Commodity Futures Trading Commission

17 CFR Part 50
Clearing Requirement Determination Under Section 2(h) of the CEA; Proposed Rule
DATES: Comments must be received on or before September 6, 2012.

ADDRESSES: You may submit comments, identified by RIN number 3038–AD86, by any of the following methods:

• The agency’s Web site, at http://comments.cftc.gov. Follow the instructions for submitting comments through the Web site.

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

• Hand Delivery/Courier: Same as mail above.

• Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.

Please submit your comments using only one method.

All comments must be submitted in English, or if not, accompanied by an English translation. Comments will be posted as received to http://www.cftc.gov. You should submit only information that you wish to make available publicly. If you wish the Commission to consider information that you believe is exempt from disclosure under the Freedom of Information Act, a petition for confidential treatment of the exempt information may be submitted according to the procedures established in § 145.9 of the Commission’s regulations. The Commission reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse or remove any or all of your submission from http://www.cftc.gov that it may deem to be inappropriate for publication, such as obscene language. All submissions that have been redacted or removed that contain comments on the merits of the rulemaking will be retained in the public comment file and will be considered as required under the Administrative Procedure Act and other applicable laws, and may be accessible under the Freedom of Information Act.

FOR FURTHER INFORMATION CONTACT: Sarah E. Josephson, Deputy Director, 202–418–5684; sjosephson@cftc.gov; Brian O’Keefe, Associate Director, 202–418–5658, bokeefe@cftc.gov; or Erik Remmler, Associate Director, 202–418–7630, eremmler@cftc.gov, Division of Clearing and Risk, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street NW., Washington, DC 20581.

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I. Background

A. Financial Crisis

In the fall of 2008, a series of large financial institution failures triggered a financial and economic crisis that threatened to freeze U.S. and global credit markets. As a result of these failures, unprecedented governmental intervention was required to ensure the stability of the U.S. financial system. These failures revealed the vulnerability of the U.S. financial system and economy to wide-spread systemic risk resulting from, among other things, poor risk management practices of financial firms and the lack of supervisory oversight for a financial institution as a whole.

The financial crisis also illustrated the significant risks that an uncleaned, over-the-counter (OTC) derivatives market can pose to the financial system. As the Financial Crisis Inquiry Commission explained:

The scale and nature of the [OTC] derivatives market created significant systemic risk throughout the financial system and helped fuel the panic in the fall of 2008: millions of contracts in this opaque and deregulated market created interconnections among a vast web of financial institutions through counterparty credit risk, thus exposing the system to a contagion of spreading losses and defaults.

Certain OTC derivatives, such as CDS, played a prominent role during the crisis. According to a white paper by the U.S. Department of the Treasury, “the sheer volume of these [CDS] contracts overwhelmed some firms that had promised to provide payment of the CDS and left institutions with losses that they believed they had been

2 On October 3, 2008, President Bush signed the Emergency Economic Stabilization Act of 2008, which was principally designed to allow the U.S. Department of the Treasury and other government agencies to take action to restore liquidity and stability to the U.S. financial system (e.g., the Troubled Asset Relief Program—also known as TARP—under which the U.S. Department of the Treasury was authorized to purchase up to $700 billion of troubled assets that weighed down the balance sheets of U.S. financial institutions). See Public Law 110–343, 122 Stat. 3765 (2008).


4 See id. at 386.
protected against." In particular, AIG reportedly issued uncleared CDS transactions covering more than $440 billion in bonds, leaving it with obligations that it could not cover as a result of changed market conditions. As a result of AIG’s CDS exposure, the Federal government bailed out the firm with over $180 billion of taxpayer money in order to prevent AIG’s failure and a possible contagion event in the broader economy. More broadly, the President’s Working Group (PWG) on Financial Policy noted shortcomings in the OTC derivative markets as a whole during the crisis. The PWG identified the need for an improved integrated operational structure supporting OTC derivatives, specifically highlighting the need for an enhanced ability to manage counterparty risk through “netting and collateral agreements by promoting portfolio reconciliation and accurate valuation of trades.” These issues were exposed in part by the surge in collateral required between counterparties during 2008, when the International Swaps and Derivatives Association (ISDA) reported an 86% increase in the collateral in use for OTC derivatives, indicating not only the increase in risk, but also circumstances in which positions may not have been collateralized.

With only limited checks on the amount of risk that a market participant could incur, great uncertainty was created among market participants. A market participant did not know the extent of its counterparty’s exposure, whether its counterparty was appropriately hedged, or if its counterparty was dangerously exposed to adverse market movements. Without central clearing, a market participant bore the risk that its counterparty would default and a possible contagion event in the broader economy.

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With only limited checks on the amount of risk that a market participant could incur, great uncertainty was created among market participants. A market participant did not know the extent of its counterparty’s exposure, whether its counterparty was appropriately hedged, or if its counterparty was dangerously exposed to adverse market movements. Without central clearing, a market participant bore the risk that its counterparty would not fulfill its payment obligations pursuant to a swap’s terms. (counterparty credit risk). As the financial crisis deepened, this risk made market participants wary of trading with each other. As a result, markets quickly became illiquid and trading volumes plummeted. The dramatic increase in “TED spreads” evidenced this mistrust. These spreads increased from a long-term average of approximately 30 basis points to 464 basis points.

The failure to adequately collateralize the risk exposures posed by OTC derivatives, along with the contagion effects of the vast web of counterparty credit risk, led many to conclude that OTC derivatives should be centrally cleared. For instance, in 2008, the Federal Reserve Bank of New York (FRBNY) began encouraging market participants to establish a central counterparty to clear CDS. For several years prior, the FRBNY had led a targeted effort to enhance operational efficiency and performance in the OTC derivatives market by increasing automation in processing and by promoting sound back office practices, such as timely confirmation of trades and portfolio reconciliation. Beginning with CDS in 2008, the FRBNY and other primary supervisors of OTC derivatives dealers increasingly focused on central clearing as a means of mitigating counterparty credit risk and lowering systemic risk to the markets as a whole. Both regulators and market participants alike recognized that risk exposures would have been monitored, measured, and collateralized through the process of central clearing.

B. Central Role of Clearing in the Dodd-Frank Act

Recognizing the peril that the U.S. financial system faced during the financial crisis, Congress and the President came together to pass the Dodd-Frank Act in 2010. Title VII of the Dodd-Frank Act establishes a comprehensive new regulatory framework for swaps, and the requirement that swaps be cleared by DCOs is one of the cornerstones of that reform. The CEA, as amended by Title VII, now requires a swap: (1) To be cleared through a DCO if the Commission has determined that the swap, or group, category, type, or class of swap, is required to be cleared, unless an exception to the clearing requirement applies; (2) to be reported to a swap data repository (SDR) or the Commission; and (3) if the swap is subject to a clearing requirement, to be executed on a designated contract market (DCM) or swap execution facility (SEF), unless no DCM or SEF has made the swap available to trade.

Clearing is at the heart of the Dodd-Frank financial reform. According to the Senate Report:

As a key element of reducing systemic risk and protecting taxpayers in the future, protections must include comprehensive rules and regulations for how the OTC derivatives market operates. Increasing the use of central clearinghouses, exchanges, appropriate margining, capital requirements, and reporting will provide safeguards for American taxpayers and the financial system as a whole.

The Commission believes that a clearing requirement will reduce counterparty credit risk and provide an organized mechanism for collateralizing the risk exposures posed by swaps. According to the Senate Report:

With appropriate collateral and margin requirements, a central clearing organization can substantially reduce counterparty risk and provide an organized mechanism for clearing transactions. * * * While large losses are to be expected in derivatives trading, if those positions are fully margined there will be no loss to counterparties and the overall financial system and none of the uncertainty about potential exposures that contributed to the panic in 2008.

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10 The TED spread measures the difference in yield between three-month Eurodollars as represented by London Interbank Offered Rate (LIBOR), and three-month Treasury Bills. LIBOR contains credit risk while T-bills do not. As the spread got larger, it meant that lenders demanded more return to compensate for credit risk then they would have needed to loan money to the U.S. Department of the Treasury without any credit risk. The U.S. Financial Crisis: Credit Crunch and Yield Spreads, by James R. Barth et al., page 5, available at http://apeaweb.org/confer/bei08/papers/bhp.pdf.
12 The Commission has proposed rules that would establish a separate process for determining whether a swap has been made “available to trade” by a DCM or SEF. Those rules, and any determinations made under those rules, will be finalized separately from the proposed clearing requirement discussed herein. See Process for a Designated Contract Market or Swap Execution Facility to Make a Swap Available to Trade Under Section 2(h)(8) of the Commodity Exchange Act, 76 FR 77728 (Dec. 14, 2011).
13 S. Rep. 111–176, at 32 (April 30, 2010). See also Letter from Senators Christopher Dodd and Blanche Lincoln to Congressmen Barney Frank and Collin Peterson (June 30, 2010). “Congress determined that clearing is at the heart of reform—bringing transactions and counterparties into a robust, conservative, and transparent risk management framework.”
Notably, Congress did not focus on just one asset class, such as CDS; rather, Congress determined that all swaps that a DCO plans to accept for clearing must be submitted to the Commission for a determination as to whether or not those swaps are required to be cleared pursuant to section 2(h)(2)(D) of the CEA.

