirical evidence or convincing argument to support that setting some nominally high capital thresholds somehow increases clearing house integrity. It is interesting to note that the proponents of such requirements are also dealer banks that may face competition from open access. The SDMA believes that such capital requirements may be unreasonable barriers to entry that are designed to protect against independent clearing members offering open access to clearing to firms and business models that would otherwise compete with such incumbent dealers interests.

The SDMA supports these rules and believes this level of capital would permit broad participation by clearing members and reduce systemic risk. Therefore, the SDMA respectfully recommends the Commission adopt proposed rules 39.12(a) (2)(ii) and 39.12(a)(2)(iii) as currently drafted.

B. Sophistication Requirements

Other clearing house membership requirements also serve no legitimate purpose and may be construed as ways to limit clearing house membership are certain "sophistication" requirements. Certain clearing houses have attempted to impose a requirement that the clearing member must have a $1 trillion swaps portfolio. Such a requirement, which artificially links execution and clearing, directly limits membership and protects against new properly capitalized firms from ever qualifying as clearing members. Some have argued that this requirement is necessary because swaps are complicated transactions, and only a clearing member that has a portfolio of significant size has the "sophistication" necessary to clear swaps.

Proponents of such a requirement fail to show any empirical evidence or indeed offer any credible academic study that supports such a notion. The SDMA sees such a requirement as nothing more than a transparent attempt to thwart competition.

The Commission correctly recognizes in proposed rules 39.12(a)(iv) and 39.21(a)(v) that the clearinghouse should not require that a clearing member be a swap dealer, have portfolio size requirements, or meet any swap transaction volume size thresholds. Specifically, proposed rule 39.12(a)(iv) provides that a clearinghouse "shall not required that a clearing members must be swap dealers", and proposed rule 39.12(a)(v) provides clearing house "shall not require that clearing members maintain a swap portfolio of any particular size, or that clearing members meet a swap transaction volume threshold". The SDMA agrees that any clearing house membership rule that artificially requires a clearing firm to have execution facilities or conversely an execution desk to have self clearing capability should be considered contrary to the express language of the Dodd Frank Act and be considered by the Commissions to be unlawful.

Clearing member eligibility requirements must focus upon the operational qualifications set out in proposed rule 39.12(a)(3), because they are the functions that clearing members traditionally provide. Specifically, proposed rule 39.12(a)(3) requires that clearing members have the ability to: (a) process expected volumes and values of transactions cleared by a clearing member in the required time frame; (b) fulfill collateral, payment, and delivery obligations imposed by the clearinghouse; and (c) reasonably participate in default management activities.

C. End of Day Pricing Requirements of Clearing Members

Some dealer owned clearing members may be seeking to limit clearing house membership by requiring fellow clearing members to contribute End of Day ("EOD") prices solely from their own dealer desks in the EOD process. In the absence of transparent exchanges where closing prices are readily available, the clearing house is right to request that clearing members provide EOD actionable swaps prices to the clearing house, so that it may properly price its book. To ensure clearing house integrity, it is even more critical that such prices be actionable on which the clearing house can execute. However, to require that these EOD prices can *only come from a clearing member's own execution desk* is an unreasonable requirement that again artificially links execution to clearing and limits competition.

Clearing members should be permitted to use third party dealers to provide actionable prices for submission in the EOD pricing process. For example, the clearing member can obtain prices from a dealer consortium or an execution platform. There is no evidence to suggest, as certain parties have argued, that a legal arrangement with a third party dealer somehow erodes the integrity of this pricing system. Obtaining actionable prices from third parties is common in the OTC markets and provides the clearing house a viable solution that both address their need to "mark their book" but also allow it to encourage broad clearing member participation, and by extension ensure clearing house integrity through more diversified constituents and importantly, comply with the law.

If no flexibility in obtaining end of day prices is offered, clearing house membership will be severely limited, the downside of which may certainly include a less rigorous and less diversified pool of clearing participants, but also restricted access to the clearing and trading of OTC derivatives.

The SDMA believes that a clearing member should not be required to provide end of day prices from its own dealer desk. Therefore, the SDMA respectfully recommends that the Commission amend 39.12(a)(1) to provide that a derivatives clearing organization shall either (a) not require that its clearing members provide end of day pricing from its own dealer desk, or (b) be permitted to obtain end of day prices from a third-party dealer.

D. Default Management: Liquidation of Clearing Member Portfolios

Other clearing member eligibility rules exist that require that a clearing member must use its own execution desk to participate in the default auction process.

A default auction's success is dependent upon the clearinghouse's ability to conduct an efficient default auction that neutralizes default risk of a distressed clearing member by selling off its entire portfolio. There are two key components to an efficient 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. A greater number of participants results in reducing the amount of risk each clearing member must assume. This, in turn, reduces the risk of additional clearing members defaulting. In an auction process, a larger number of participants also increases price competition and results in getting the "best price" possible for the swaps at auction. The default process will be more efficient, because it would increase the number of participants in the auction.

To somehow limit the auction process to only clearing members and not the broader market not only decreases the likelihood of obtaining "best price" in the auction but also promotes a market inefficiency that should be seen as nothing more that another discriminatory construct that links execution to clearing to restrict participation and limit membership.

Therefore, the SDMA respectfully suggests that the Commission amend 39.12(a)(1) to provide that a derivatives clearing organization may permit its clearing members to contract with a third party, (that meets objective, publically disclosed risk based default management standards), to handle default auction process on behalf of the clearing member.

The SDMA supports proposed rules 39.12(a)(iv), 39.12(a)(v) and 39.12(3), which recognize that clearing member eligibility requirements be based upon the operational functions that a clearing member traditionally provides in reducing systemic risk. Therefore, the SDMA respectfully recommends the Commission adopt proposed rules 39.12(a)(iv), 39.12(a)(v) and 39.12(3) but clarify that participation in the default management process should not require that a clearing member maintain an execution desk to provide end of day prices or participate in liquidation auction process.

III. Clearinghouse Governance & Open Access

A second area where conflicts of interest manifest themselves is the governance and ownership of clearinghouses. High ownership concentrations and exclusivity of membership create fertile ground for the creation of potential conflicts of interest. Those that clear swaps have attempted to use restrictive clearinghouse membership eligibility requirements to keep the number of their members low. This high concentration of ownership coupled with limited membership raises serious concerns about the dealer banks' ability to exert undue influence over the clearinghouses to support their own interests and stifle open access to clearing.

Dealers that own or are able to control significant concentrations of equity in a clearinghouse can attempt to enact policies and practices that enhance their own execution and clearing businesses. As a result, the potential for conflicts of interest between the dealers desire to enhance profits and the clearinghouse's obligation to provide nondiscriminatory clearing, will have a significant impact on clearinghouse governance. How the clearinghouse is governed and who has the ability to participate in making key business decisions has a direct impact on vital aspects of the clearinghouse's business. These key areas are: (1) membership, (2) product eligibility, (3) acceptable collateral for margin, (4) proper risk models and default procedures, and (5) documentation.

The Dodd Frank Act and the Commissions proposed rules address the potential conflicts of interest by creating a governance framework that establishes standards for clearinghouse ownership, board composition, governance fitness standards and conflicts of interest rules. This framework starts with the Core Principles for Derivatives Clearing Organizations that relate to clearinghouse governance. These Core Principles are: (1) O: *Governance and Fitness Standards,* (3) P: *Conflicts of Interest*, and (3) Q: *Composition of Governing Boards*. The Commission has further defined the standards for the clearinghouse governance framework in the following proposed rules: (a) 39.13 *Risk Management;* (b) 39.24 *Governance Fitness* Standards; (c) 39.25 *Conflicts of Interest*; (d) 39.26 *Composition of Governing Boards*; and (e) 40.9 *Governance*.

This framework seeks to create an independent governance structure for clearinghouses and has several components. The first component is a limitation on clearinghouse ownership and voting rights. The second component is a mandate that the clearinghouse board of directors include market participants. Next, this framework requires that the clearinghouse establish and enforce fitness

standards. And finally, the clearinghouse must establish procedures for mitigating and resolving conflicts of interest. Each of these components is discussed below.

A. Limitations on Ownership and Voting Rights

Establishing limitations on ownership levels and voting rights is a key aspect of minimizing conflicts of interest. These limitations are addressed in both the Core Principles and the proposed rules. Core Principle P requires that a clearinghouse establish and enforce rules that minimize conflicts of interest. Proposed rule 39.25 provides two alternatives for limiting ownership and voting rights of clearinghouses.

