



UNIVERSITY OF MARYLAND
SCHOOL OF LAW

January 3, 2011

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

Re: Process for Review of Swaps for Mandatory Clearing (RIN 3038-AD00)

Dear Mr. Stawick:

These comments are submitted in response to the Commodity Futures Trading Commission's ("CFTC" or "Commission") Notice for Proposed Rulemaking on the Process for Review of Swaps for Mandatory Clearing (RIN 3038-AD00)¹ under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act² (the "Dodd-Frank Act").

I. General Comments

One of the main principles shaping derivatives regulation under the Dodd-Frank Act is to provide *free and open access* to clearing and exchange trading (including alternate swaps execution facilities).³ Specifically, Section 723(a)(3) of the Dodd-Frank Act amends the

¹ Proposed Rules, 75 Fed. Reg. 67277 (November 2, 2010), *available at* <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2010-27532a.pdf>.

² Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

³ *See, e.g.,* S. REP. 111-176, at 32–35 (2010) (noting that draft provisions concerning OTC derivatives were designed to minimize non-cleared, off-exchange trades); Letter from Stephen F. Lynch, U.S. House of Representatives, to the Commodity Futures Trading Commission (October 18, 2010), *available at* <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26291&SearchText> ("clearing is at the heart of reform"); Transcript of Public Roundtable on Governance and Conflicts of Interest in the Clearing and Listing of Swap, August 20, 2010, at 33, *available at* <http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/derivative9sub082010.pdf> (statement of Randy Kroszner, University of Chicago, Booth School of Business, "And the law is clear: Open access is the fundamental principle.").

Commodity Exchange Act⁴ (“CEA”) to provide that “it shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a derivatives clearing organization [(“DCO”)] that is registered under [the CEA] or a [DCO] that is exempt from registration under [the CEA] if the swap is required to be cleared.”⁵ Congress acknowledges the importance of the central clearing requirement in Section 745(b) of Dodd-Frank by directing the Commission to prescribe criteria, conditions, or rules under which the Commission will determine the initial eligibility or the continuing qualification of a DCO to clear swaps.⁶

As part of this endeavor, the Commission has proposed Regulation 39.5 to “implement procedures for determining the eligibility of a DCO to clear swaps that it plans to accept for clearing; for DCOs submitting swaps to the Commission for review; for Commission-initiated reviews of swaps; and for staying a clearing requirement while the clearing of a swap is reviewed.”⁷ While the regulation as proposed promotes financial strength and stability, thereby fostering efficiency and a greater ability to compete in the broader financial markets, there are some areas where more specificity or stronger regulatory requirements are necessary.

II. Determining Eligibility of a DCO to Clear Swaps That It Plans to Accept for Clearing

Proposed Regulation 39.5(a) correctly requires a DCO to request a determination for eligibility to clear any swap that not within a group, category, type, or class of swaps that the DCO already clears. The Proposed Regulation also correctly allows the Commission, through its own motion, to review whether any swap falls into a group, category, type, or class of swaps that the DCO already clears.

The requirement for a DCO to request, in writing, a review of eligibility to clear certain swaps (whether the DCO knows in advance it is a new group, category, type, or class of swap or the Commission determines it is through a review) is important, and it must be more than a mere formality. In order to ensure that the DCO will be able to effectively clear the new group, category, type, or class of swap, while maintaining compliance with the core principles for DCOs set out in Section 5b(c)(2) of the CEA, the two items addressed in the written request⁸ must be stated with specificity. Mere promises of compliance and rough projections should be rejected by the Commission.

The Commission has the greatest opportunity to ensure financial strength and stability when a DCO *first* attempts to gain eligibility for clearing a group, category, type, or class of

⁴ 7 U.S.C. 1 *et seq.*

⁵ See Section 2(h) of the CEA, 7 U.S.C. 2(h).

⁶ See Section 5c(c)(5)(C)(iii) of the CEA, 7 U.S.C. 7a-2(c)(5)(C)(iii).

⁷ Proposed Rules at 67278, *supra* note 1.

⁸ “(1) The sufficiency of the DCO’s financial resources and (2) the DCO’s ability to manage the risks associated with clearing the swap.” See Proposed Rules, *supra* note 1.

swap, and should take advantage of that chance. Additionally, the Commission should use its powers to review the eligibility of DCOs to clear certain swaps as frequently and assiduously as possible. This review power presents an opportunity for the Commission to target groups, categories, types, or classes of swaps that may otherwise escape Commission review.