G. G–20 and International Commitments on Clearing

The financial crisis generated international consensus on the need to strengthen financial regulation by improving transparency, mitigating systemic risk, and protecting against market abuse. As a result of the widespread recognition that transactions in the OTC derivatives market increased risk and uncertainty in the economy and became a significant contributor to the financial crisis, a series of policy initiatives were undertaken to better regulate the financial markets.

In September 2009, leaders of the Group of 20 (G–20)—whose membership includes the United States, the European Union, and 18 other countries—agreed that: (1) OTC derivatives contracts should be reported and traded on exchanges or electronic trading platforms, where appropriate, by the end of 2012; and (3) non-centrally cleared contracts should be subject to clearing through central counterparties and traded on exchanges or electronic trading platforms, where appropriate, by the end of 2012; and (3) non-centrally cleared contracts should be subject to higher capital requirements.

In June 2010, the G–20 leaders reaffirmed their commitment to achieve these goals. In its October 2010 report on Implementing OTC Derivatives Market Reforms (the October 2010 Report), the Financial Stability Board (FSB) made twenty-one recommendations addressing practical issues that authorities may encounter in implementing the G–20 leaders’ commitments. The G–20 leaders again reaffirmed their commitments at the November 2011 Summit, including the end-2012 deadline. The FSB has issued three implementation progress reports.

The most recent report urged jurisdictions to push forward aggressively to meet the G–20 end-2012 deadline in as many reform areas as possible. On mandatory clearing, the report observed that “[j]urisdictions now have much of the information they requested in order to make informed decisions on the appropriate legislation and regulations to achieve the end-2012 commitment to centrally clear all standardized OTC derivatives.”

Specifically with regard to required clearing, the Technical Committee of the International Organization of Securities Commissions (IOSCO) has published a final report, Requirements for Mandatory Clearing, outlining recommendations that regulators should follow to carry out the G–20’s goal of requiring standardized swaps to be cleared.

D. Overview of Section 2(h) and § 39.5

The Commission has promulgated § 39.5 of its regulations to implement procedural aspects section 2(h) of the CEA. Regulation 39.5 establishes procedures for: (1) Determining the eligibility of a DCO to clear swaps; (2) the submission of swaps by a DCO to the Commission for a clearing requirement determination; (3) Commission initiated reviews of swaps; and (4) the staying of a clearing requirement.

This determination and rule proposed today would require that certain swaps submitted by Commission-registered DCOs are required to be cleared under section 2(h) of the CEA. Under section 2(h)(1)(A), “it shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a [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.”

A clearing requirement determination may be initiated by a swap submission. Section 2(h)(2)(B)(i) of the CEA requires a DCO to “submit to the Commission each swap, or any group, category, type, or class of swaps that it plans to accept for clearing, and provide notice to its members of the submission.” In addition under section 2(h)(2)(B)(ii) of the CEA, “[a]ny swap or group, category, type, or class of swaps listed for clearing by a [DCO] as of the date of enactment shall be considered submitted to the Commission.”

E. Submissions From DCOs

On February 1, 2012, Commission staff sent a letter requesting that DCOs submit all swaps that were accepting for clearing as of that date, pursuant to § 39.5. The Commission received submissions relating to CDS and IRS clearing from: the International Derivatives Clearinghouse Group (IDCH) on February 17, 2012; the CME Group (CME), ICE Clear Credit, ICE Clear Europe, each dated February 22, 2012, and a submission from LCH.Clearnet Limited (LCH) on February 24, 2012.

This proposal’s clearing requirement determination would cover certain CDS and IRS currently being cleared by a DCO. The Commission intends subsequently to consider other swaps submitted by DCOs, such as agricultural, energy, and equity indices.

The decision to focus on CDS and IRS in the initial clearing requirement determination is a function of both the market importance of these swaps and the fact that they already are widely cleared. In order to move the largest number of swaps to required clearing in its initial determination, the Commission believes that it is prudent to focus on those swaps that have the highest market shares and market impact. Further, for these swaps there is already a blueprint for clearing and appropriate risk management. CDS and IRS fit these considerations and therefore are well suited for required clearing consideration.

Significantly, market participants have recommended that the Commission take this approach. In their joint comment letter to the Commission’s proposed Compliance and Implementation Schedule for the clearing requirement, the Futures Industry Association (FIA), ISDA, and the Securities Industry and Financial Markets Association (SIFMA) opined


18 See section 2(h) of the CEA. A clearing requirement determination also may be initiated by the Commission. Section 2(h)(2)(A)(i) of the CEA requires the Commission on an ongoing basis to “review each swap, or any group, category, type, or class of swaps to make a determination as to whether the swap, category, type or class of swaps should be required to be cleared.” As previously noted, the Commission intends to consider swaps submitted by DCOs prior to undertaking any Commission-initiated reviews.
that CDS and IRS should be required to be cleared first because they are already being cleared. FIA, ISDA, and SIFMA commented further that it would make sense for the Commission to require commodity and equity swaps to be cleared later because fewer of these swaps are currently being cleared. Similarly, the letter sent by the Alternative Investment Management Association (AIMA) in response to Commissioner O’Malia’s request for comment concerning the implementation of the clearing requirement argues that the Commission should first review those swaps currently being cleared and then swaps that currently trade in large numbers.

IRS accounts for about $500 trillion of the $650 trillion global OTC swaps market, in notional dollars—the highest market share of any class of swaps. LCH claims to clear about $302 trillion of those—meaning that, in notional terms, LCH clears approximately 60% of the IRS market. While CDS indices do both single and multi-name products. During the 2008 financial crisis, overall, a sizeable market impact, as they did not have as prominent a market share as IRS. CDS indices are capable of having a sizeable market impact, as they did during the 2008 financial crisis. Overall, the CDS marketplace has almost $29 trillion in notional outstanding across both single and multi-name products. CDS on standardized indices accounts for about $10 trillion of the global OTC market in notional dollar amount outstanding. Since March 2009, the ICE Clear Credit and ICE Clear Europe have combined to clear over $30 trillion in gross notional for all CDS. Because of the market shares and market impacts of these swaps, and because these swaps are currently being cleared, the Commission decided to review CDS and IRS in its initial clearing requirement determination. The Commission recognizes that while this is an appropriate basis for this initial proposal, swap clearing is likely to evolve and clearing requirement determinations made at later times may be based on a variety of other factors beyond the extent to which the swaps in question are already being cleared.

II. Review of Swap Submissions

A. General Description of Information Considered

The Commission reviewed each of the submissions in detail. Based on these submissions, the Commission was able to consider the ability of an individual DCO to clear a given swap, as well as to consider the information supplied cumulatively across all submissions for a given swap. The analysis included reviews of the DCOs’ existing risk management frameworks and their risk management policies. The Commission relied on industry data as available, such as publicly available Depository Trust and Clearing Corporation (DTCC) data from the Trade Information Warehouse (TIW) on CDS transactions. Other publicly available data sources, such as data from the Bank of International Settlements (BIS) on the OTC derivatives markets are analyzed and cited throughout this notice of proposed rulemaking. The Commission also was able to review letters from market participants directly related to the clearing requirement. Other market input on the clearing requirement could be taken from comments received with regard to rules relating to the proposed Swap Transaction Compliance and Implementation Schedule: Clearing and Trade Execution Requirements under Section 2(b) of the CEA 32 and the Process for Review of Swaps for Mandatory Clearing. This notice of proposed rulemaking also reflects consultation with the staff of the Securities and Exchange Commission (SEC), prudential regulators, and international regulatory authorities. As § 39.5 provides for a 30-day comment period for any clearing determination, the final clearing requirement will be informed by public feedback.

B. Commission Processes for Review and Surveillance of DCOs

i. Part 39 Regulations Set Forth Standards for Compliance

Section 2(h)(2)(D)(i) of the CEA provides that the Commission shall review whether the submissions are consistent with section 5b(c)(2) of the CEA. Section 5b(c)(2) of the CEA sets forth eighteen core principles with which DCOs must comply to be registered and to maintain registration. The core principles address numerous issues, including financial resources, participant and product eligibility, risk management, settlement procedures, default management, system safeguards, reporting, recordkeeping, public information, and legal risk.