The first alternative proposes a single member limit and an aggregate limit. The single member limit caps a clearing member's (and their related persons) ownership level and exercise of voting rights at 20% (proposed rule 39.25(b)(2)(i)(A)). The proposed aggregate limit imposes a 40% cap on an Enumerated Entity's[2] (and their related persons) ownership and exercise of voting rights, regardless of whether the Enumerated Entity is a clearing member (proposed rule 39.25(b)(2)(i)(B)). The second alternative proposes a 5% limitation on the ownership and voting rights that a member or an Enumerated Entity (and their related persons) collectively own. (Proposed Rule 39.25(b)(2)(ii))

The SDMA supports Alternative 1, contained in 39.25(b)(2)(i), which limits (a) a clearing member ownership and voting rights to 20% of any one class of equity and (b) an Enumerated Entities' ownership and voting rights to 40% of any one class of equity. The SDMA does not support Alternative 2, contained in 39.25(b)(2)(ii), which limits a member's or an Enumerated Entities' ownership and voting rights to 5% of any one class of equity, as the SDMA does not believe this is adequate to limit conflicts of interest.

B. Board Composition

The SDMA believes that the Core Principles and the Commission's proposed rules regarding board composition strike the proper balance to ensure independent governance. Core Principle Q requires that each clearinghouse make certain that the composition of the governing board (or committee) includes market participants. The Commission has mandated the requirements of Core Principle Q in proposed

[2] Proposed rule 39.25(b)(1) defines Enumerated Entities as (a) a bank holding company with total consolidated assets of $50 million or more, (b) a nonbank financial company supervised by the Board of Governors of the Federal Reserve System, (c) an affiliate of either of the previously described bank holding company or nonbank financial company, (d) a swap dealer, (e) a major swap participant, and (f) an associated person of a swap dealer or major swap participant.

rule 39.26 *Composition of Governing Boards*. Subsection (b) of proposed rule 39.26 requires that at least 10% of the clearinghouse's board of directors be customer representatives (proposed rule 39.26(b)). In addition, the Commission has mandated other board composition requirements in proposed rule 40.9. Proposed rule 40.9(b) requires that the board of directors must be composed of at least 35%, but not less than two, public members.

The SDMA believes that these composition requirements are not burdensome and strike a good balance between independent directors, clearinghouse members and customers. These requirements properly diversify the composition of the board of directors, promote broader participation in governance, and encourage diverse perspectives. The SDMA believes that the composition requirements mandated by the Core Principal Q and proposed rules 39.26 and 40.9 will help to reduce the potential for conflicts of interest. Therefore, the SDMA respectfully recommends that the Commission adopt proposed rules 39.26 and 40.9 as drafted.

C. Governance Fitness Standards

Governance fitness requirements also play an important role in mitigating conflicts of interest. Fitness standards for board members (and other governing committees) help to assure the integrity and independence of an individual to properly fulfill their fiduciary responsibilities. In addition, governance fitness standards should also encourage independent and transparent governance. The framework for governance fitness requirements are established by Core Principle O and proposed rules 39.24 *Governance and Fitness Standards* and 40.9.

Core Principle O mandates that each clearinghouse have transparent governance arrangements that (a) are in the public interest, and (b) "... permit the consideration of the views of owners and participants". In addition, Core Principle O requires that the clearinghouse must establish and enforce fitness standards for any (a) director, (b) disciplinary committee members, (c) clearinghouse members, (d) "... other individual or entity with direct access to the settlement or clearing activities ..." of the clearinghouse, and (e) party affiliated with an individual or entity that has direct access to settlement or clearing activities.

Proposed rule 39.24 addresses governance fitness standard in two respects. First, proposed rule 39.24(a) mandates transparency of the governance process. This rule requires that each clearinghouse

make the description of "... the manner in which its governance arrangements permit the consideration of the views of its owners, whether voting or non-voting, and its participants, including, without limitation, clearing members and customers" available to the public. Second, proposed rule 39.24(b) provides that the clearinghouse must specify and enforce fitness standards for (a) members and affiliates, (b) persons with direct access to settlement and clearing activities, (c) persons that own 10% or more of any on class of equity and (d) their affiliates.

In addition, proposed rule 40.9(d) promotes transparency of clearinghouse governance by requiring that clearinghouses make all of the following items available to the public: (a) the clearinghouse charter, (b) the charter of the board of directors and each committee with the ability to amend or constrain the actions of the board, (c) the nominating process for the board of directors, (d) the names of the members of the board of directors and each committee with the ability to amend or constrain the actions of the board, (e) the names of all of the public directors, (f) the lines of responsibility and accountability for each operational unit of the clearinghouse, and (g) summaries of significant decisions implicating the public interest.

These governance fitness standards are important for a number of reasons. First, they mandate transparency. Transparency ensures that the governance process is followed and that decisions are made only by those authorized to do so. Second, they give clearing members and market participants the right to know about and the ability to participate in decisions that affect them. Third, fitness standards ensure the impendence of the board members. These governance fitness standards are necessary to prevent self-interested parties from exerting undue influence.

The SDMA strongly believes that governance fitness standards are needed to promote independent and transparent governance, and it supports the standards established by proposed rules 39.24 and 40.9. Therefore, the SDMA respectfully suggests that the Commission adopt proposed rule 39.24 and 40.9 as drafted.

D. Customer Eligibility For Clearing Services

The need to stifle competition in order to increase profits may also manifest conflicts of interest regarding customer eligibility for clearing services. To enhance profits, members of the trading desk may seek to influence the decision of the clearing unit with respect to its decision to accept a particular customer for

clearing services, or compel the linkage of execution and clearing services. The execution desk's undue influence over the clearing unit may also adversely affect the clearing unit's decisions regarding margin levels and risk limits. As a result, clearing services may not be provided on an equal basis to all customers.

The SDMA believes that the Commission has correctly addressed this issue in proposed rule 39.12(b)(3) which requires that clearinghouses provide for non-discriminatory clearing of swaps and proposed rules 1.71(d) and 23.605(d), which implement the separation of clearing and execution services. These rules enable clearing units to evaluate customer eligibility for clearing services based upon objective standards, and not based upon pressure from by the execution desk. As a result, the clearing units will offer clearing services to eligible customers on a non-discriminatory and "execution blind" basis. Publicly available, uniform and objective standards for acceptance of clients across all customer groups into clearing, and fee structures not tied to execution, will greatly increase the odds of central clearing being a success. Therefore, the SDMA respectfully suggests that the Commission adopt proposed rule 39.12(b)(3) as drafted.

E. Product Eligibility For Clearing

A fourth area where conflict of interest may arise is in the clearinghouse's determination of what products should be eligible for clearing. An independent clearinghouse acting in its own economic self-interest would want to increase their profits by clearing as many products as possible. However, this is not be possible if the clearinghouses are controlled by self-interested parties acting for their own benefit in determining what products are eligible for clearing.

Nearly all credit default swaps ("CDS") and interest rate swaps ("IRS") are eligible for clearing. Most CDS have well defined economic terms, legal documentation, market definition and trade protocols. SDMA members who are daily participants in this market estimate that at least 80% of CDS trades are standardized and ready to be cleared. Approximately half of these are index products, and half are standard single name CDS swaps that make up the indices. All index and single name constituents are liquid, easily priced and should be centrally cleared. Arbitrarily making CDS names ineligible from clearing could adversely affect liquidity and distort the market by affecting the bid ask spread.

In addition, a large majority of interest rate swaps are eligible for clearing. IRS are extremely liquid instruments focused over a finite set of maturity points along a single curve. IRS instruments possess well defined economic terms, legal documentation, market definitions and trade protocols.

Despite the fact that CDS and IRS are ready to be cleared today, some clearinghouses suggest using volume thresholds and grandfathering to determine whether products are eligible for clearing. They argue that volume thresholds are an appropriate measure in determining product eligibility because volume creates price transparency serving two purposes: (a) it provides more accurate information for better risk management, and (b) the ability to price positions for clearing. However, this argument -- that only high volume products can be priced -- is a red herring. Prices in the credit markets are a not based upon volume. Prices are a function of the yield curves[3] and perceived and actual fluctuations in credit ratings. Grandfathering is used as a method of blocking existing swaps from eligibility for clearing. Under grandfathering the clearinghouse would determine only new trades as being eligible for clearing and seek to exempt the clearing of existing swaps.

The Dodd Frank Act correctly recognizes the potential for conflicts of interest created by allowing self-interested parties to determine product eligibility for clearing and addressed this issue in Core Principle C *Participant and Product Eligibility*. Core Principle C requires that each clearinghouse will have "... appropriate standards for determining the eligibility of agreements, contracts, or transactions submitted to [the clearinghouse] for clearing." The Commission has outlined an objective, comprehensive approach to determining product eligibility in proposed rule 39.12(b)(1).

Proposed rule 39.12(b)(1) requires that the clearinghouse have appropriate standards for determining product eligibility for clearing that consider the clearinghouse's ability to manage the risks associated with clearing those products. In addition, proposed rule 39.12(b)(1) provides a list of factors the clearinghouse should consider in determining product eligibility. These factors are: (a) trading volume, (b) liquidity, (c) market participants ability to use portfolio compression, (d) the clearinghouse's and clearing members' ability to access the relevant market to create and liquidate positions, and (e) the operational capacity of the clearinghouse to address any unique risk characteristics of the product.

