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ISDA

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COMMENT

June 18, 2001

Commodity Futures Trading Commission
Three Lafayette Center
1155 Twenty First Street, N.W.
Washington, D.C. 20581

Attention: Office of the Secretariat

Re: Clearing Organizations

Ladies and Gentlemen:

This letter contains the comments of the International Swaps and Derivatives Association, Inc. ("ISDA") on proposed regulations (the "Proposed Regulations") issued by the Commodity Futures Trading Commission (the "Commission") to implement the statutory framework for derivatives clearing organizations ("DCOs") contained in the Commodity Futures Modernization Act of 2000 (the "CFMA"). The Proposed Regulations were published in the Federal Register for May 14, 2001 (66 Fed. Reg. No. 93 at 24308 et seq.).

ISDA is a global trade association representing more than 530 members including the world's leading dealers in swaps and other off-exchange derivatives transactions (collectively "OTC derivatives transactions"). ISDA's dealer-members are among the principal users of the futures exchanges that are regulated by the Commission under the Commodity Exchange Act (the "CEA"), as amended by the CFMA. ISDA's members also include many of the businesses, financial institutions, governmental entities and other end users that rely on OTC derivatives transactions to manage their financial and commodity market risks with a degree of efficiency and effectiveness that would not otherwise be possible.

Commodity Futures Modernization Act

ISDA welcomes the continuing commitment of the Commission, and its professional staff, to proceed promptly to implement the CFMA. A major goal of Congress in enacting the CFMA was to provide "legal certainty" with respect to the status of OTC

derivatives transactions under the CEA. This was accomplished by the enactment of a series of statutory exclusions and exemptions from the CEA, as well as provisions prohibiting the use of asserted failures to comply with the CEA (or rules and regulations thereunder) by parties to OTC derivatives transactions as a basis for abrogating otherwise binding contractual obligations. The "legal certainty" provisions of the CFMA were based in large measure upon the recommendations contained in the November 1999 report of the President's Working Group on Financial Markets (the "PWG Report")[1] and the "New Regulatory Framework" adopted by the Commission on its own initiative in December 2000 prior to the enactment of the CFMA.[2]

Clearing Systems

As noted in the Preamble to the Proposed Regulations, the PWG Report also recommended that, in order to reduce systemic risk, " . . . legal obstacles to the development of appropriately regulated clearing systems should be removed". In the 15 years preceding the issuance of the PWG Report, the volume of OTC derivatives transactions grew dramatically, but the development of clearing systems for these transactions was hindered by several factors, including the provision in the Commission's 1993 Swaps Exemption that transactions exempted thereunder ". . . not be subject to a clearing system where the credit risk of individual members of the system to each other in a transaction to which each is a counterparty is effectively eliminated and replaced by a system of mutualized risk of loss that binds members generally whether or not they are counterparties to the original transaction".[3] Since the Swaps Exemption constituted one of the principal sources of "legal certainty" for OTC derivatives transactions prior to the enactment of the CFMA, the regulatory barriers to the development of clearing systems were obvious and significant.

ISDA remains uncertain whether clearing systems for OTC derivatives transactions will in fact be developed and broadly used in the future. Nevertheless, ISDA agrees with the decision of Congress, as embodied in the CFMA, to remove the regulatory barriers to the development of clearing systems and to provide a suitable regulatory framework for clearing organizations.

It is important that the clearing organization provisions of the CFMA be implemented in a flexible manner if clearing systems for OTC derivatives are in fact to have the opportunity to gain sufficient acceptance within the private sector that systemic risk reduction can be accomplished in the manner envisioned by the President's Working Group and Congress. ISDA believes that, as a general matter and subject to comments below, the Proposed Regulations appropriately implement Congressional intent with respect to clearing organizations and reflect a reasonable and proper exercise of the Commission's discretion.

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[1] *Over-the Counter Derivatives Markets and the Commodity Exchange Act* (Report of the President's Working Group on Financial Markets, November 1999)

[2] (65 Fed. Reg. No. 121at 38986 et seq.)

[3] [(17 CFR Part 35)]

Comments

Clearing of Excluded and Exempt Contracts

We note the Commission statement in the Preamble to the Proposed Regulations that "excluded or exempted contracts, including those elected pursuant to section 5a(g) to be traded on a registered derivatives transaction execution facility, are not required to be cleared by a DCO, although a clearing organization that clears these contracts may voluntarily apply, pursuant to section 5b(b), to register with the Commission as a DCO." We agree with this conclusion both as a matter of statutory interpretation and as a matter of policy.