All of the DCOs that submitted swaps for review are registered with the Commission and their submissions identify swaps that they are already clearing. Consequently, the Commission has been reviewing and monitoring compliance by the DCOs with the core principles for the submitted swaps. For purposes of reviewing whether the submissions are consistent with section 5b(c)(2) of the CEA, the Commission will rely on both the information received in the submissions themselves and on its ongoing review and risk surveillance programs. These processes are summarized below to provide a better understanding of the information the Commission uses in its review of consistency of the submissions with the core principles. The Commission believes this overview is particularly helpful for this rulemaking because the clearing requirement proposed herein is the first such undertaking by the Commission under the provisions of the Dodd-Frank Act.

The primary objective of the CFTC supervisory program is to ensure compliance with applicable provisions of the CEA and implementing regulations, and in particular, the core principles applicable to DCOs. A primary concern of the program is to monitor and mitigate potential risks that can arise in derivatives clearing activities for the DCO, its members, and entities using the DCO’s services. Accordingly, the CFTC supervisory program takes a risk-based approach. In addition to the core principles set forth in section 5b(c)(2) of the CEA, section 5c(c) of the CEA governs the procedures for review and approval of new products, new rules, and rule amendments submitted to the Commission.
Commission by DCOs. Part 39 of the CFTC’s regulations implements sections 5b and 5c(c) of the CEA by establishing specific requirements for compliance with the core principles as well as procedures for registration, for implementing DCO rules, and for clearing new products. Part 40 of the CFTC’s regulations sets forth additional provisions applicable to a DCO’s submission of rule amendments and new products to the CFTC.

The Commission has means to enforce compliance, including the Commission’s ability to sue the DCO in federal court for civil monetary penalties, issue a cease and desist order, or suspend or revoke the registration of the DCO. In addition, any deficiencies or other compliance issues observed during ongoing monitoring or an examination are frequently communicated to the DCO and various measures are used by the Commission to ensure that the DCO appropriately addresses such issues, including escalating communications within the DCO management and requiring the DCO to demonstrate, in writing, timely correction of such issues.

ii. Initial Registration Application Review and Periodic In-Depth Reviews

Section 5b of the CEA requires a DCO to register with the Commission. In order to do so, an organization must submit an application demonstrating that it complies with the core principles. During the review period, the Commission generally conducts an on-site review of the prospective DCO’s facilities, asks a series of questions, and reviews all documentation received.

The Commission may ask the applicant to make changes to its rules to comply with the CEA and the Commission’s regulations. After registration, the Commission conducts examinations of DCOs to determine whether the DCO is in compliance with the CEA and Commission regulations. The examination consists of a planning phase where staff reviews information the Commission has on hand to determine whether the information raises specific issues and to develop an examination plan. The examination team participates in a series of meetings with the DCO at its facility. Commission staff also communicates with relevant DCO staff, including senior management, and reviews documentation. Data produced by the DCO is independently tested. Finally, when relevant, walk-through testing is conducted for key DCO processes.

iii. Commission Daily Risk Surveillance

Commission risk surveillance staff monitors the risks posed to and by DCOs, clearing members, and market participants, including market risk, liquidity risk, credit risk, and concentration risk. This analysis includes reviews of daily, large trader reporting data obtained from market participants, clearing members, and DCOs, which is available at the trader, clearing member, and DCO levels. Relevant margin and financial resources information is also included within the analysis.

Commission staff regularly conducts back-testing to review margin coverage at the product level and follows up with the relevant DCO regarding any exceptional results. Independent stress testing of portfolios is conducted on a daily, weekly, and ad hoc basis. The analysis of independent stress tests may lead to individual trader reviews and/or future commission merchant (FCM) risk reviews to gain a deeper understanding of a trading strategy, risk philosophy, risk controls and mitigants, and financial resources at the trader and/or FCM level. The traders and FCMs that have a higher risk profile are then reviewed during the Commission’s on-site review of a DCO’s risk management procedures.

C. Credit Default Swaps

i. Submissions Provided Information per § 39.5

Pursuant to § 39.5, the Commission received filings with respect to CDS from CME, ICE Clear Credit, and ICE Clear Europe. The CME and ICE Clear Credit submissions included the CDS that each clear on North American corporate indices, covering various tenors and series. The ICE Clear Europe submission includes, among other swaps, the CDS contracts on European corporate indices that they clear, with information on each of the different tenors and series. Each of the submissions contained information relating to the five statutory factors set forth in section 2(b)(2)(D) of the CEA and other information required under § 39.5.

CME, ICE Clear Credit, and ICE Clear Europe provided notice of their § 39.5 swap submissions to their members by posting their submissions on their respective Web sites. The submissions are also published on the Commission’s Web site.

Regulation 39.5(b)(3)(vi) also directs a DCO’s submission to include a summary of any views on the submission expressed by members. CME’s submission did not address this. In their submissions, ICE Clear Credit and ICE Clear Europe stated that neither has solicited nor received any comments to date and will notify the Commission of any such comments. The Commission expects that DCOs will provide any feedback they receive regarding their submissions to the Commission for consideration.

ii. Background on Market

A credit default swap is a bilateral contract that allows the counterparties to trade or hedge the risk that an underlying entity will default—in most cases, either a corporate or a sovereign borrower. The protection buyer makes a quarterly premium payment until a pre-defined credit event occurs or until the swap agreement matures. In return, the protection seller assumes the financial loss in the case the reference borrower becomes insolvent or an underlying security defaults. In addition to such “single name” CDS described above, the market also developed CDS to cover multi-name baskets of entities. While these baskets can be specifically created by the parties in a bespoke swap transaction, the large majority of multi-name baskets are based on both standardized indices and standardized swap agreements. These index CDS can cover up to 125 reference entities. Each of these entities may be weighted equally within the index or have different weightings depending on the terms of the specific index.

Unlike a single name CDS, these contracts generally continue until the swap agreement reaches its scheduled termination date. Under the contract, the protection seller would assume the financial loss associated with, and make payment to the protection buyer on, each of the individual entities in the index that suffers a credit event during the swap’s maturity. Those entities suffering a credit event would be removed from the index. The swap would continue on the remaining names, with the protection buyer making reduced quarterly premium payments.
payments based upon the now smaller index covered by the swap.

The most recent BIS study39 found that, as of December 2011, the size of the overall CDS marketplace exceeded $28.6 trillion in notional amount outstanding. Of that amount, $11.8 trillion was in multi-name CDS agreements. Within this sub-category of CDS, CDS on indices accounted for more than 89% of the total notional amount outstanding. This continues a trend as CDS on standardized indices have seen increasing volumes relative to other multi-name instruments such as synthetic collateralized debt obligations and other bespoke products.

Multiple providers have established CDS indices to be used by market participants. These providers typically establish an index’s constituents, as well as standard terms and tenors. They also may provide on-going pricing services for their indices. The CDS indices owned and managed by Markit have the dominant market share within this class of CDS. There are other providers of CDS indices, though to date, those indices have not been widely used. Currently none of the indices are the basis for any CDS cleared by a DCO.40 The Markit CDX family of indices is the standard North American credit default swap family of indices, with the primary corporate indices being the CDX North American Investment Grade (consisting of 125 investment grade corporate reference entities (CDX.NA.IG)) and the CDX North American High Yield (consisting of 100 high yield corporate reference entities) (CDX.NA.HY). The standard currency for CDS on these indices is the U.S. dollar.

Additionally, Markit owns and manages the iTraxx indices covering reference entities in the European and Asia/Pacific markets. The primary indices for the European markets are the iTraxx Europe which covers 125 European investment grade corporate reference entities, the iTraxx Europe Crossover covering 50 European high yield reference entities and the iTraxx Europe High Volatility, which is a 50-entity subset of the European investment grade index. These indices are generally denominated in euro.

Beyond those discussed above, Markit provides more granular indices covering specific corporate sectors in both the United States and Europe. Markit also provides indices that cover non-corporate reference entities, including indices of sovereign reference entities from around the world, U.S. municipal issuers and structured finance issuers.

Some of the sector specific CDS, particularly those based on indices in the iTraxx family have significant volumes. For example, the iTraxx Europe Senior Financials referencing European financial institutions has over $13 billion in net notional and 3,711 open contracts for Series 17 according to DTCC data.42 Those contracts are not currently cleared by a DCO and thus have not been submitted to the Commission. Therefore, these contracts are not being considered as part of the proposed clearing requirement determination discussed herein. To the extent these contracts were to be cleared by a DCO in the future, the DCO would be required to submit those contracts to the Commission for review pursuant to § 39.5. If those contracts were not cleared by any DCO, they may still be subject to a Commission-initiated review pursuant to § 39.5(c) in the future.