[3] A yield curve is a line that plots, at set points in time, the relationship between the interest rate and the time to maturity of a debt for a borrower in a particular currency.

The SDMA believes that there should be objective, publically available standards for determining product eligibility for clearing. The SDMA believes that the Commission has correctly addressed this issue in section 39.12(b)(1) requiring clearinghouses to adopt product eligibility standards which consider clear and objective criteria relevant to the clearing of transactions. Therefore, the SDMA respectfully suggests that the Commission adopt proposed rule 39.12(b)(1) as drafted.

F. Clearing Workflow

Conflicts of interest also manifest themselves through the asymmetrical workflows that currently exist in the clearinghouses that clear swaps. These clearinghouses may be utilizing workflows designed to protect the profits of self-interested parties by favoring a particular type of trade execution process or forcing indirect access to clearing.

The current workflow at these clearinghouses for clearing swaps transactions has many steps. Upon trade execution the dealer submits the trade to the customer via an electronic affirmation platform for the customer to affirm or reject. If the customer affirms the trade, the dealer will submit the trade to the clearinghouse for clearing. Once the clearinghouse receives the trade it will determine whether to accept it for clearing. Last, the clearinghouse notifies the parties whether or not the trade has been accepted for clearing. This workflow currently takes anywhere from four hours to one week to complete.

There are a number of problems with this workflow. First, by inserting additional unnecessary steps into the clearing process, there is a slower, inefficient clearing process that impedes liquidity and increases risk. Once the trade is executed it should be immediately sent to the clearinghouse. Instead the trade is only sent for clearing after (a) dealer submits the trade to the customer for the customer to affirm or reject and (b) the customer affirms that trade. This affirmation process delays the submission of the trade for clearing by several hours. In addition, the trade counterparties still have to wait for notification from the clearinghouse to find out whether the trade will clear.

Second, this work flow forces indirect access to clearing. The customer is denied direct access to clearing, because the dealer submits the trades on their behalf creating a restriction on trade. In addition, the electronic affirmation system sits between the counterparties and the clearinghouse.

Indirect access to clearing is limiting and dangerous because it prevents trade anonymity, which greatly increases the risk of front-running orders. Additionally, it prevents competition since the dealers

control the customer's access to clearing. Finally, indirect access means that buy side firms cannot trade directly with each other, which reduces competition and increases execution costs.

The SDMA recommends that clearing workflow be efficient and symmetrical. At the time of execution the sell side and the buy side of the trade must be sent directly to the clearinghouse simultaneously regardless of whether the trade was executed on a request for quote or central limit order book platform. This allows for prompt and efficient clearing via straight through processing that does not require middleware to affirm a trade.

The Commission correctly recognizes the importance of workflows in achieving prompt and efficient clearing and has proposed a number of rules to address this issue. It is clearly written that a transaction executed on a SEF must be confirmed upon execution (proposed rule 37.6(b) *Enforceability)*, and immediately accepted for clearing (proposed rule 39.12(b)(7)(ii)). Proposed rule 39.12(b)(4) mandates that clearinghouses shall not require that in order for the swap to clear one of the executing parties must be a clearing member. Proposed rule 23.506(a)(2) requires each SD and MSP to coordinate with the clearinghouse to facilitate prompt and efficient swap transaction processing in accordance with the requirements of 39.12(b)(7). Therefore, the SDMA supports proposed rules 37.6(b), 39.12(b)(7)(ii), 39.12(b)(4), 23.506(a)(2) and respectfully suggests the Commission adopt the rules as drafted.

G. Clearing Documentation Requirements

Lastly, conflicts of interest manifest themselves through give up documentation used to limit competition in execution and clearing services. These "tripartite" or "trilateral" agreements are nothing but a bilateral wolf in the proverbial sheep's clothing and they unreasonably restrict trading and competition. In the bilateral world one counterparty to the trade is the self-clearing dealer, providing both trading and clearing services, and the other counterparty is typically a customer. In the trilateral world the parties to the agreement are (1) the dealer's trading desk, (2) the dealer's clearing member and (3) the customer. These trilateral agreements assume that one side of every trade is a dealer, and, if the trade does not clear permits the dealer to determine, on its own, any breakage amount. This documentation does not permit anonymous trading or symmetrical workflows. In addition, these documents (a) restrict customer choice of execution venue (as they are designed for request for quote venues and do not allow for execution on a central limit order book), (b) seek to supersede the rules of execution venues, and (c) negate trade anonymity.

The SDMA strongly believes that if a give-up agreement is used in the post Dodd Frank swap market it should have similar give up documents that have been successfully used in other markets. Specifically, these give up agreements should only be used to decide the rights and obligations between the: (1) executing broker and the customer; (2) clearing member and the execution broker; and (3) clearing member and the customer. The SDMA respectfully suggests that the Commission amend proposed rule 39.12 to prohibit any documentation that attempts to supersede SEF or clearinghouse rules.

IV. Prohibition of Conflicts of Interest is Essential to Open Access to Clearing

The Dodd Frank Act correctly recognizes that open access to clearing requires that clearinghouses and clearing members be independent. Creating an environment that enables clearinghouses and clearing members to be independent has two components. First, the clearinghouse must have a governance structure that is autonomous and transparent. Second, the clearing members should not be subject to interference or undue influence from the trading units of their firm.

As discussed above, the Commission has proposed a number of rules to regarding the independence and transparency of clearinghouse governance. The proposed rules that implement the mandate the separation of trading and clearing complement the rules regarding clearinghouse governance by ensuring the independence of its clearing members.

Proposed rules 1.17(d) and 23.605(d) provide clear standards for preventing conflicts of interest between the trading and clearing units of a firm. These rules mandate that the FCM, IB, SD and MSP establish and maintain a firewall between their trading and clearing units through the use of informational partitions. In addition, these rules mandate that FCM, SD and MSP shall not "directly or indirectly interfere with or attempt to influence" the personnel of their clearing unit (proposed rule 1.71(b)) and or affiliated clearing member (proposed rule 23.605(d)) with respect to six key decisions. Specifically, these decision points are: (1) what clearing services and activities will be offered to customers; (2) who will be accepted as a customer; (3) which clearinghouse will clear a particular transaction or group of transactions; (4) determining customer risk limits; (5) determining acceptable forms of collateral; and (6) determining fees for clearing services. In addition, proposed rule 23.605(e) requires SDs and MSPs to establish written policies that require the disclosure of any material incentives

or conflicts of interest to their counterparties regarding that counterparty's decision where to execute and clear their transactions. These rules correctly address the key areas where conflicts arise.

Clearing members play an essential role in the operation and governance of the clearinghouse. Independence of clearing members ensure that both (a) the clearinghouse adopts appropriate standards for membership eligibility standards, governance, customer eligibility, product eligibility, workflow and documentation; and (b) clearing members accept customers, provide clearing services, submit transactions, set risk limits, determine acceptable forms of collateral and set fees in a manner that promotes open access to clearing.

V. Conclusion

Proposed rules 1.71 and 23.605 are among the most important rules issued by the Commission, because they provide standards to ensure the independence of the clearing units of FCMs, IBs, SDs and MSP. Independence of clearing members is essential to the Dodd Frank Act's goal to provide nondiscriminatory, open access to clearing.

The SDMA supports proposed rules 1.71 *Implementation of Conflicts of Interest Policies and Procedures by Futures Commission Merchants and Introducing Brokers* and 23.605 *Implementation of Conflicts of Interest Policies and Procedures* because they ensure the independence of clearing members, which is essential to nondiscriminatory, open access to clearing. Therefore, the SDMA respectfully suggests that the Commission adopt proposed rules 1.71 and 23.605 as drafted and not make any revisions that dilute their effectiveness.

Sincerely,

James Cawley
The Swaps & Derivatives Market Association
(646) 588-2011

ADDENDUM 2

SDMA SWAPS & DERIVATIVES MARKET ASSOCIATION

June 3rd, 2011

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

Elizabeth Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: OTC Derivative Market Integrity & Real-time Trade Processing Requirements for Processing, Clearing, and Transfer of Customer Positions 17 CFR Parts 23, 37, 38 and 39, RIN 3038-AC98; Clearing Agency Standards for Operation and Governance 17 CFR Part 240, RIN 3235-AL 13

Dear Mr. Stawick and Ms. Murphy:

The Swaps & Derivatives Market Association ("SDMA") appreciates the opportunity to provide comments to the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") (CFTC and SEC collectively the "Commissions") on the CFTC's Notice of Proposed Rulemaking regarding Parts 23, 37, 38 and 39 of Title 17 of the Code of Federal Regulation ("CFR 17") entitled "Requirements for Processing, Clearing, and Transfer of Customer Positions" and the SEC's Notice of Proposed Rulemaking regarding Part 240 of Title 17 CFR entitled "Clearing Agency Standards for Operation and Governance". This letter supersedes an earlier submission dated April 19th 2011.

