



December 17, 2010

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: In comment, objection & suggested remedy to general and specific provisions of the ICE Trust DCO application (Pursuant to Section 5b of the Commodity Exchange Act and Part 39 of the Regulations of the Commission).

Dear Sir/Madam Secretaries,

The Swaps & Derivatives Market Association ("SDMA") appreciates the opportunity to comment on ICE Trust's ("ICE") Application for Registration as a Derivatives Clearing Organization Pursuant to Section 5b of the Commodity Exchange Act and Part 39 of the Regulations of the Commission.

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

The SDMA is a financial markets trade group of United States and internationally based broker-dealers, futures commission merchants and investment managers participating in all segments of the exchange-traded and over-the-counter derivatives and securities markets. The SDMA was created as a nonprofit organization in January 2010 and today has over 20+ member institutions representing all facets of derivatives execution and clearing.

Introduction

The systemic risk posed by the swaps market, which contributed to the global financial crisis of 2008, shall continue to exist and threaten the US economy until the OTC swaps market migrates to a cleared environment. Only then shall bilateral counterparty risk be mutualized and properly mitigated.

There is no doubt, clearing houses, such as ICE Trust, play an important and pivotal role to the successful mitigation of this risk. To this end, regulators must ensure that ICE operates with this prudential goal in mind as it serves both its shareholders and the needs of the US financial system.

Upon review of the ICE application, the SDMA finds several areas of concern where ICE is not in compliance with the express provisions of the Dodd Frank Act. Specifically, ICE's membership artificially links *execution to clearing* which results in limited clearing broker participation. In addition, ICE goes beyond its clearing mandate by restricting the methods of swap execution, and the free trading of swaps, by requiring that all trades be executed through a dealer member. Finally, ICE's desire to require ISDA



agreements – for no perceived legitimate purpose – may inhibit open trading and competition in the swaps market.

I. ICE Membership Requirements (Problems and the Solutions)

ICE membership criteria for agent clearing brokers or so called 'Participants' are unnecessarily limited, not based upon an objective or transparent capital standard and, moreover, calls for certain operational requirements that are subjective, vague and could be abused.

Moreover, ICE's requirements contravene the express provisions of the Dodd Frank Act that call for its membership requirements to be 'objective', 'be publicly disclosed' and 'permit fair and open access'

A. ICE Member Capital Requirements

There is no doubt that ICE should move to ensure that all its clearing members are appropriately capitalized, especially considering the credit crisis of 2008. But such a requirement should be based upon an objective and transparent risk-based standard.

Section 2 of the ICE application, entitled "Membership", requires that ICE Participants (only clearing members that can both clear and execute) have at least \$1 Billion of adjusted net capital. ICE fails however to properly validate its mythology for determining such a number.

Capital requirements for clearing members (i.e. those that clear only for external independent execution-only broker/dealers or can clear and execute within the same firm) should be objective and based on open risk calculations as in other markets like Futures (e.g. CME) and Options (OCC).

For the guaranty fund in those markets, they rationally start with the premise that the margin is sized to be sufficient for 99+% coverage over a relevant time horizon, including taking liquidity risk of a dislocation into account.

Then they say, in the event that one or more of the largest clearing members defaults in an extreme dislocation scenario, the guaranty fund would be sized large enough to absorb any losses beyond what is covered by the margin, without the need for an assessment.

Certain OTC clearing houses started that way, but were then forced up by certain incumbents. CME CDS originally had a \$7mm initial guaranty deposit that was forced to \$1B. IDCG is still at reasonable levels, and OCC for Equity Derivatives is planning, based on careful risk management scenario analysis, to have essentially the same deposit requirements as for their listed products. There is no reason you can't start that way, and then scale with size.

Similarly, for net capital in the clearing vehicle, futures and the original requirements for certain OTC products were scaled to be sufficient meeting a clearing member's assessment, in the extreme scenario where it was called. Again, this amount would scale as a factor of margin posted, which is a way of scaling to the risk that the individual clearing member brings to the CCP.

These reasonable requirements all have obvious systemic benefits while all are safe.

The benefits are a broader spreading of mutualization/risk absorption rather than concentrating amongst a small group of incumbent banks. The benefits are also, of course, consistent with the SEC and CFTC's mandate to preserve open access and competition.



Regulators should be on guard that capital adequacy requirements can be used as a politically popular, but anticompetitive weapon, to limit access to clearing. To this end, the regulators should enforce strict oversight, and transparency standards on ICE's risk committee. Regulators should also ensure that ICE's risk committee is truly representative of the market with significant independent directorships and not be populated just a few correlated parties.

B. ICE's End of Day ("EOD") Price Requirement

Under Rule 201, Section B, (iv), ICE requires that 'Participants' provide daily swap End Of Day ("EOD") prices from their own internal trading desks. ICE legitimately requires EOD prices, so that it can 'mark' its own book and properly determine a customer's margin. To prevent improper pricing, ICE also requires that these prices be actionable or 'tradable.'