As administrator of these indices, Markit reviews the composition of underlying reference entities in the indices every six months. Once Markit establishes the constituents to be included within the indices, a new series of the respective index is created. Additionally, each time one of the reference entities within an index suffers a credit event, a new version of an existing series of the index is created. In addition to the series and version variations that may exist on the index, the parties can choose the tenor of the CDS on a given index. While the 5-year tenor is the most common, and therefore most liquid, other standard tenors may include 1-, 2-, 3-, 7-, and 10-year swaps.

Beyond these administrative functions, Markit, in conjunction with ISDA, has established standardized transaction terms and legal documentation in the form of standard terms supplements and confirmations for their indices. In the vast majority of cases, transactions using the indices are executed using these standard terms, although the indices also may be used in connection with non-standard transactions. A particular CDS index agreement will only be eligible to be cleared by a DCO to the extent the agreement is based upon the standard terms. Consistent with the movement of the CDS market to standardized contracts and spreads, cleared contracts all use standardized spreads of 100 or 500 basis points on the cost of protection, with the use of the upfront payments to accurately capture the cost of the credit protection on the indices.43

The CDS cleared by CME, ICE Clear Credit, and ICE Clear Europe that were submitted to the Commission are standardized contracts providing credit protection on an untranche basis, meaning that settlement is not limited to a specific range of losses upon the occurrence of credit events among the reference entities included within an index. Besides single name CDS, these untranche CDS on indices are the only type of CDS being cleared by these DCOs. Other swaps like credit index tranches, options, and first- or Nth-to-default baskets on these indices are not currently cleared.

Both CME and ICE Clear Credit have submitted standard untranche CDS on the CDX.NA.IG and the CDX.NA.HY indices that they clear. CME offers the CDX.NA.IG at the 3-, 5-, 7- and 10-year tenors for each series going back to Series 9 for those contracts that have not reached their termination date. For the North American high yield index, CME offers clearing for Series 11 and each subsequent series at the 5-year tenure.

ICE Clear Credit offers CDX.NA.IG Series 8 and all subsequent series of that index that are still outstanding at the 5- and 10-year tenors. Additionally, Series 8 to Series 10 are cleared at the 7-year tenor. For the high yield index, ICE Clear Credit clears all series from the current series through the CDX.NA.HY Series 9 at the 5-year tenor.

The term “reference entities” refers to those entities that form the basis of an index. For the indices discussed in this proposal, all of the reference entities are corporate entities. For example, when one of those corporate entities declares bankruptcy, it may trigger a credit event under the terms of the index. A credit event also may be declared when a reference entity fails to pay on an outstanding debt.


43 ISDA’s Big Bang Protocol in April 2009, in addition to providing the “hardwiring” necessary for Auction Settlement and the establishment of the Credit Derivatives Determination Committees, also created a new standardized North American corporate CDS contract with fixed scheduled termination dates, fixed payment and accrual dates, and standardized coupons. See http://www.isda.org/companies/auctionhardwiring/auctionhardwiring.html.


40 S&P/ISDA have, for example, co-branded additional indices for use in the CDS marketplace. These indices cover similar classes of reference entities as the Market indices. To date, however, the use of these indices by market participants has been limited. With insufficient data regarding outstanding notional amounts and trading volumes, the Commission does not believe it appropriate to include these indices in the mandatory clearing determination. To the extent other providers establish indices with demonstrable open interest, trading volumes and pricing sources, the Commission will consider them for inclusion either within the current proposed classes of swaps, or within a separate class of swaps. Exclusion for the proposed classes only means that the CDS on such indices are not subject to a clearing requirement, and has no other impact on the use of such indices by market participants.

41 The term “reference entities” refers to those entities that form the basis of an index. For the indices discussed in this proposal, all of the reference entities are corporate entities. For example, when one of those corporate entities declares bankruptcy, it may trigger a credit event under the terms of the index. A credit event also may be declared when a reference entity fails to pay on an outstanding debt.
In addition to these indices, ICE Clear Credit has also cleared the CDX North American Investment Grade High Volatility (consisting 30 names from the CDX.NA.IG) (CDX.NA.IG.HVOL). ICE Clear Credit is not however clearing Series 18, the most recently established series of the CDX.NA.IG.HVOL or Series 17, given the limited trading volumes for this swap. ICE Clear Credit only clears the CDX.NA.IG.HVOL for Series 9 through Series 16, and only at the 5-year tenor.

ICE Clear Europe, another registered DCO, made a submission covering the index CDS that it clears. Similar to the other submissions, the contracts that ICE Clear Europe clears are focused on corporate reference entities, though in this case, the entities are based in Europe. Also, similar to the CME and ICE Clear Credit submissions, the swaps cleared by ICE Clear Europe are indices owned and administered by Markit. ICE Clear Europe clears the euro-denominated contracts referencing the iTraxx Europe, the iTraxx Europe Crossover, and the iTraxx Europe High Volatility. For the iTraxx Europe and Crossover, ICE Clear Europe clears outstanding contracts in the Series 7 and 8, respectively, through the current series. For the High Volatility index, ICE Clear Europe clears outstanding contracts in the Series 9 through the current series. In terms of tenors, ICE Clear Europe clears the 5-year tenor for all swaps, as well as the 10-year tenor for the iTraxx Europe index.

Based upon those portions of the CME, ICE Clear Credit, and ICE Clear Europe swap submissions relating to the cleared CDS contracts discussed above, as well as the analysis conducted by the Commission pursuant to § 39.5(b) and set forth below, the Commission is reviewing the following classes of swaps for purposes of the clearing requirement.

iii. CDS Trading and Risk Management

The indices were created in the mid-2000s. Parties to these OTC contracts could use the indices to express their bullish or bearish sentiments on credit as an asset class, or to actively manage their credit exposures. As standardized contracts and indices, they had increased liquidity and were cheaper and easier to enter into than a customized transaction. Following the financial crisis, the popularity of such bespoke transactions like synthetic collateral debt obligations decreased and the standardized indices continued to grow.

Markit licenses its indices to market making financial institutions. Notwithstanding that these contracts trade as OTC products, the standardization of the contracts has allowed for them to be completed and confirmed electronically by a number of service providers. The 5-year tenor is the most liquid of the tenors. Similarly, the current "on-the-run" series tend to see the most liquidity, while the older "off-the-run" series tend to see less liquidity. Many investors exit positions in an existing series when a new series "rolls," explaining increased liquidity in the "on-the-run" series. As noted above, the pricing for the contract is generally set at a standardized rate of 100 or 500 basis points, with upfront payments exchanged to compensate for the actual price of the credit protection being provided.

For the DCOS clearing these swaps, the key factors in managing the risk of CDS portfolios that they clear are changes in the price of the swaps, the idiosyncratic risk related to the default of a reference entity, and the liquidity risk associated with unwinding a portfolio of a defaulting clearing member. While differing in the specific margin methodologies, each of the DCOS uses methodologies designed to capture 99% of potential portfolio losses over a five-day period. The DCOS will stress CDS portfolios with shifts both up and down in the price of the CDS, as well as with changes to the shape of the term structure of the CDS pricing curve. Idiosyncratic risk will be captured by a "jump-to-default" analysis in which widely held reference entities are assumed to default with limited or no recovery. Liquidity risk seeks to capture the cost of liquidating a portfolio, with assumed higher costs associated with concentrated portfolios.

The DCOS conduct end-of-day settlement on the CDS, using prices submitted by clearing members that hold a cleared position in that swap. According to DCO rules, the submitted prices may be traded against, such that members are incentivized to submit accurate pricing data. The DCOS analyze the submitted data to remove any outliers. The DCOS then calculate a composite spread or price by aggregating all the prices individually submitted, after deleting the outliers. The more liquid a particular swap, the more price submissions will be made.

In the event of a default of a clearing member, the DCOS have the ability to conduct an auction for other members to bid on all or a portion of the defaulting member’s portfolio of CDS positions. To the extent that the DCO was unable to sell the entire portfolio, the clearing rules require the non-defaulting clearing members to accept an apportionment of such portfolio if required by the DCO. To the extent the market for a swap is more liquid, the chances for a successful auction would likely be increased. Further, to the extent an auction is unsuccessful, a more liquid market would give the clearing member receiving such an apportionment a better opportunity to successfully sell or otherwise offset the risk associated with the CDS it accepted.