The SDMA is a non-profit financial trade group formed in 2010 to support the goals of the Dodd Frank Act. It believes that systematic risk of OTC derivatives can be mitigated through their regulation, the creation of central clearing, and by ensuring open and transparent access to ensure greater competition, lower transaction costs and greater liquidity. The SDMA is comprised of many US and internationally based broker-dealers, investment banks, futures commission merchants and asset managers participating in all segments of the exchange-traded and over-the-counter derivatives and securities markets.

Introduction

Immediate acceptance of OTC swaps trades into clearing is critical to accomplishing the goals of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank Act") to: (1) reduce systemic risk, (2) increase trade integrity and (3) promote market stability.[1] Settlement uncertainty, caused by time delays between the point of *trade execution* and the point of *trade acceptance into clearing* could destroy confidence in the cleared OTC derivatives markets. As the CFTC has correctly asserted, such a time delay or "trade latency", (which in the bilateral swaps markets can be as long as a week) directly constrains liquidity, financial certainty and increases risk.[2]

The SDMA supports current proposed CFTC rules that seek to strengthen the financial integrity of the cleared swap markets by addressing the aforementioned trade latency issue by imposing certain uniform standards for prompt processing, submission and trade acceptance into clearing. Specifically, the SDMA strongly believes that the Commissions in their entirety adopt proposed CFTC Rule 39.12 (B) (7) that requires that Derivatives Clearing Organizations (DCOs) accept for clearing 1) all eligible swaps trades transacted on Swap Execution Facilities ("SEFs") *immediately upon execution* and; 2) all eligible swaps trades transacted off SEFs *immediately upon trade submission*. Importantly, the SDMA respectfully requests that the Commissions properly clarify Rule 39.12 (B) (7) consistent with their original intent of ensuring market adoption of "perfect Settlement."

Perfect Settlement, DCO and Clearing Member Compliance

The SDMA agrees with CFTC proposal 39.12 (B) (7) that asserts that the issue of time delay be removed from the trade settlement process by mandating that DCOs require their constituent clearing members to comply with the doctrine of "perfect settlement." With perfect settlement, DCOs mitigate trade latency by requiring that their constituent clearing members guarantee all their customer trades at time of execution. It is well established market practice in certain other cleared derivatives markets that the trade is assumed to be accepted into clearing *immediately upon execution*.

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[1] Throughout this letter all references to "swaps" refers to both swaps and security-based swaps that are required to be cleared by Sections 723 and 763, respectively, of the Dodd Frank Act.
[2] Page 13101. (*Federal Register*, Volume 76, No. 47, 3/10/11).

That is to say, the trade is both executed and simultaneously accepted into clearing unless the clearing member has given prior notice to the execution venue or SEF to prevent such a trade from occurring. Trade integrity is assured and settlement risk mitigated because the trade counterparty can look to the customer's FCM or clearing member to be made whole if that defaulting customer cannot pay.

Perfect settlement works well in many cleared derivatives markets globally currently. Some of these markets, such as the CME Eurodollar or CBOT Treasury futures markets, are the largest and most liquid in the world. In these high volume markets, clearing members properly protect themselves by strictly and proactively enforcing customer margin and trading parameters. Clearing members routinely restrict customer trading at execution venues where appropriate. As a consequence, trade integrity is achieved as these markets flow smoothly.

It is functionally proper and appropriate that clearing members have the ability to restrict its customer's trading with regard to prudent risk management, but it is likewise well established and appropriate that clearing members bare the burden of guaranteeing their customer's trades for the following reasons. First, clearing members are the entities best positioned in the trade workflow to monitor a market participant's ability to pay for its trade. Because clearing members administer the customer account, they can easily access this information to assess customer margin and spending power in real time.

Second, the clearing broker is the central *nexus* where all trades, executed across multiple SEF's or execution venues, ultimately intersect. The clearing member is best positioned to proactively monitor such trades flowing in from multiple execution venues and thus quantify its risk to the customer in the aggregate at the respective DCO. By contrast, it is functionally impossible for SEFs, DCM's and bilateral trading environments to link with each other to monitor customer activity across the market and thus their only option is to rely upon DCO connectivity to its constituent clearing members for customer margin visibility and spending power.

Third, the clearing member is in the best position to protect itself. If the clearing member believes itself to be exposed to a customer, it can simply notice the customer, its execution broker and SEF community to restrict the customer's trading real time in advance of a problem. Moreover, clearing members are incented to work with SEFs and execution brokers in such matters as ticket "clipsize" and daily trading notional limitations to protect themselves.

Fourth—because the clearing member charges customers for it's services, they can appropriately require higher fees and margin to reflect higher risk candidates.

Finally, the clearing member is optimally positioned to require additional funds or liquidate a customer position in order to cover any breakage amounts or cover any expenses it may have incurred from a customer trade problem.

Through these proactive actions, the clearing member not only protects itself but, by extension, the execution venue, the customer and the market as a whole.

Commission's Intent of Perfect Settlement with Rule 39.12 (B)

That the CFTC reasonably contemplated perfect settlement with Rules 39.12 (B) (6 & 7) is clear. In Rule 39.12 (B) (7) entitled *Time Frame for clearing,* the CFTC states that to facilitate prompt and efficient processing of transactions on SEFs and DCMs, the DCO "*will accept for clearing, immediately upon execution,* all contracts, agreements, and transactions..." (Emphasis added, FR Rule 39.12 (B) (7) (ii)). Likewise for transactions that occur off SEF's and DCM's, the DCO "will *accept for clearing, immediately upon submission*, all contracts, agreements, and transactions..." (Emphasis added, FR Rule 39.12 (B) (7) (ii)).

Under Rule 39.12 (B) (6), the CFTC properly clarifies the meaning of "accept for clearing." Acceptance into clearing does not mean that the DCO merely acknowledges the receipt of the trade in order for the clearing member to ultimately accept or reject the trade after execution, but rather acceptance into clearing means the following according to the CFTC:

(i) "The original swap is extinguished;

(ii) The original swap is replaced by equal and opposite swaps between clearing members and the derivatives clearing organization;

(iii) All terms of the cleared swap must conform to templates established under the derivatives clearing organization; and

(iv) If a swap is cleared by a clearing member on behalf of a customer, all the terms of the swap, as carried in the customers account on the books of the clearing member, must conform to the terms of the cleared swap

established under the derivatives clearing organization's rules." (FR Rule 39.12 (B) (6)).

Under Rule 39.12 (B) (7), the CFTC properly asserts the doctrine of perfect settlement by explicitly stating that trades clear "immediately upon execution." As the rule is written, the CFTC requires that acceptance by the DCO and its clearing member is *automatic* upon execution. Therefore trade "acceptance" is *equal* to trade "execution". Moreover, it logically follows that the *opposite* is also true. That is, the only way to prevent the trade from being accepted into clearing (i.e. trade rejection) is to prevent the trade from being executed in the first place. Logically only cleared trades can exist. Again, this is consistent with the concept of perfect settlement in other successfully cleared derivatives markets. As the CFTC intends, the DCO and its clearing member must notice the execution venue or SEF to prevent the unsafe customer from executing a rejected trade.

Perfect Settlement: Swap Dealers, DCM and Clearing Member Compliance with CFTC & SEC intent

The CFTC rightfully requires that Swap Dealers, SEFs and DCMs also comply with their doctrine of perfect settlement. The SDMA respectfully asks that the Commissions adopt in their entirety proposed CFTC Rules 23.506, (SDs) 37.702 (SEFs) and 38.601 (DCMs) which require that these entities have the operational capacity to route transactions to DCOs in a real time and that these entities coordinate with DCOs in the "development of rules and procedures to facilitate prompt transaction processing in accordance with Section 39.12 (B) (7)." (FR Rule 23.506, FR Rule 37.702, FR Rule 38.601).

Importantly, the SDMA respectfully requests that the Commissions clarify their rule that requires constituent clearing members or FCMs of DCOs comply with the doctrine of perfect settlement as required of the DCO itself. The SDMA supports CFTC Rule 39.12 (3) and requests that the Commissions adopt it with regard to the requirement that clearing members are required "to have adequate operational capacity to meet obligations arising from participation in the derivatives clearing organization...[that] shall include...the ability to process...transactions cleared within required time frames" but, the SDMA requests, *in strict accordance with Section 39.12 (B) (7) and the doctrine of perfect settlement.*

Perfect Settlement: SEF Compliance with CFTC & SEC intent

SEFs and other execution venues should also comply with the Commission's requirement of perfect settlement. The construct of perfect settlement is also consistent with the Commission rules for SEF's. The SDMA requests that the Commissions adopt CFTC Rule 37.6 (B) in it's entirety with regard to *enforceability*. In such a rule, the CFTC appropriately requires that the "confirmation of all the terms of the transaction shall take place at the same time as execution." (FR Rule 37.6 (B)). Thus, the SDMA supports the CFTC rules that require that OTC derivative trades are both confirmed and accepted into clearing at time of execution.