In other cleared derivative markets, such EOD prices come from exchanges or execution venues.

Under current ICE rules, however, such EOD prices cannot come from third party services, such as Markit or the CMA, as they are not actionable.

Interestingly though, ICE also mandates that such EOD prices can only come from a Participants' own dealer desk. Such a rule is misguided and unnecessarily restricts clearing member and independent execution-only broker/dealer participation to all but a handful of players who possess both.

An additional solution to encourage broad participation and competition in clearing should follow that the CFTC require ICE to allow independent clearing firms access as 'Participants'. The CFTC could do so by encouraging ICE to allow independent clearing firms to partner with independent broker/dealers for these same actionable EOD prices such that the requisite EOD price requirement is met. Several non-incumbent broker/dealers already actively trade corporate credit, act as US government primary dealers, price and use credit default and interest swaps as customers. These broker/dealers certainly have the ability to provide actionable EOD prices to independent clearing members.

In fact, joint ventures, similar to these, are already common in the cleared derivatives marketplace. In several clearing house contexts, several Futures Commission Merchants (i.e. clearing member firms in the futures markets) currently provide operational trade processing, risk determination and facilities management to other firms who may have capital but find it more cost effective to farm out these services to a specialist third party.

It should be noted that under ICE Rule 201, Section B, (iv), such facilities management arrangements are permissible—so why not extend this and allow EOD pricing from third parties?

C. Clearing Member Liquidation & Restricted Auction Participation

Another clearing house membership rule that unnecessarily restricts clearing membership and stands to limit the potential success of OTC derivative clearing is the auction of trade positions in a distressed clearing member liquidation scenario.

In this scenario, when an clearing member fails and must be liquidated, its customer accounts (and positions) are transferred to other clearing members within the group. In addition, the failing clearing member's own positions must be auctioned off.

Presently, CCP's require that only clearing firms that have internal dealing desks can properly qualify and participate in these auctions. Thus, since participation in these auctions is a precursor to qualify to clear OTC swaps, this artificial construct of linking clearing to execution is deployed to limit independent clearing firm's participation.



An alternative solution would be to open such auctions to the entire market. If the goal of such auctions is to achieve 'best price' and to ensure the orderly wind up of a failed clearing member through the auction of its positions, then such an auction should include as many bidders as possible within the given time frame.

It is well established that 'best price' is only attained when many bidders participate.

To achieve this goal, such auctions should be opened to the broad market as a whole.

In fact, there is already precedent in the OTC marketplace for rapid and highly organized auctions. For example, ISDA currently manages a default auction process when an event triggers a payout on a default swap and these auctions include many, not a limited few, participants. There were over 400 participants in the Lehman Brothers auction, which clearly yielded better prices than if there were less than 10 participants.

Speed is also not a legitimate excuse to restrict auctions to only a few select bidders as speed is already present in other auction scenarios. For example, successful auctions in CDS for bid wanted in comp/offers wanted in comp ("BWIC/OWIC") exist. For BWICs, institutional investors enter the market with multiple swap positions for auction by submitting them to dealers for bid, with time frames as short as 60 to 90 minutes. Market auction participants then bid on these BWICs accordingly and the auctions proceed efficiently.

Electronic platforms such as Creditex already provide such auction venues. Indeed, CCP's, like the US Government today with Blackrock Solutions, can outsource their auction process to a third party.

Inclusion of more bidders or eligible contract participants ('ECP's') in these liquidation auctions, including non-clearing broker/dealers and the buy-side, is the optimal solution. Independent clearing members and broker/dealers can agree to jointly participate in portfolio auctions to find the best price in the event of any default and liquidation scenario.

D. Membership Requirements: Conclusion

With regard to ICE's membership requirements for clearing firms or 'Participants', ICE, in its application, has laid out a limited and inflexible approach, not properly befitting the important role that a clearing house now plays in a post Lehman world. Regulators should be mindful that ICE's linkage of clearing to execution, although clever, is an artificial construct, not seen in the listed derivatives marketplace, which for the greater success of OTC clearing, should be protected against.

II. ICE Trade Submission & Acceptance Requirements (Problems & Solutions)

With regard to accepting trades for clearing, ICE clearly discriminates against trades and limits participation in clearing. Under ICE Rule 309, ICE specifies that it "shall accept the submission of Trades for clearance hereunder only from or on behalf of Participants." (emphasis added).

Thus, ICE requires that a member dealer or 'Participant' must be on one side of every trade. Such a limitation prohibits 1) customer to customer trading, 2) non 'Participant' dealer to 'Participant' trading and 3) non 'Participant' dealer to customer trading.

In other words, unfettered, anonymous trading between two parties, or Eligible Contract Participants ('ECP's') is strictly forbidden.

In fact, ICE rule 301 actually identifies acceptable trade types based on their execution method: interdealer trades (between two dealer 'Participants'), bilateral client trades (between a dealer 'Participant' and a client), DCM trades (from trade submission platforms, with at least one side being a dealer 'Participant') etc.