In addition to the CDS indices, ICE Clear Credit and ICE Clear Europe also offer single name CDS for clearing. Of the $29 trillion in CDS notional outstanding, approximately $17 trillion is in single name swaps according to the latest market survey of BIS. As part of their margining methodology, DCOS are seeking approval to offer portfolio margining for the single name CDS and the CDS indices held within a given portfolio. Given that the single name reference entities will likely also be constituents of a given index within a portfolio, the Commission generally believes that such portfolio margining initiatives are consistent with the sound risk management policies for DCOS that are required under § 39.13(g)(4). Moreover, DCOS such as ICE Clear Credit already use margining methodologies that provide for appropriate portfolio margining treatment with regard to clearing.

44 Generally the market for all CDS is driven by dealers. Recent estimates found that about 74% of CDS trading takes place among 20 dealer-banks worldwide, according to data from DTCC, which runs a central registry for credit derivatives. See http://www.bloomberg.com/news/2011-11-01/selling-more-insurance-on-shaky-european-debt-risk-for-u-s-banks.html.


The Commission is committed to working toward establishing similar portfolio margining programs for DCOs clearing customer positions in CDS indices and single name CDS.

iv. CDS Classes Based on Key Specifications

Under §39.5, the decision of the Commission to require that a group, category, type, or class of swaps be required to be cleared is informed by a number of factors. As an initial matter, the Commission looks to the submissions of the DCOs themselves with regard to the swaps they submit. After analyzing the key attributes of the swaps submitted, the Commission is proposing to establish two classes of CDS subject to the clearing requirement. The first class is based on the North American untranched indices and the second class is based on the European un tranched indices.

Given the different markets that the CDS indices cover, the different currencies and other logistical differences in how the CDS markets and documentation work, the Commission believes this is an appropriate basis for separate classes. In the case of the submissions received to date, the U.S. dollar-denominated CDS covering North America corporate credits would be a separate class of CDS from a euro-denominated CDS referencing European obligations.

The nature of the underlying reference entities for the CDS serve to establish the another specification. Each index referenced was a broad-based pool of corporate entities. These indices included both investment grade and high yield corporate entities and they were not limited by a specific sector type. The data available for corporate CDS transactions, including the CDS indices, is substantial. As new swaps are cleared and considered by class, the nature of the underlying index will continue to be a factor in the establishment of such classes.

As noted above, the regional differences in the way CDS indices are traded and cleared warrant a separate specification based upon common market standards established within the regions. Beyond different currencies, the key terms of the underlying CDS, including the relevant credit events, may differ with direct impact on the clearing and risk management of these products by DCOs.

The actual indices included within a class are also specified. As only certain indices for a type of reference entity may have significant trading volumes and be cleared within a particular region, it is necessary to identify those specific indices within the classes.

The classes are also being defined by particular tenors for the various indices included within the class. Given varying outstanding notional amounts and trading volumes on different tenors of existing indices, the Commission has analyzed the impact of including all or only select tenors within a given class. In addition, applicable series are identified within each tenor so that market participants can identify whether a particular series of given index is required to be cleared.

Finally, the nature of the CDS itself referencing the underlying indices will be a factor as well. Each of the submissions dealt only with un tranched CDS on the indices. There is a significant market for tranched swaps using the indices, where parties to the CDS contract agree to address only a certain range of losses along the entire loss distribution curve. Other swaps such as first or “Nth” to default baskets, and options, also exist on the indices.

v. Identification of Specifications

The Commission is proposing two classes of CDS contracts subject to the clearing requirement. The first class would be untranched CDS contracts referencing corporate entities in North America via Markit’s CDX.NA.IG and CDX.NA.HY indices. The second class would include untranched CDS referencing European corporate entities via Markit’s iTraxx Europe, iTraxx Europe Crossover and iTraxx Europe High Volatility. The following table sets forth the specific specifications of each class:

### TABLE 1

**North American Untranched CDS Indices Class**

<table>
<thead>
<tr>
<th>Specification</th>
<th>1. Reference Entities</th>
<th>Corporate.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Region</td>
<td>North America.</td>
<td></td>
</tr>
<tr>
<td>3. Indices</td>
<td>CDX.NA.IG.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>CDX.NA.HY.</td>
<td></td>
</tr>
<tr>
<td>4. Tenor</td>
<td>CDX.NA.IG: 3Y, 5Y, 7Y, 10Y.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>CDX.NA.HY: 5Y.</td>
<td></td>
</tr>
<tr>
<td>5. Applicable Series</td>
<td>CDX.NA.IG: Series 15 and all subsequent Series, up to and including the current Series.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>CDX.NA.IG: Series 11 and all subsequent Series, up to and including the current Series.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>CDX.NA.HY: Series 8 and all subsequent Series, up to and including the current Series.</td>
<td></td>
</tr>
<tr>
<td>6. Tranced</td>
<td>No.</td>
<td></td>
</tr>
</tbody>
</table>

**European Untranched CDS Indices Class**

<table>
<thead>
<tr>
<th>Specification</th>
<th>1. Reference Entities</th>
<th>Corporate.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Region</td>
<td>Europe.</td>
<td></td>
</tr>
<tr>
<td>3. Indices</td>
<td>iTraxx Europe.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>iTraxx Europe Crossover.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>iTraxx Europe HiVol.</td>
<td></td>
</tr>
<tr>
<td>4. Tenor</td>
<td>iTraxx Europe: 5Y, 10Y.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>iTraxx Europe Crossover: 5Y.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>iTraxx Europe HiVol: 5Y.</td>
<td></td>
</tr>
<tr>
<td>5. Applicable Series</td>
<td>iTraxx Europe 5Y: Series 10 and all subsequent Series, up to and including the current Series.</td>
<td></td>
</tr>
</tbody>
</table>

51 See ICE Clear Credit’s certification to the Commission, dated as of November 25, 2011. The certification is available at http://www.cftc.gov/stellent/groups/public/trulesandproducts/documents/ifdocs/rul112511icecc001.pdf;
The Commission is proposing to separate the classes of corporate swaps between the North American contracts and European contracts. The Commission believes that indices based on other types of entities would be viewed as a separate class and would be subject to a separate determination by the Commission. For example, given the differences that exist with regard to volumes and risk management of indices based on sovereign issuers, it is likely that such CDS would represent their own class of swaps. Similarly, to the extent indices from other regions were submitted by a DCO, it is likely that the Commission would take the view that they are part of their own class of swaps as well.

The Commission believes it appropriate to define the classes of swaps as untranced CDS contracts referencing the broad-based corporate indices of Markit. These corporate indices have the most notional outstanding, the most trading volumes, and the best available pricing. The risk management frameworks for the corporate index swaps are the most well-established, and have the most available data in terms of CDS spreads and corporate default studies for analysis of the underlying constituents of the indices. Agreements based on these indices also are widely accepted and use standardized terms.52

Both of the CDS classes presented herein assume that the relevant CDS agreement will use the standardized terms established by Markit/ISDA with regard to the specific index and be denominated in a currency that is accepted for clearing by DCOs. To the extent that a CDS agreement on an index listed within the classification is not accepted for clearing by any DCO because it uses non-standard terms or is denominated in a currency that makes it ineligible for clearing, that CDS would not be subject to the requirement that it be cleared, notwithstanding that the CDS is based on such index.

With regard to the specific indices, the Commission has not included the CDX.NA.IG.HVOL within the North American swap class. While older series of this swap were cleared at the 5-year tenor by ICE Clear Credit, neither of the two most recent series has been cleared, given the lack of trading volume in this swap. The swap is not offered for clearing by CME. To the extent that any DCO decides to clear future series of this particular indice, it would need to be submitted pursuant to §39.5, at which time, the Commission would be able to revisit the profile of the underlying index and determine whether swap contracts associated with this index should be subject to a clearing requirement.

ICE Clear Europe continues to clear the iTraxx Europe High Volatility through the current series at the 5-year tenor, notwithstanding declines in the volume for the recent series. Overall, the outstanding notional amounts and trading volumes are substantially less than those of the other iTraxx swaps. Recent DTCC data indicates that the gross notional amounts on contracts on the iTraxx Europe High Volatility index was $1.8 billion, representing less than 1% of those volumes for the European investment grade index and approximately 2.5% of the European high yield index for the same series.53

Notwithstanding the relatively small volumes, the Commission is proposing to include the iTraxx Europe High Volatility index within the class of European corporate indices subject to required clearing at this time. Because the current on-the-run series of this particular index is cleared, unlike the similar North American contract, the Commission believes the contract should be included within the class of European corporate swaps that is required to be cleared.