By contrast it is important to note that SEC proposed rules 242.815 "Financial Integrity of Transactions" and 240.17Ad-22(d) (12) "Standards for Clearing Agencies" fail to provide clear standards for real time trade processing. Proposed rule 242.815 merely provides that security-based swap execution facilities will establish rules to ensure the financial integrity of transactions, and proposed rule 240.17Ad-22(d)(12), provides that a clearinghouse may "... require that intraday or real-time finality be provided where necessary to reduce risks".

The SDMA believes that these SEC rules fail to create a clear standard and, therefore, do not provide a workable framework for cleared swaps trade processing and clearing.

The SDMA respectfully recommends the SEC adopt rules equal to CFTC Rule 37.6(b) and CFTC Rule 39.12 (B) (7) which mandates that SEF traded swaps are immediately confirmed and accepted for clearing upon execution consistent with the doctrine of perfect settlement.

Perfect settlement is also consistent with CFTC SEF Core Principle 7—*Financial Integrity of Transactions.*[3] Such a Core Principle requires that the SEF "establish and enforce rules and procedures for ensuring the financial integrity of swaps...including the clearance and settlement of swaps pursuant to Section 2 (h) (1) of the Act." (FR Rule 37.700). Such a requirement is wholly consistent with the notion that trade rejection is optimally minimized through perfect settlement whereby clearing members guarantee customer trades at point of execution. Likewise, under this Core Principle, the SEF should work with DCOs and their constituent clearing members to ensure that communication systems are in place such that DCO clearing members can notice the SEF of a customer's execution restriction.

[3] All references to "CFTC Core Principles" refer to the core principles for swap execution facilities set forth in section 733 of the Dodd Frank Act, which amends the Commodity Exchange Act to include a new section 5h entitled "Swap Execution Facilities".

Importantly, SEFs cannot practically establish and maintain the financial integrity of transactions without the trade certainty that results from perfect settlement.

Indeed, without perfect settlement where trades are accepted in real time, SEFs will find it difficult to comply with other Core Principles that have a real-time component.

Specifically, SEC and CFTC Core Principle 4--*Monitoring of Trading and Trade Processing* require SEFs to conduct real-time monitoring of trading.[4] Clearly, there can be no real-time monitoring of trading, unless trades occur in real-time. Trades do not occur in real-time if there is a delay between execution and clearing.

SEC Core Principle 8--*Timely Publication of Trading Information* and CFTC Core Principle 9 -- *Timely Publication of Trading Information*, require that SEFs report transaction data on timely basis. The current standard for the transmission of transaction data in other markets is real-time. Without mandated immediate acceptance of cleared swaps upon execution there would be a significant delay between the time of trade execution and clearing of swaps that will adversely impact price transparency, and the SEFs' ability to comply with the core principles related to timely publication of trading information.

Perfect settlement of cleared swaps is also essential to the creation of an accurate, comprehensive audit trail, which is fundamental to SEFs' ability to comply with all the core principles that have an audit trial component. These core principles are: (a) SEC Core Principle 3--*Security-Based Swaps not Readily Susceptible to Manipulation* and CFTC Core Principle 3--*Swaps not Readily Susceptible to Manipulation*, (b) SEC and CFTC Core Principle 5 --*Ability to Obtain Information*, (c) CFTC Core Principle 6--*Position Limits or Accountability*; and (d) SEC Core Principle 9--*Recordkeeping and Reporting* and CFTC Core Principle 10 --*Recordkeeping and Reporting*. Without perfect settlement where trades are accepted into clearing immediately at point of execution, the delay between trade execution and clearing will impede the SEFs ability to maintain an accurate audit trail. This will adversely impact the SEFs' ability to analyze audit trail information to monitor position limits and detect susceptibility to market manipulation.

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[4] All references to "SEC Core Principles" refer to the core principles for security-based swap execution facilities set forth in section 763 of the Dodd Frank Act, which amends the Securities Exchange of 1934 to include a new section 3D entitled "Security-Based Swap Execution Facilities".

Lastly, SEFs would not be able to comply with SEC and CFTC Core Principle 1 "Compliance with Core Principles", which requires that the SEFs comply with all of the core principles, and SEC and CFTC Core Principle 2 "Compliance with Rules", that requires SEFs to establish and enforce rules that include, without limitation, trading and trade processing.

Perfect Settlement: Trade Allocations or "Bunched" Trades

The SDMA respectfully requests that the Commissions adopt 39.12 (B) and its clarified doctrine of perfect settlement to include "bunched" trades or trades allocated after the point of execution.

As empirically evident from other cleared markets, it is well established that the doctrine of perfect settlement works quite well for trade allocations or "bunched" trades. The CFTC correctly notes that "for futures traded on a DCM, rules and procedures are in place under which bunched orders are accepted for clearing *immediately upon execution*, with allocation to individual customer accounts occurring before the end of the day" (emphasis added, *Federal Register*. p. 13106).

Similar to the futures markets, swaps customers or asset managers that execute on behalf of multiple legal entities at one time in a "bunched" trade can do so via *omnibus* accounts issued by their clearing member.

The process for swaps trade allocation should be similar to that of the futures markets. First, the customer executes the master swaps trade using such an omnibus account. Second, the clearing member and the DCO accept the master trade into clearing at the time of execution. The DCO and its constituent clearing member does this with the knowledge that the customer will later allocate the master trade later in the day, thus meeting it's obligation under Rule 39, 39.12 (B) (7) clarified for the doctrine of perfect settlement. Third, before 7pm the same trading day, the customer notifies it's clearing member directly of the breakout sub accounts into which the master swaps trade is allocated. If there is a residual amount that has not been paid for, the customer and its clearing member have a previously negotiated solution. For example, common solutions from the listed derivatives markets include the customer absorbing the ticket into one of the other functioning accounts or the clearing member extending temporary credit to cover any temporary shortfall.

Perfect settlement works well for all parties involved in the bunched trade workflow. Asset manager customers that routinely trade on behalf of multiple entities continue to enjoy the efficiencies

and transaction savings that a trade of large size can achieve. Operationally they are easier for the customer because they are not forced to do a pre-trade allocation, but instead have considerable time after trade clearing acceptance and execution to complete the allocation process. Because the allocation occurs directly at the clearing member, the execution venue or SEF is no longer necessary in, what is arguably, a secondary post trade process. Likewise, for a transaction that occurs off SEF or DCM, only the allocating party need concern itself with its own allocation.

In conclusion, the SDMA believes that the CFTC has appropriately set the correct standard with Rule 39.12 (B) (7) and it's doctrine of perfect settlement that efficiently removes the latency issue of time delay between point of execution and point of trade acceptance into clearing. It is this latency that, as the CFTC has correctly noticed directly constrains liquidity, financial certainty and increases risk. It is proper and prudent for the Commissions to require that the OTC swaps market comply with the regulators requirement for perfect settlement. As discussed, it works well in other cleared derivatives markets, it provides for smooth workflow with regard for bunched orders and it provides the framework for execution venues such as SEFs to properly meet their obligation with Core Principles for financial integrity, real time reporting, audit and enforcement.

The SDMA respectfully requests that the Commissions adopt such rule sets and clarify (where necessary) to ensure that DCOs and their constituent clearing members conform to such rules by adopting perfect settlement as the standard for the newly cleared OTC swaps markets.

Allowing Time Delay in the Workflow: Lesser Solutions to Perfect Settlement

There are two proposed alternatives to perfect settlement that attempt to address the trade latency issue. Discussed below they are 1) the *Low Latency Solution* and 2) the *High Latency Solution*. Both are inferior to perfect settlement, though the High Latency solution is considerably worse that the Low Latency alternative. They are similar in premise because they both allow a time delay to exist between point of trade execution and point of trade acceptance into clearing; they just differ on how to manage it.

Specifically both alternatives reject proposed CFTC Rule 39.12 (B) (7) that requires that a trade is accepted into clearing immediately upon execution. Instead they both require that a trade, *after execution*, be affirmatively approved by: (1) clearing member of the buyer; (2) the clearing member of

the seller and then lastly; and (3) the DCO before it is accepted into clearing. In essence, the clearing member and DCO must have negotiated a 'last look' option whereby they can reject the trade.

This is an issue, because if the counterparty has its trade rejected due to another's margin insufficiency, the trade may be broken and the non-violating counterparty may suffer economic loss. It must re enter the market to re execute the same trade, albeit with a new functioning counterparty. If a trade is rejected hours after the trade has been executed, as could be the case with certain current DCO candidate workflows, then the non violating counterparty could face significant economic loss or 'breakage.'