ICE Rule 301 and ICE Rule 309 specifically contravene the express language of the *Dodd Frank Act*. Under Dodd Frank Section 723 (B) (ii), DCO's shall "provide for non-discriminatory clearing of a swap...executed bilaterally or on through the rules of an unaffiliated designated contract market or swap execution facility." It is well established that 'nondiscriminatory' means clearing house neutrality to execution methods.

Such a restriction is also contrary to the core principals of the *Dodd Frank Act* that prohibit actions that 'results in any unreasonable restraint of trade; or impose any material anticompetitive burden on trading or clearing.'

Moreover, by limiting trade execution methods to flows where the dealer 'Participant' is required, ICE rules dangerously limit market liquidity which is essential for the market to properly function and so craved in times of market crisis.

The negative consequences of liquidity loss were clear in evidence from OTC derivative markets in 2008 when so many incumbent dealers failed.

Regulators should compel ICE to maintain execution neutrality to comply with the Act. Similar to the CME and IDCG, ICE, as a clearing house, should focus solely on the risk of a trade, not the method in which a trade is executed.

Therefore, ICE must allow the following anonymous trade execution methods:

- 1) Dealer to Dealer; be the dealer 'Participant' or not
- 2) Customer to Customer
- 3) Dealer to Customer; be the dealer 'Participant' or not

III. Execution Venue, SEFs & Open Access

With regard to execution venues and SEFs, ICE Rule 314 allows ICE to set its own criteria to determine SEF eligibility. Although, ICE may have certain discretion to ensure SEFs and exchanges meet certain technical standards—such standards must not be used to prevent properly registered SEF's from accessing ICE.

Regulators should require that ICE publish a single, transparent and objective technical specification that is uniformly administered to all SEF's and execution venues. Regulators should also ensure that it is uniformly applied with proactive oversight.

Regulators should also ensure that the ICE workflow provides for real time trade confirmation and same day settlement of trades via electronic means. ICE should be required to provide nondiscriminatory direct

access for all SEF's and market participants to submit trades either through a standard API, or user interface capability.

ICE should also be required to accept trades either on a 'Single Side' trade or 'Dual Sided' trade submission Basis. A 'Single Side' trade submission occurs when customers submit trade sides at the completion of a deal. Trade sides are then matched when both sides (buyer and seller) have submitted equal and opposite transactions. The resulting matched trade then clears once both clearing brokers approve it.

A 'Dual Sided' trade submission occurs when a broker/dealer, SEF or affirmation platform submits both sides (buy & sell) simultaneously. Once at the CCP, the trade is then claimed by the respective clearing firms and cleared.

Importantly, regulators should be mindful that ICE comply with the expressed open access provisions of Dodd Frank that require non-discriminatory clearing of a swap executed on a CFTC registered and approved SEF.

IV. ISDA's, Documentation and ICE

ICE rules currently require that ISDA bilateral agreements be in place between all execution parties. Such a requirement serves no purpose in a multilateral world and may be required for purely anti-competitive reasons.

It is well established in the cleared marketplace that master clearing agreements govern the rights and obligations of the parties with regard to a customer and its clearing agent. Similarly, it is well established in the cleared marketplace that execution 'give up' agreements govern the rights and obligations with regard to a customer and its execution agent.

The ICE requirement that ISDA bilateral agreements be also signed as a credit failsafe measure is nonsensical. Simply put, if a customer's trade is not approved by its clearing firm, it is because the customer cannot pay. Most likely, the customer will never be able to pay for the trade. Thus, if the customer is bankrupt, having a secondary document (ISDA or any other) does not escape this unfortunate fact and offers the aggrieved party no additional protection.

In fact, allowing trades to exist in a bilateral state either *before* a trade is accepted to clearing or *after* (if one party's clearing firm denies the trade) is contrary to the express provisions of the *Dodd Frank Act*. Section 723 of the Act requires that "it shall unlawful for any person to engage in a swap unless that person submits such swap for clearing to a derivatives clearing organization that is registered under this Act or a derivatives clearing organization that is exempt from registration under this Act if the swap is required to be cleared."

Thus if a CCP agrees to clear the swap product, it can *only* exist in a cleared state, it would be unlawful for it to exist in a *bilateral* state. Customers, clearing firms and ICE have no choice. The eligible swap trade is approved for clearing, or the trade is broken.

V. Conclusion

We appreciate the opportunity to comment with regard to the limitations of the current ICE application. Our goal has been to offer proactive solutions that could address some of the broader market's concerns with regard to ICE. We hope that we have properly addressed the issues of limited clearing broker membership and discriminatory trade execution practices currently in the ICE model. There is no doubt, ICE, as a clearing house, serves an important need in the marketplace. Therefore, it is vitally important that ICE be successful in its mission to increase transparency and offer open, unfettered access to clearing, while seeking to lessen the systemic risk that remains in the OTC Swaps marketplace today.

Respectfully,



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