With regard to tenors, Markit, as administrator of the indices, publishes the initial spreads on the roll for each of the tenors offered for a given index. For the CDX.NA.IG, it publishes spreads for the 1-, 2-, 3-, 5-, 7-, and 10-year tenors. For the CDX.NA.HY, the spreads are set for the 3-, 5-, 7-, and 10-year tenors. For the iTraxx Europe, Crossover and High Volatility, spreads are similarly set for the 3-, 5-, 7-, and 10-year tenors.

Notwithstanding these various tenor offerings, the 5-year tenor for all indices is by far the most liquid tenor in the CDS marketplace. As a result, each DCO clears the 5-year tenor of the CDS index swaps that they clear. CME additionally offers clearing for 3-, 7-, and 10-year tenors on the CDX.NA.IG. ICE Clear Credit offers clearing on the 10-year tenor for the North American investment grade swap in addition to the 5-year contract. In the past, ICE Clear Credit has cleared the 7-year tenor of that index, but has not offered that tenor since Series 10. For the iTraxx indices, ICE Clear Europe offers the 10-year tenor on the investment grade index, in addition to the 5-year tenor.

Based upon its analysis of the §39.5 factors, the Commission is proposing that each of the 3-, 5-, 7-, and 10-year tenors be included within the class of swaps subject to the clearing requirement determination for CDX.NA.IG. While the DCO submissions indicate varying degrees of trading volumes among the indices at tenors other than the 5-year tenor, there are clearly large notional volumes and trading activity across the products as a whole. The risk management frameworks and methodologies employed by the DCOs should not be substantially impacted or can be adjusted to accommodate additional tenors. The remaining factors should be unchanged.

The Commission is proposing to exclude the 1- and 2-year tenors of the CDX.NA.IG from the class at this point. The Commission would like to see more data on the volumes of these tenors. Importantly, these tenors of swaps have not been submitted to the Commission by a DCO, so the Commission could review them when submitted by a DCO or on its own initiative pursuant to the §39.5(c). Because many investors use the 5-year tenor to take a view on credit as an asset class, and then exit the position when the new index rolls rather than hold a less liquid position in an off-the-run swap, the Commission is concerned that those seeking to avoid clearing may shift to the 1- or 2-year tenor to take a position on credit. The Commission will monitor volumes in the swaps at these tenors and evaluate

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52 To the extent other vendors successfully develop similar indices, the Commission would conduct the analysis required by §39.5, either on its own initiative or based on a DCO submission. If based on that analysis the Commission issued a clearing requirement determination, it is likely that such indices would be considered to be part of an existing class of CDS that are required to be cleared.

whether a change in the class of swaps to include these tenors is warranted.

With regard to the CDX.NA.HY, the Commission’s proposal will be limited to the 5-year tenor, the predominant tenor in this contract. Similarly, the Commission’s proposal with regard to the iTraxx indices will capture only those tenors that are currently offered for clearing—the 5- and 10-year tenors for the iTraxx Europe, and the 5-year tenors for the iTraxx Crossover and the iTraxx High Volatility.

The Commission’s proposed clearing determination will be limited to only those series of a given index, which are currently being cleared. Therefore, no swaps referencing a series prior to Series 8 for the CDX.NA.HY and CDX.NA.HY would be required to be cleared. For the iTraxx Europe and iTraxx Europe Crossover, no contracts referencing a series prior to Series 7 would be required to be cleared, and in the case of the iTraxx Europe High Volatility, no series prior to Series 9 would be required to be cleared.

Further, to the extent that any contract is of a tenor such that it is scheduled to terminate prior to July 1, 2013, such contract would not be part of this proposed clearing determination. Given the implementation periods provided for under §50.25, discussed below in Section IV, the Commission does not want to create a situation where certain market participants would be required to clear a contract based upon their status under the implementation provisions, but other parties would never be required to clear that same contract before its scheduled termination.

The Commission also is proposing that the classes be limited to untranche
der the aforementioned indices where the contract covers the entire index loss distribution of the index and settlement is not linked to a specified number of defaults. Tranche
d swaps, first- or “Nth”-to-default, options, or any other product variations on these indices are excluded from these classes. These other swaps based on the indices, such as tranches, have very different profiles in terms of the

§39.5 analysis. Besides very different notional and trading volumes, the risk management processes and operations may be significantly different. The Commission believes it appropriate to consider tranch
ed swaps and other variations on the indices as outside of the classes of swaps proposed herein. Such swaps, if submitted, likely would be viewed as a separate class.

D. Proposed Determinations Analysis for Credit Default Swaps

Section 2(b)(2)(D)(i) of the CEA requires the Commission to review whether a swap submission under section 2(b)(2)(B) is consistent with section 5b(c)(2) of the CEA. Section 2(b)(2)(D)(ii) of the CEA also requires the Commission to consider five factors in a determination based on a Commission initiated review or a swap submission: (1) The existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data; (2) the availability of risk management capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded; (3) the effect on the mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the DCO available to clear the contract; (4) the effect on competition, including appropriate fees and charges applied to clearing; and (5) the existence of a reasonable legal framework in the event of the insolvency of the relevant DCO or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property.

i. Consistency With Core Principles for Derivatives Clearing Organizations

Section 2(b)(2)(D)(i) of the CEA requires the Commission to review whether a submission is consistent with the core principles for DCOs. Each of the DCO submissions relating to CDS provided data to support the Commission’s analysis of the five factors under section 2(b)(2)(D) of the CEA. The Commission also was able to call upon independent analysis conducted with regard to CDS market, as well as its knowledge and reviews of the registered DCOs’ operations and risk management processes, covering items such as product selection criteria, pricing sources, participant eligibility, and other relevant rules. The discussion of all of these factors is set forth below.

The swaps submitted by CME, ICE Clear Credit, and ICE Clear Europe pursuant to §39.5(b) are currently being cleared by those organizations. As discussed above, the risk management, rules, and operations used by each DCO to clear these swaps are subject to review by the Commission risk management, legal, and examinations staff on an on-going basis.

Additionally, each of the DCOs has established procedures for the review of any new swaps offered for clearing. Before the indices referenced herein were accepted for clearing by any of the DCOs, they were subject to review by the risk management functions of those organizations. Such analysis generally focuses on the ability to risk manage positions in the potential swaps and on any specific operational issues that may arise from the clearing of such swaps. In the case of the former, this involves ensuring that adequate pricing data is available, both historically and on a “going forward” basis, such that a margining methodology could be established, back-tested, and used on an on-going basis. Operational issues may include analysis of additional contract terms for new swaps that may require different settlement procedures. Each of the contracts submitted by CME, ICE Clear Credit, and ICE Clear Europe and discussed herein has undergone an internal review process by the respective DCO and has been determined to be within their product eligibility standards.

As part of their rule frameworks, each of the DCOs also maintains participant eligibility requirements. On April 20, 2012, CME filed its amended rule concerning CDS Clearing Member Obligations and Qualifications (Rule 8H04). Pursuant to the amended rule, published to comply with Commission Regulation 39.12(a)(2), a CDS clearing member would have to maintain at least $50 million of capital. The amended rule would also require a CDS clearing member’s minimum capital requirement to be “scalable” to the risks it poses. Further, CME already has client clearing available for its CDS index contracts. Similarly, on March 23, 2012, ICE Clear Credit filed its amended Rule 201(b) to incorporate the $50 million minimum capital requirement for clearing members. ICE Clear Credit also has client clearing available for its CDS index contracts.

ICE Clear Europe has adopted similar rules to comply with §39.12(a)(2), and has instituted changes to its rules to permit client clearing of its iTraxx contracts.

In their submissions, CME and ICE Clear Credit enclosed their risk management procedures. In its submission, ICE Clear Europe references

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54 After its initial submission, ICE Clear Credit added the CDX.NA.HY, Series 15, 3-year contract to its list of CDS contracts eligible for clearing. The Commission has reviewed this contract, but is not including this particular contract within its proposed determination. The Commission will monitor volumes in the product at these tenors and evaluate whether a change in the class of swaps to include additional tenors is warranted.

55 As discussed in further detail below, the clearing requirement would not require existing swaps in the older series to be cleared. The requirement is prospective, only requiring newly executed swaps in these older series to be cleared.
may be set based upon the erosion of margin to a specific level or a call may be made at the discretion of the clearinghouse. When necessary, DCOs apply concentration charges to a clearing member’s house or customer account in order to address situations where the DCO believes a given position may be under-collateralized because the size of the position relative to the size of the market may increase the cost of liquidating the position.