Option 1: The Low Latency Solution

The Low Latency solution recognizes that while breaking a rejected trade is suboptimal, it is acceptable if certain conditions are met. The associated economic loss suffered can be minimal if "no trade" is coupled with near immediate notification of trade rejection to the two trade counterparties. If the parties are notified in seconds, economic loss is minimized as it is assumed that the market may have moved little. Thus "breakage" and the cost of executing a new trade to replace the rejected trade is minimized. "Good" trade counterparties can re-enter the market quickly to execute new trades with solvent counterparties that are accepted into clearing. In contrast, "bad" trade counterparties are restricted by both the SEF and their clearing firm from executing further trades.

In certain markets, (e.g. Clearport), such a solution is in place and is considered acceptable because trade rejections rarely occur in market practice.

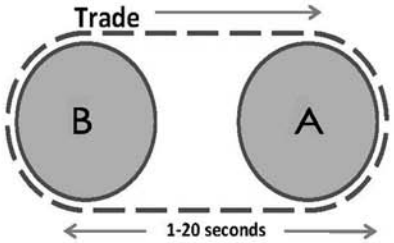

Figure 1.

As seen in above *Figure 1*, where the Low Latency workflow is expressed as a production line conveyor belt, the Commissions would need to ensure that Trade Acceptance ("A") be brought as close as technologically possible to Trade Execution ("E"). It would have to be seconds, to ensure its success.

For this Low Latency model to work, regulators would have to mandate that execution venues (SEFs & DCMs), DCM's work together. As recent industry conflict on this matter has evidenced, that the market, with it's various competing interests and execution models, would somehow voluntarily come together to ensure the success of the Low Latency alternative is an impractical and optimistic expectation.

Importantly, the Commissions should recognize that SEF Core Principle 7 and DCM Core Principle 11 (both entitled *Financial Integrity of Transactions*) may be vague and do not go far enough to ensure that the various competing interests of incumbent dealers, independent FCM's, independent dealers, DCOs, their clearing members & SEFs come together on this matter.

Consequently, to ensure trade integrity under this solution, the Commissions would need to explicitly and prescriptively require that all execution venues (SEFs, DCMs), DCOs and their constituent clearing members (1) utilize current and available technology, and (2) adopt symmetrical post trade workflow to ensure near immediate notice of trade confirmation or rejection.

Importantly, the Commissions would have to mandate that (1) all SEFs deliver both sides of the trade simultaneously directly to the DCO in seconds or milliseconds; (2) all DCOs respond directly in seconds or milliseconds with the trade acceptance or rejection likewise in seconds back to the SEF, such that the SEF could in turn notify the counterparties; and (3) all DCOs establish standards and technological requirements that ensure all clearing members also comply with near immediate trade acceptance/rejection notices in seconds. (See attached Exhibit A entitled *Symmetrical Workflow Diagram*).

Such a requirement would not be unduly burdensome to the market; the SDMA recommends that a phased in approach could be deployed by the Commissions. The market could initially comply with a trade notice in seconds and then graduate to trade notice communication in milliseconds to ensure that customers are protected.

Improving Option 1: The Low Latency Solution with the Pre Trade Margin Check

To further mitigate settlement risk in the Low Latency Option, the Commissions would need to compel the market to adopt a pre-trade customer margin check.

The SEF & DCM could institute such a pre-trade margin check to protect the market from a customer who either *knowingly* or *unknowingly* violates its own margin parameters by initiating a trade that ultimately would be rejected. (See No. 4, Exhibit A attached).

Specifically, the Commissions could compel all clearing members be required to share customer margin information with their DCO who in turn could share it with SEFs or DCMs on a near real-time basis. SEFs, which operate in a neutral agency capacity for the customer, could transmit such information back to the customer so that it does not unknowingly breach its own trading parameters within the DCO. Importantly, through such workflow, customer anonymity would be preserved as customers would see only their own margin information.

To further protect the market from a rejected trade, the SEF could further impose it's own pre trade trading limit with guidance from the DCO and its clearing member to ensure that the customer would not knowingly exceed its own limit and attempt to place a trade order that would certainly result in a trade rejection.

To act as a deterrent, SEFs and DCOs could utilize their authority granted them by the Commissions to impose sanctions and fines on customers who knowingly breach their limits. At a higher level, regulators could also impose fines or take more punitive action on such customers.

It is important to note, that the technology, workflow and connectivity needed to support such a pre-trade margin system exists today and is being deployed and utilized by certain DCOs and SEF execution venues. Such technology uses current connectivity that exists between (1) the DCO and its constituent clearing members, and (2) existing connectivity that exists between the DCO and the execution venue.

Option 2: The High Latency Solution

The second alternative, advocated by certain incumbent dealers, is the High Latency Solution. Unlike Perfect Settlement which removes time delay from the workflow completely and Low Latency that tolerates small time delays in the workflow, the High Latency alternative not only tolerates time delay

but argues that even long time delays (spanning hours or an entire trading day) between point of execution and point of acceptance into clearing are perfectly acceptable.

The High Latency alternative works as follows: (1) the customer executes a trade with a dealer who then submits the trade to the DCO for clearing on behalf of both parties; (2) before the dealer sends the trade to the DCO, however, both parties are given an open time period in which to "confirm" the trade; and (3) once the trade is 'confirmed' it is sent to the DCO, where both the dealer's clearing member and the customer's clearing member then are given another time window in which to accept or reject the trade. These time windows can be hours and can even role into the next trading day. Lastly, In certain DCO workflows proposed, the clearing member is then required to post funds to the DCO. Only then is the trade accepted.

If the trade is rejected, the violating counterparty has the option to submit the trade to a secondary clearing member of the DCO. Again, this action takes more time. If that fails, the parties can agree to "fall back" to an ISDA bilateral agreement between the parties. If the parties do not have an ISDA, the trade can finally be broken and breakage is calculated in accordance with the 2002 ISDA agreement.

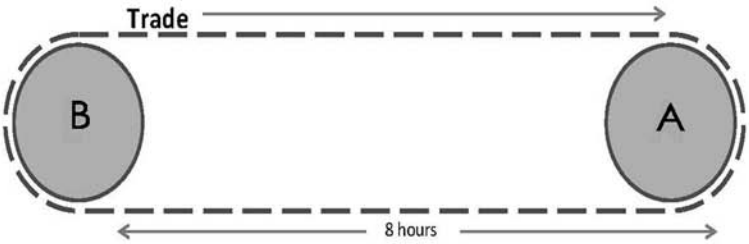

Figure 2.

As illustrated in above *Figure 2*, where the High Latency workflow is expressed as a production line conveyor belt, the proponents of the High Latency model have sought to introduce several steps to stretch out the distance (or time) between Trade Acceptance ("A") and Trade Execution ("E") to as long as 8 hours or even the next trading day.

Some of its proponents accept that the High Latency solution may suffer from certain limitations. To that end, they have suggested a corollary addendum or "Tripartite" solution. The tripartite solution offers a limited version of a pre trade credit check.

Still under discussion, before some incumbents advocate it as a market standard, such a pre-trade credit check would work as follows: (1) the clearing member would set a trading limit on its customer; (2) with the customer's permission, the credit limit would be shared with dealers; (3) the dealer would then check the customer's credit before the trade has occurred and thus no trade would be executed that would likely be rejected; and (4) to avoid two dealers from using up the same credit limit at the same time (and thus having one of their trades being rejected), the customer would have to take its gross credit limit and break it out into sub amounts with each of its dealer counterparties.

The High Latency Solution: Restrictions on Trade

Such a tripartite solution limits customer choice and restricts trade. First, because the per dealer limit decreases with the more dealers you add to the system, it practically limits the number of dealers with whom a customer can trade to no more than a handful. What happens if the customer seeks to trade with 10, 20 or even 30 dealers? With customer choice of dealer counterparty significantly restricted, the market suffers as new dealers cannot enter and compete with incumbents to drive costs lower, increase liquidity and transparency.

Second, such a tripartite solution removes trade anonymity, long held to be a huge benefit of cleared markets, because the customer must now be known to the dealer before the trade.

Third, conflicts of interest now manifest themselves because one principal to the trade -- the dealer –now conveniently, has material information on the other principal—the customer.

Fourth, functionally the tripartite solution restricts 'all to all' and anonymous central limit order book trading, long held to be another benefit to the swaps marketplace, to promote competition, increase transparency, market liquidity and lessen the systemic risk of the OTC derivative market.

Fifth, for the clearing broker to share customer information with its own dealer desk creates a conflict of interest that is expressly forbidden under Sections 731 and 764 of the Dodd Frank Act. These sections create information partitions within the dealer that strictly prohibit their clearing brokers from sharing customer information with their dealer desk counterparts.

Interestingly enough, the pre trading margin check offered under the Low latency solution, (discussed in an earlier section), does not suffer from the same limitations. Because the pre trade check occurs at the neutral SEF or execution venue, there is no limitation on the number of dealers with which a customer can trade. Indeed, the pre trade check is execution method agnostic. Customers can continue to trade anonymously if they so choose, or on whatever platform they so desire. Likewise, there is no conflict of interest between the principals because the customer's credit information is never shared with anyone other than itself and the agent SEF or DCM.