Proposed Anti-Fraud Rule

The Proposed Regulations provide for the adoption of an anti-fraud rule, which, as described in the Preamble, is proposed by the Commission pursuant to its authority under section 8a(5) of the CEA to adopt such rules as the Commission determines are reasonably necessary to effectuate the purposes of the CEA. This rule, proposed section 39.7, would be in addition to the anti-fraud rule proposed by the Commission on March 5, 2001 (66 Fed. Reg. No. 47 at 14262 et seq.) applicable to fraud in or in connection with certain transactions in foreign currency. The Preamble of the Proposed Regulations indicates that the Commission concluded that an additional anti-fraud rule was necessary ". . . to address fraud in or in connection with clearing, which might not be covered by any other antifraud provision or by one of the core principles [applicable to clearing organizations]".

As stated in prior submissions to the Commission,[4] ISDA believes that the Commission is free under the CEA, as amended by the CFMA, to adopt whatever anti-fraud rules it concludes are required by the public interest, but only if the scope of the rule is circumscribed by the scope of the Commission's jurisdiction. At the same time, however, past experience suggests that the Commission must be vigilant in structuring any such rules to avoid creating any uncertainty with respect to the views of the Commission with respect to the scope of its jurisdiction. Thus, any such rule must be *explicitly* limited to those transactions that are in fact otherwise subject to the Commission's jurisdiction.

In its comments on the proposed regulations relating to trading facilities,[5] ISDA concluded that the anti-fraud rule contained in those proposed regulations satisfied this standard and thus did not create uncertainty with respect to the Commission's views as to the scope of its jurisdiction under the CEA.

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[4] International Swaps and Derivatives Association, Comment Letter to the Commodity Futures Trading Commission, Implementation of the Commodity Futures Modernization Act (66 Fed. Reg. No. 47 at 14262 et seq.), April 9, 2001.

[5] Ibid.

In ISDA's view, the proposed clearing anti-fraud rule likewise seems intended to satisfy this standard. By its terms, proposed section 39.7 is limited to fraud "in or in connection with the clearing of transactions by a derivatives clearing organization" and proposed section 39.6 ensures that violations of the clearing anti-fraud rule may not be used as a basis for invalidating the underlying transactions submitted for clearing. In this regard, we assume that the reference in the proposed anti-fraud rule to fraud "in or in connection with the clearing of transactions" is intended to be narrowly construed to mean fraud specific to the clearing function and not, for example, fraud in connection with the solicitation or execution of a transaction, merely because the transaction is also cleared. It is important for the Commission to clarify this in the final rulemaking.

Ambiguity and uncertainty may be created by the unnecessary reference in the first sentence of proposed section 39.6 to contracts "cleared pursuant to the rules". The Commission may want to clarify the applicability of the enforceability provisions to contracts or transactions cleared by non-registered DCO's. We suggest that the reference "cleared pursuant to the rules of" be deleted and the words " submitted to a derivatives clearing organization for clearance" be inserted in their place.

With these helpful clarifications by the Commission, we believe that the Commission will have appropriately stated both the anti-fraud provision and the enforceability provision, with the result that, as the Commission stated in the Preamble, the proposed anti-fraud rule ". . . would not interfere with the enforceability of contracts cleared on DCOs." For these reasons, while ISDA expresses no view on the underlying need for inclusion of a special anti-fraud rule in Part 39, it has no objection in principle to such rule as it will not create legal uncertainty with respect to the Commission's views as to the scope of its jurisdiction.

Core Principle B

The application guidance for Core Principle B looks, *inter alia*, to "the level of member/participant default [a DCO's financial] resources could support." This guidance implies that a DCO should have some level of financial resources to provide support in the case of defaults. However, as noted by the Commission in footnote 8 of the Preamble to the Proposed Regulations, DCOs may include organizations that provide no credit support function. This reflects the fact that benefits other than credit support can be provided by organizations that provide multilateral settlement and netting functions. Accordingly, it would be helpful if the Commission would clarify that Core Principle B should not be construed as implying a requirement that a DCO provide financial resources as protection against member/participant default. Of course, a DCO should not be organized in a manner that increases the risk, or the extent of loss upon the occurrence, of a default.

Core Principle G

Item 5 of the application guidance for Core Principle G addresses customer priority rules. We note that certain DCO structures may not include indirect or direct participation by customers. Without knowing the particular structure or format of a DCO and the relevant market, it is difficult to know whether the kind of customer

priority that is contemplated and promoted by the CEA is appropriate for that DCO. Accordingly, it may be desirable for the Commission to clarify in the final rulemaking that Core Principle G is not intended to imply that customer priority procedures are a necessary element in the structure of a DCO.

Conclusion

As stated at the outset of this letter, ISDA welcomes the issuance of the Proposed Regulations as further evidence of the commitment of the Commission to implement the CFMA promptly and in a manner that will enhance the utility of OTC derivatives transactions as a risk management tool. ISDA and its members have appreciated the opportunity to work with Acting Chairman Newsome, his colleagues on the Commission, and its professional staff, from the outset of the process and we look forward to continuing to do so in a cooperative and constructive manner.

Sincerely,

Robert G. Pickel

Robert G. Pickel
Executive Director and Chief Executive Officer