In addition to the initial margin and variation margin collected by each DCO, each of the clearinghouses maintains a separate guaranty fund for its CDS clearing business. Using a combination of factors from their margining methodologies, positions are stressed to replicate extreme but plausible market conditions. Using these stressed results, each of the clearinghouses sizes its guaranty fund to cover the positions of its two largest debtor clearing members. Clearing members are required to contribute to the guaranty fund based on their relative positions.

The clearinghouse is unable to meet a margin call, or otherwise violated clearinghouse rules, each of the clearinghouses has the ability to find a clearing member in default. In such cases, each of the clearinghouses has established procedures by which it attempts to minimize the risk associated with a defaulting member’s positions. A clearinghouse would activate its default committee, seconding traders from clearing participants, to work to partition the portfolio for sale and for hedging purposes. The clearinghouse would then conduct an auction among its clearing participants for the sale of the portfolio. To the extent certain positions were unsold, each of the clearinghouses has the ability to allocate such positions to the remaining clearing members.

While other resources of the clearinghouse would be available in the event of a default of a clearing member, including clearinghouse contributions, the initial margin and guaranty fund contributions, and the primary financial resources of the clearinghouses. In total, CFTC-registered DCOs are currently holding more than $20 billion in aggregate in initial margin to cover cleared CDS positions.56 Additionally, publicly available data shows that CME’s CDS guaranty fund has approximately $629 million; ICE Clear Credit has a guaranty fund equal to $4.4 billion; and ICE Clear Europe has a guaranty fund €2.7 billion for its CDS business.57 In addition to the guaranty fund contributions made by clearing members, each of the clearinghouses also makes contributions to their respective funds, ranging in amounts from $50 to $100 million.58

Based upon the Commission’s ongoing risk management and rule reviews, and its annual examinations of the DCOs, the Commission believes that the submissions of CME, ICE Clear Credit, and ICE Clear Europe are consistent with section 5b(c)(2) of the CEA and the related Commission regulations. In analyzing the CDS products submissions discussed herein, the Commission does not believe that a clearing determination with regard to the specified CDS products would be inconsistent with CME, ICE Clear Credit, or ICE Clear Europe’s continued ability to maintain such compliance with the DCO core principles.

The predominant provider of CDS indices is Markit. Markit has indices covering corporate and sovereign entities, among others, in the United States, Europe, and Asia. Recent Markit data shows daily transaction volumes of 1,561 transactions using its licensed family of CDX indices, and 1,266 daily transactions using its European iTraxx index swaps.59 Further, it shows a rolling monthly average of $68 billion in gross notional amount for the CDX family of indices and €499 billion for

56 Based on Commission data for registered DCOs as of May 10, 2012.


58 Many DCOs also have rules allowing for an assessment of the remaining clearing members in the event of a default.

the iTraxx family. Nearly all of the CDX contracts and volumes come from indices that would be subject to the proposed clearing requirement determination. For the iTraxx, more than 79% of those daily contract volumes and 82% of the daily gross notional volumes come from the iTraxx investment grade and high yield indices contemplated by the proposed clearing requirement determination.

One point highlighted by this data, however, is the declining trading liquidity in the off-the-run series that can occur. Of the volumes noted by Markit, nearly 60% was in the current on-the-run series, as compared to all other outstanding series combined. The submissions of ICE Clear Credit, ICE Clear Europe, and CME also note the decline in average weekly gross notional amounts and contracts for benchmark tenors for off-the-run indices. The decline however can be more precipitous among older off-the-run indices. While many market factors can contribute to the actual volumes for a specific off-the-run contract, subject to certain exceptions, the trend is generally toward lower volumes.

Set forth below is a table of data taken from DTCC as of May 22, 2012, highlighting the net notional amounts and outstanding contracts across all tenors available for each series in the proposed determination.60

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60 Data available at www.dtcc.com. In 2006, DTCC began providing warehouse services for confirmed CDS trades through its Trade Information Warehouse (TIW). With the commitment of global market participants in 2009 to ensure that all OTC derivatives trades are recorded by a central repository, TIW has become a global repository for all CDS trades. With all major market participants submitting their trades to the TIW, it is estimated that 98% of all CDS trades are included within the warehouse, making it the primary source of CDS transaction data.
Notwithstanding the declining volumes that occur when an index is no longer on-the-run, the Commission does not believe that is sufficient reason to exclude the older series from the classes of CDS. As the DTCC data indicates, there are still significant volumes of outstanding notional amounts in each of these series. From the perspective of the clearinghouse, the risk management of the older series of swaps should not provide significant additional challenges. With the significant notional and contract volumes still outstanding at DTCC, many clearing members already have these positions on their books and are meeting their risk management requirements, even in the face of declining trading volumes.

Finally, while the volumes may decline, the data included in the submissions indicates that volume still does exist, and parties should be able trade as necessary. Additionally, as discussed further below, the clearing requirement would apply only to new swaps executed in the off-the-run indices.

Beyond clearing member submissions, there are a number of third-party vendors that provide pricing services on these swaps. Third-party vendors typically source their data from a broader range of dealers. The data includes both direct contributions as well as feeds to automated trading systems. This data is reviewed for outliers and aggregated for distribution.

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b. Availability of Rule Framework, Capacity, Operational Expertise and Resources, and Credit Support Infrastructure

Section 2(h)(2)(D)(ii)(II) of the CEA requires the Commission to take into account the availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded. The Commission preliminarily has determined that this factor is satisfied by each of CME, ICE Clear Credit, and ICE Clear Europe. CME, ICE Clear Credit, and ICE Clear Europe, respectively, currently are clearing the swaps each submitted under § 39.5. As such, they have developed respective rule frameworks, capacity, operational expertise and resources, and credit support infrastructure to clear the contracts on terms that are consistent with the material terms and trading conventions on which the contracts currently are trading. The Commission believes that these are scalable and that CME, ICE Clear Credit, and ICE Clear Europe would be able to risk manage the additional swaps that might be submitted due to the clearing requirement determination.

Following the financial crisis, the major market participants committed in 2009 to the substantial reforms to the OTC derivatives markets. Among the commitments from CDS dealers and buy-side participants was to actively engage with central counterparties to broaden the range of cleared swaps and market participants. These changes were in addition to those generated through organizations like ISDA and their protocols impacting CDS. For broadly traded swaps like the CDS indices, the ultimate impact of these initiatives was operational platforms, rule frameworks, and other infrastructure initiatives that replicated the bilateral market and supported the move of these CDS to a centrally cleared environment. In this way, the CDS clearing services offered by DCOs, including CME, ICE Clear Credit, and ICE Clear Europe, were designed to be cleared in a manner that is consistent with the material terms and trading conventions of a bilateral, uncleared market.

In addition, CME, ICE Clear Credit, and ICE Clear Europe are registered DCOs. To be registered as such, CME, ICE Clear Credit, and ICE Clear Europe have, on an on-going basis, demonstrated to the Commission that they are each in compliance with the core principles set forth in the CEA and Commission regulations, as discussed above. As a general matter, any DCO that does not have the rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the swaps that are subject to mandatory clearing is not in compliance with the core principles or the Commission regulations promulgating these principles.

The Commission requests comment on all aspects of this factor, including whether or not commenters agree that an applicant’s status as a registered DCO is sufficient for meeting the factor’s requirements.

c. Effect on the Mitigation of Systemic Risk

Section 2(h)(2)(D)(ii)(III) of the CEA requires the Commission to take into account the effect on the mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the DCO available to clear the contract. The Commission agrees with the § 39.5 swap submissions of the CME, ICE Clear Credit, and ICE Clear Europe that requiring certain classes of CDS to be cleared would reduce systemic risk in this sector of the swaps market. As CME noted, the 2008 financial crisis demonstrated the potential for systemic risk arising from the interconnectedness of OTC derivatives market participants and the limited transparency of bilateral, i.e. uncleared, counterparty relationships. According to the Quarterly Report (Third Quarter 2011) on Bank Trading and Derivatives Activities of the Office of the Comptroller of the Currency (OCC Report), CDS index products account for a significant percentage of the notional value of swaps positions held by financial institutions. According to ICE Clear Credit, the CDS indices it offers for clearing are among the most actively traded swaps with the largest pre-clearing outstanding positions, and ICE Clear Credit’s clearing members are among the most active market participants. ICE Clear Credit also noted that its clearing members clear a significant portion of their clearing-eligible portfolio.

Clearing the CDS indices subject to this proposal will reduce systemic risk in the following ways: Mitigating counterparty credit risk because the DCO would become the buyer to every seller of CDS indices subject to this proposal and vice versa; providing counterparties with daily mark-to-market valuations and exchange of variation margin pursuant to a risk management framework; posting initial margin with the clearinghouse in order to cover potential future exposures in the event of a default; achieving multilateral netting, which substantially reduces the number and notional amount of outstanding bilateral positions; reducing the counterparties’ operational burden by consolidating collateral management and cash flows; and eliminating the need for novations or tear-ups because clearing members may offset opposing positions.