In summary such a tripartite corollary should be seen by the Commissions for what it is—nothing more than a transparent attempt to thwart competition. Simply put, the SDMA believes that it is contrary to the express rules of the Commissions governing Swap Dealers and should be prohibited.

The High Latency Solution: Compliance Limitations for DCOs, SEFs and SDs

Broadly speaking, the SDMA strongly believes that such a High Latency solution suffers from severe limitations because it directly contravenes the express rule sets as promulgated by the Commissions, the Dodd Frank Act, and its specific intent envisaged it's the framers.

The High Latency workflow inserts considerable time delay and numerous linear contingent steps that increase latency and purposefully delay the trade from being accepted into clearing in a timely manner. It is contrary to the Commissions stated intent of "Trade Processing Requirements for Processing, Clearing..." 17 CFR Parts 23, 37, 38 and 39 in which the CFTC correctly asserts that any time delay or latency between the point of execution and the point of trade acceptance into clearing directly constrains liquidity, financial certainty and increases risk.[5]

Specifically, such a workflow violates CFTC Rule 39.12 (B) (7) and the doctrine of perfect settlement that requires that Derivatives Clearing Organizations (DCOs) accept for clearing (1) all eligible swaps trades transacted on Swap Execution Facilities ("SEFs") *immediately upon execution*; and (2) all eligible swaps trades transacted off SEFs *immediately upon trade submission*.

[5] Page 13101. (*Federal Register*, Volume 76, No. 47, 3/10/11).

Moreover, such a workflow inappropriately separates trade *execution* from trade *confirmation* to violate CFTC Rule 37.6 (B) that appropriately requires that the "confirmation of all the terms of the transaction shall take place at the same time as execution." (FR Rule 37.6 (B)).

The High Latency solution contravenes proposed CFTC Rules 23.506, (SDs) 37.702 (SEFs) and 38.601 (DCMs) which require that these entities have the operational capacity to route transactions to DCOs in a real time and that these entities coordinate with DCOs in the "development of rules and procedures to facilitate prompt transaction processing in accordance with Section 39.12 (B) (7)." (FR Rule 23.506, FR Rule 37.702, FR Rule 38.601).

With regard to SEF's, the High Latency solution is contrary to CFTC SEF Core Principle 7—*Financial Integrity of Transactions*. Such a Core Principle requires that the SEF "establish and enforce rules and procedures for ensuring the financial integrity of swaps...including the clearance and settlement of swaps pursuant to Section 2 (h) (1) of the Act." (FR Rule 37.700).

Importantly, the High Latency option would make it impossible for SEF's to comply with SEC and CFTC Core Principle 4--*Monitoring of Trading and Trade Processing that* requires SEFs to conduct real-time monitoring of trading. Clearly, there can be no real-time monitoring of trading, unless trades occur in real-time. Trades do not occur in real-time if there is a delay between execution and clearing.

Moreover, the High Latency option would equally make it difficult to comply with SEC Core Principle 8--*Timely Publication of Trading Information* and CFTC Core Principle 9 --*Timely Publication of Trading Information*. Both core principles require that SEFs report transaction data on timely basis. The current standard for the transmission of transaction data in other markets is real-time. Without mandated immediate acceptance of cleared swaps upon execution there would be a significant delay between the time of trade execution and clearing of swaps that will adversely impact price transparency, and the SEFs' ability to comply with the core principles related to timely publication of trading information.

The lack of real time trade acceptance in the High Latency alternative also limits the SEF's ability to comply with all the core principles that have an audit trial component. These core principles are: (a) SEC Core Principle 3--*Security-Based Swaps not Readily Susceptible to Manipulation* and CFTC Core Principle 3--*Swaps not Readily Susceptible to Manipulation*, (b) SEC and CFTC Core Principle 5 --*Ability to Obtain Information*, (c) CFTC Core Principle 6--*Position Limits or Accountability*; and (d) SEC Core Principle 9--*Recordkeeping and Reporting* and CFTC Core Principle 10 --*Recordkeeping and Reporting*.

Without perfect settlement where trades are accepted into clearing immediately at point of execution, the delay between trade execution and clearing will impede the SEFs ability to maintain an accurate audit trail. This will adversely impact the SEFs' ability to analyze audit trail information to monitor position limits and detect susceptibility to market manipulation.

Not only does the High Latency alternative run contrary to the Commissions' express rules regarding swaps trade settlement and trade integrity, but it also contravenes some of the most basic language of the Dodd Frank Act. The High Latency solution requires that a swaps trade, if rejected, may proceed unbroken by "falling back" to a bilateral, un-cleared trade governed by an ISDA swaps agreement. In this case, the Sections 723 and 763 of the Dodd Frank Act are clear. These sections provide that it is unlawful for any person to engage in a swap or security-based swap unless that person submits such swap or security based swap for clearing to a DCO, if the swap is required to be cleared.

The High Latency Solution: Operational Limitations

Further, the SDMA believes that certain practical limitations exist with regard to the High Latency workflow. Specifically, to force a trade into a bilateral state, which the parties had originally contemplated was to have been cleared, is to *materially* change the terms of the trade in the following ways. First, a bilateral trade has higher capital costs than a cleared trade. Second, a bilateral trade introduces counterparty credit risk that was not contemplated under the original terms of the cleared trade. To change these terms midway requires that a new 'bargain' or price be agreed to by the buyer and seller. Thus, it would be critical to break the first trade and start a new one.

To force the alternative—a cleared trade that now becomes a bilateral trade-- would be not only unworkable, but would be nothing more than a 'bait and switch' that would harm the parties, destroy market integrity and be patently unfair.

Interestingly enough, requiring the use of an ISDA Agreement to save a trade that has been rejected from clearing may not escape one obvious fact ---that the bad counterparty still cannot pay for the trade in the un-cleared state. In practice, trades are rejected not because the offending counterparty cannot pay for the trade same day. It is because the counterparty's clearing broker reasonably expects that the offending counterparty will not be able to pay for the trade next day or any day thereafter. Thus, to somehow force a counterparty into a bilateral trade with a non credit worthy

counterparty seems an unfair cure that benefits the offending counterparty at the direct expense of the compliant counterparty. Simply put, having an ISDA Agreement in place with an insolvent counterparty does not improve a counterparty's chance of getting paid on the trade.

In conclusion, while the High Latency Solution may protect certain incumbent dealer interests and attempt to restrict competition and market choice, it is certainly the most inferior alternative when compared to both 1) the Low Latency Solution and 2) the Perfect Settlement Solution as contemplated by the Commissions Rules in sections 17 CFR Parts 23, 37, 38 and 39.

In Preparation for the Perfect Settlement Solution

The Commissions should recognize that current proposed workflows at certain DCOs do not presently require tight response time frames and certain approved workflows may actually impede real-time confirmation. For example, certain DCOs presently fail to acknowledge CFTC Rule 37.6 (B) that appropriately requires that the "confirmation of all the terms of the transaction shall take place at the same time as execution." Instead, these DCOs assert trade confirmation can only occur *after* execution when additional information is added later in the workflow either at third party middleware systems or indeed at the DCO itself. Adding such information after execution not only violates CFTC Rule 37.6, but can slow or, more dangerously, halt the workflow from continuing. More specifically, if both buyer and seller are required to 'approve' the trade on a middleware system what happens if one party does not? Such trade counterparties could force the trade to remain purposely in an 'unconfirmed' state at the direct expense of the non offending counterparty.

The Commissions should also be cognizant that certain DCOs presently do not offer a direct application program interface ("API") connectivity through which a SEF or execution venues can directly connect to settle trades. Instead, these swap DCOs offer connectivity and trade confirmation only via third party middleware systems. Such middleware systems may add extra steps to the workflow or add unnecessary communication latency thus increasing time delay and undermining trade certainty.

The SDMA recommends that following rules be amended to address this important issue. To support proposed rule 37.702 "General Financial Integrity", which requires swap execution facilities to have the capacity to route transactions to a derivative clearing organization ("DCO"), the SDMA recommends the CFTC add a corresponding requirement in Part 39 for DCOs to provide direct

connectivity, via a direct API connection, for swap execution facilities. We also urge the SEC to mandate direct connectivity between clearing agencies and security-based swap execution facilities by amending (a) proposed Part 240 and (b) section 242.815 "Financial Integrity of Transactions" of the proposed rules for security-based swap execution facilities.