III. DCO Submittal of Swaps to Commission for Review Must be Bolstered

Proposed Regulation 39.5(b) lays out the process for a DCO's submission of a swap to the Commission for review. As the heart of the review process, it is imperative that the Commission ensures that DCOs are complying with both the spirit and the letter of the legal framework developed under Dodd-Frank. The strength and stability of the financial system and the economy relies on vigilant oversight of the derivatives market.

As such, section 39.5(b)(1) is insufficiently specific in some circumstances. While a DCO's eligibility to clear certain groups, categories, types, or classes of swaps may have been determined by CFTC review under 39.5(a),⁹ in many cases that will not be true. If a DCO is presumed eligible to clear swaps because they are of a group, category, type, or class of swap the DCO traditionally clears, there will have been no review by the Commission of whether the DCO is maintaining compliance with the principles set out in Section 5b(c)(2) of the CEA.

In the latter case, 39.5(b)(1)'s requirement that a simple statement promising compliance is not satisfactory. Every DCO, when submitting a swap, must show either (a) that they have previously satisfied the requirements of a Commission review under 39.5(a) for that group, category, type, or class of swap, or (b) satisfy those requirements anew. Thus, a simple statement of compliance would only be appropriate for a DCO that has previously undergone a 39.5(a) review. Those who have yet to face such review should be forced to detail (1) the sufficiency of the DCO's financial resources, and (2) the DCO's ability to manage the risks associated with clearing the swap. It is critically important that *all* DCOs are subject to the review of *all sections* of 39.5.

Similarly, it is imperative that the Commission meaningfully enforce the requirement upon each DCO to assist the Commission's review. The requirement to release information "relating to product specifications; participant eligibility standards; pricing sources, models, and procedures; risk management procedures; measures of market liquidity and trading activity; the effect of a clearing requirement on the market for the swap; applicable rules, manuals, policies, or procedures; and terms and trading conventions on which the swap is currently traded"¹⁰ is at the heart of the Commission's ability to effectively conduct its review. The Proposed Regulations correctly place the responsibility to provide that information on the DCO. The Commission must receive detailed information from the DCO on each of these items to appropriately consider the swap submission.

⁹ Either by voluntary application on part of the DCO or Commission-instigated review. See Proposed Rules, *supra* note 1.

¹⁰ Proposed Rules a t67278, *supra* note 1.

Finally, the requirements in 39.5(b) regarding notice by the DCOs to their members are generally well-constructed. While the Commission may believe that deference should be given to the DCO to give notice in their usual manner, it would be preferable for the regulations to prescribe a specific manner and timeline for notice. As the Commission is correctly requiring DCOs to summarize the objections by its members to the swap, it is important that the Commission know how the objections came to light and the process by which those opinions were gathered. Prescribing the precise manner of notice would allow the Commission to know that the notice was given with sufficient time and in the proper manner to gather *all* of the appropriate objections by DCO members.

Upon receipt of the necessary materials, the Commission should begin its review by posting the materials for public comment *not only* on the Commission web site, but *also* in the Federal Register. Public access to the materials and ability to comment are necessary for a strong and open financial market.

IV. Commission-initiated Reviews of Swaps

The Commission's responsibility, under Dodd-Frank, to actively review swaps that have not been accepted for clearing by a DCO should be prioritized. The responsibility is an "on-going" one, and the Commission should be actively mining all sources of information for swaps or groups, categories, types, or classes of swaps that no DCO has accepted for clearing that may require clearing. While these endeavors may be the most personnel and resource-intensive actions under the Commission's purview, they are essential to ensuring that the appropriate swaps, or groups, categories, types, or classes of swap are subject to clearing rules and regulations. Unregulated or under-regulated swaps present a clear and present danger to the strength of the recovering economy.

V. Staying a Clearing Requirement while Clearing of Swap is Reviewed

Proposed Regulation 39.5(d) correctly gives the Commission the ability to stay a clearing requirement for a swap upon application by counterparty to the swap. It is important that the written request should be very specific and the involvement of the DCO involved in aiding the investigation should be substantial. The Commission must ensure that 39.5(d) does not become a loophole that swallows the rest of the well-constructed regulations.

Sincerely,

A handwritten signature in blue ink that reads "Michael Greenberger". The signature is fluid and cursive, written on a white background.

Michael Greenberger, J.D.
Law School Professor
University of Maryland School of Law