Importantly, the Commissions should be mindful that although market participants intellectually appreciate the universal benefits of central clearing and open access, it is an impractical assumption to believe that competing market interests will work together because their Core Principles require it. The Commissions must stay ever vigilant to ensure that central clearing takes hold in the OTC swaps marketplace. The Commissions should be mindful not to allow any proposed workflow be restrictive or represent an anticompetitive restraint on customer choice of counterparty or execution method. Nor should it be a restraint on a buyer's or seller's choice of clearing firm. Consistent with the Commissions intent, any proposed workflow must increase, not decrease, the speed at which a trade is confirmed.

Conclusion

The SDMA supports current proposed Commissions' rules that seek to strengthen the financial integrity of the cleared swap markets by addressing the trade latency issue by imposing certain uniform standards for prompt processing, submission and trade acceptance into clearing. Settlement uncertainty, caused by time delays between the point of *trade execution* and the point of *trade acceptance into clearing* could destroy confidence in the cleared OTC derivatives markets. As the CFTC has correctly asserted, such a time delay or 'trade latency,' (which in the bilateral swaps markets can be as long as a week) directly constrains liquidity, financial certainty and increases risk.[6]

In consideration of the various market alternatives discussed above, including inferior market solutions that add unnecessary latency or time delay to exist whether for a long or short time, the SDMA strongly believes that the Commissions adopt in their entirety proposed CFTC Rule 39.12 (B) (7) that requires that DCOs accept for clearing 1) all eligible swaps trades transacted on SEFs *immediately upon execution* and; 2) all eligible swaps trades transacted off SEFs *immediately upon trade submission*. Importantly, the SDMA respectfully requests that the Commissions properly clarify Rule 39.12 (B) (7) consistent with their original intent of ensuring market adoption of 'Perfect Settlement.'

[6] Page 13101. (*Federal Register*, Volume 76, No. 47, 3/10/11).

Simply put, to conquer the issue of latency is to remove it completely.

Moreover, the SDMA respectfully requests that the Commissions mandate all such rules currently before them that compel Swap Dealers, Major Swap Participants, Derivative Clearing Organizations, their constituent clearing members, Swap Execution Facilities, DCMs and ECPs to comply with the established market doctrine of Perfect Settlement.

Respectfully Submitted,

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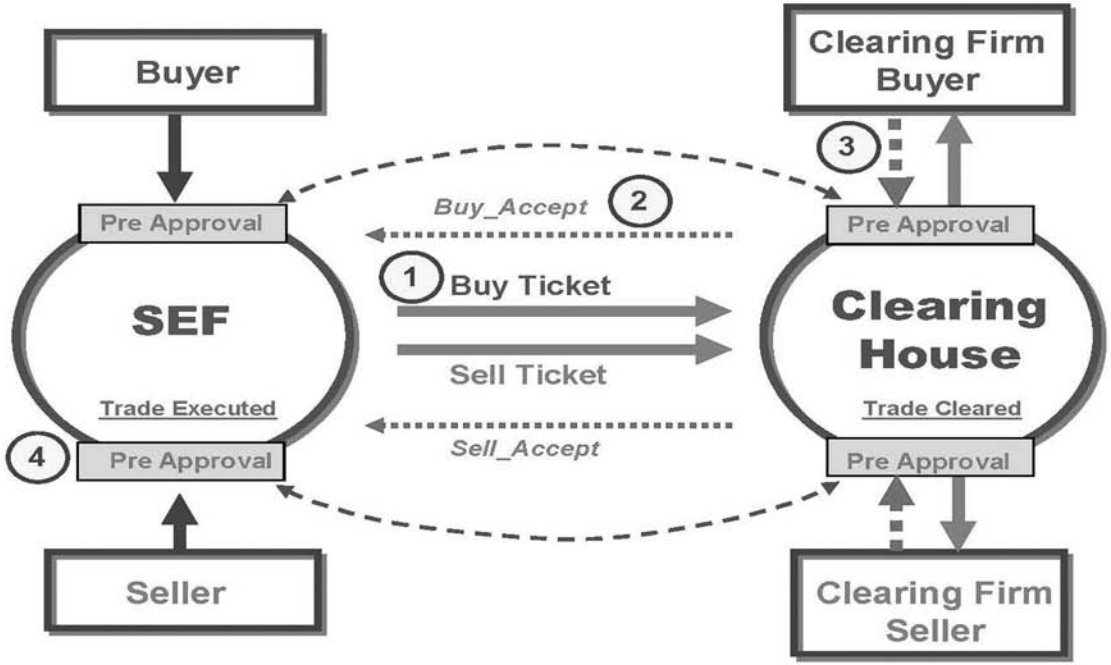
Exhibit A: Symmetrical Workflow



ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

LETTER SUBMITTED BY THOMAS C. DEAS, JR., VICE PRESIDENT AND TREASURER, FMC CORPORATION

Dear Chairman Johnson and Ranking Member Shelby, I very much appreciate your having given me the opportunity to present the views of end users on the complex topic of derivatives reform at the Committee's hearing on April 12, 2011. I was speaking as the Vice President and Treasurer of FMC Corporation, as the President of the National Association of Corporate Treasurers, and on behalf of the Coalition for Derivatives End Users, on whose steering committee I serve. I also very much appreciate your efforts on behalf of end users as we join with you to bring about sensible reform of derivatives.

I would like to respond for the record to comments made at a subsequent hearing of the Subcommittee on Securities, Insurance, and Investment on May 25, 2011. Dr. Benn Steil, Senior Fellow and Director of International Economics of the Council on Foreign Relations asserted that margining by end users would bring about increased transparency and that treasurers oppose margin requirements in order to conceal the inefficiency of their unmargined derivatives transactions.

We believe that Dr. Steil's analysis reflects several flawed assumptions. For example, he assumes that corporate treasurers do not have access to market pricing information and also that policy makers intended margin as a mechanism to address transparency gaps in the over-the-counter (OTC) derivatives market. Both of these assumptions are flat wrong.

End users generally value the ability to customize their derivatives transactions. Because customized derivatives have unique attributes that affect their price, some have suggested that end users are unable to discern the appropriate price of a derivative. In fact, corporate treasurers today have access to tools that allow them to price unique transaction structures. When corporate treasurers enter into hedging arrangements to mitigate risk, they utilize these tools to identify the appropriate price prior to transacting. Moreover, like any consumer, corporate treasurers comparison shop to ensure they get the best price. They often do this by conducting competitive auctions that ensure the best execution is achieved.

Although end users generally execute at the best price available to them, there are situations in which treasurers may opt to execute transactions slightly above market levels. Contrary to Dr. Steil's assertion, such situations are not indicative of a treasurer's inability to achieve efficient pricing outcomes. For example, a treasurer generally attempts to mitigate counterparty credit risk by executing transactions with multiple counterparties. If a given counterparty is especially competitive in other credit products such as letters of credit to facilitate foreign trade payments or undrawn credit lines committed for future use, corporate treasurers may find that a disproportionate amount of credit risk consisting of future credit commitments together with derivatives may be with a single counterparty. An excess concentration of counterparty credit risk will generally be unacceptable for an end user. In order to spread its counterparty credit risk across multiple banks, treasurers will often choose to accept a price from a bank that may be slightly wide of the best price. Contrary to Dr. Steil's assertion, prudence dictates that companies weigh not only the price of a given transaction, but also factors such as counterparty credit risk and even legal risks.

A report published November 1, 2010, by the International Swaps and Derivatives Association (ISDA) entitled, "Interest Rate Swap Liquidity Test", found that the difference in pricing between the best and worst quotes for any interest rate swap in their sample was just 1.3 basis points (a range of from 0.0000 percent to 0.0130 percent). The average difference between the best and worst quotes for each swap was just 0.38 basis points (0.0038 percent). ISDA concluded that the narrow spreads between the best and worst quotes attest to an extremely competitive marketplace for uncleared and unmargined OTC derivatives and that the benefits to counterparties with collateralized swap documentation consistent with margining would be "extremely modest."

Though end users already have access to pricing information that enables them to secure efficient market pricing, end users have long supported efforts to increase transparency in the OTC derivatives market by increasing access to such information and lowering the cost of obtaining it. The Dodd-Frank Act and its associated rules employ several mechanisms aimed at increasing transparency. For example, regulators have proposed requirements for banks to disclose midmarket swap prices to their customers. Additionally, Dodd-Frank includes a real-time reporting requirement and a trading requirement, each aimed at increasing pricing transparency for market participants.

However, margin was not among the policy tools implemented to increase pricing transparency. Rather, margin was intended to reduce systemic risk by dictating that certain market participants back their trades with cash. It is the cash and committed credit that margin requirements would tie up, to the detriment of productive investment in their businesses that concerns corporate treasurers, not any incremental disclosure that such requirements might bring.

Though we appreciate Dr. Steil's desire to increase transparency in a manner that benefits end users, we believe his analysis inaccurately characterizes the motivations of corporate treasurers. In particular, his analysis ignores the trade-offs inherent in the decisions treasurers make when managing their risks.

Thank you for your consideration of these comments. Please let me know if you have any questions or if I can be of assistance in further elaborating these ideas.