As discussed previously, the clearinghouses collect substantial amounts of collateral in the form of initial margin and guaranty fund contributions to cover potential losses on CDS portfolios. The methodologies for calculating these amounts are based on covering 5-day period payments on a portfolio with a 99% confidence level for initial margin, and longer liquidation periods and higher confidence levels under “extreme but plausible” conditions in the case of guaranty fund requirements. Beyond these financial resources, the clearinghouses have in place established risk monitoring processes, system safeguards, and default management procedures, which are subject to testing and review, to address potential systemic shocks to the financial markets.

The Commission requests comment on all aspects of this factor, including the risk mitigation associated with proposed clearing determination.

d. Effect on Competition

Section 2(h)(2)(D)(ii)(IV) of the CEA requires the Commission to take into account the effect on competition, including appropriate fees and charges applied to clearing. Of particular concern to the Commission is whether this proposed determination would harm competition by creating, enhancing, or entrenching market power in an affected product or service market, or facilitating the exercise of market power. Under U.S. Department of Justice guidelines, market power is viewed as the ability “to raise price [including clearing fees and charges], reduce output, diminish innovation, or otherwise harm customers as a result of...
diminished competitive constraints or incentives.”

The Commission has identified the following putative product and service markets as potentially affected by this proposed clearing determination: A DCO service market encompassing those clearinghouses that currently (or with relative ease in the future) could clear the CDS subject to this proposal, and a CDS product market or markets encompassing the CDS that are subject to this determination. Without defining the precise contours of these markets at this time, the Commission recognizes that, depending on the interplay of several factors, this proposed swap determination potentially could impact competition within the affected markets. Of particular importance to whether any impact is, overall, positive or negative, is: (1) Whether the demand for these clearing services and swaps is sufficiently elastic that a small but significant increase above competitive levels would prove unprofitable because users of the CDS products and DCO clearing services would substitute other products/clearing services co-existing in the same market(s), and (2) the potential for new entry into these markets. The availability of substitute products/clearing services to compete with those encompassed by this proposed determination, and the likelihood of timely, sufficient new entry in the event prices do increase above competitive levels, each operate independently to constrain anticompetitive behavior.

Any competitive import would likely stem from the fact that proposed determination would (1) remove the alternative of not clearing the CDS subject to this proposal, and/or (2) single out Markit indices and certain tenors for determination. The proposed determination would not specify what CDS products (or products that compete with the proposed CDS classes) may or may not be offered, traded, or voluntarily cleared; or who may or may not compete to provide clearing services for the CDS subject to this proposal (as well as those not required to be cleared). With respect to the first potential area of competitive import, to the extent that parties to the CDS subject to this proposal consider clearing the transactions reasonably interchangeable with not clearing them, the proposed determination would eliminate at least one competitive substitute within the clearinghouse services market for the CDS subject to this proposal. Given the risk-mitigation purpose and benefit of migration to voluntary CDS clearing, however, the Commission sees some basis to doubt that, under the “hypothetical monopolist” methodology, counterparties to cleared swaps would consider the alternative of not clearing CDS under this proposal as a reasonable substitute to a degree sufficient that they should be viewed as populating the same relevant market. And, if the alternative of not clearing the proposed classes of CDS falls outside of the relevant market that includes clearing, the proposed clearing determination should not impact competition in the clearing services market. The Commission requests comment on the extent to which foregoing clearing is considered reasonably interchangeable with clearing the CDS subject to this proposal and, in particular, if parties transacting cleared swaps in these classes would forego clearing if clearinghouses raised the price of clearing five percent. The Commission also requests comment on whether a different percentage than five percent should be used.

Moreover, even if cleared and non-cleared transactions in the proposed CDS clearing requirement are now within the same relevant market, removing the uncleared option through this proposed rulemaking is not determinative of negative competitive impact. Other factors—including the availability of other substitutes within the market or potential for new entry into the market—may constrain market power.

The Commission recognizes that currently no DCO clears CDS indices licensed by any other provider than Markit, suggesting the possibility that currently the clearing service market may be limited to the three providers (CME, ICE Clear Credit, and ICE Clear Europe) now clearing CDS indices licensed by Markit. This could be indicative, but is not dispositive, of whether a concentrated clearing services market susceptible to exercises of market power exists. The possibility remains that uncleared transactions on other indices, as well as cleared and uncleared transactions on Markit indices of tenors not included within the proposed determination, may also populate the affected clearing services market to constrain CME, ICE Clear Credit, and ICE Clear Europe from exercising market power. The Commission requests comment on the extent to which uncleared transactions on non-Markit indices, and cleared and uncleared transactions on Markit indices of tenors not included within the proposed determination, are considered reasonably interchangeable with clearing the CDS subject to this proposal; and, in particular, if parties transacting cleared CDS subject to this proposal would substitute uncleared transactions on non-Markit indices and/or transactions on Markit CDS tenors not subject to this proposal if clearinghouses raised the price of clearing the CDS required to be cleared five percent.

Additionally, the potential for new entry may constrain market power in an otherwise concentrated clearing services market. The Commission does not foresee that the proposed determination constructs barriers that would deter or impede new entry into a clearing services market. Indeed, there is some
basis to expect that the determination could foster an environment conducive to new entry. For example, the proposed clearing determinations, and the prospect that more may follow, is likely to reinforce, if not encourage, growth in demand for clearing services. Demand growth, in turn, can enhance the sales opportunity, a condition hospitable to growth, in turn, can enhance the sales prospect that more may follow, is likely to new entry. For example, the proposed clearing determinant could have a negative competitive impact by increasing market concentration.

Further, this proposed determination may increase the incentive of competing indices providers (for illustration purposes, Standard & Poor’s) to support a new clearing services entrant through some form of partnership or other sponsorship effort. The Commission requests comment on the extent to which (1) entry barriers currently do or do not exist with respect to a clearing services market for the identified CDS classes; (2) the proposed determinations may lessen or increase these barriers; and (3) the proposed determinations otherwise may encourage, discourage, facilitate, and/or dampen new entry into the market.

Also, while the proposed rule does single out Markit indices and certain CDS tenors for required clearing, for reasons similar to those discussed above, this does not foreclose competition from CDS on other indices or tenors, and may in fact encourage it. For example, the Commission anticipates that an attempt by Markit to increase indices licensing fees would present a competitive opportunity for current and potential future indices providers to capture market share and/or entrants to leverage from market entry. The Commission requests comment on the extent to which competition in identified Markit CDS product markets may be impacted, including any expected impact on the price of Markit indices licenses, cost of swaps in the required classes, and entry conditions.

In addition to what is noted above, the Commission requests comment, and quantifiable data, on whether the required clearing of any or all of these swaps will create conditions that create, increase, or facilitate an exercise of (1) clearing services market power in CME, ICE Clear Credit, ICE Clear Europe, and/or any other clearing service market participant, including conditions that would dampen competition for clearing services and/or increase the cost of clearing services, and/or (2) market power in any product markets for Markit indices and CDS tenors, including conditions that would dampen competition for these product markets and/or increase the cost of CDS involving the proposed clearing requirement. The Commission seeks comment, and quantifiable data, on the likely cost increases associated with clearing, particularly those fees and charges imposed by DCOs, and the effects of such increases on counterparties currently participating in the market. The Commission also seeks comment regarding the effect of competition on risk management by DCOs. The Commission welcomes comment on any other aspect of this factor.

d. Legal Certainty in the Event of the Insolvency

Section 2(h)(2)(D)(ii)(V) of the CEA requires the Commission to take into account the existence of reasonable legal certainty in the event of the insolvency of the relevant DCO or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property. The Commission is proposing this clearing requirement based on its view that there is reasonable legal certainty in the event of the insolvency of the relevant DCO (CME, ICE Clear Credit, or ICE Clear Europe) or one or more of the DCO’s clearing members.

The Commission concludes that, in the case of a clearing member insolvency at CME or ICE Clear Credit, subchapter IV of Chapter 7 of the U.S. Bankruptcy Code (11 U.S.C. 761–767) and Part 190 of the Commission’s regulations would govern the treatment of customer positions. Pursuant to section 4d(f) of the CEA, a clearing member accepting funds from a customer to margin a cleared swap must be a registered FCM. Pursuant to 11 U.S.C. 761–767 and Part 190 of the Commission’s regulations, the customer’s CDS positions, carried by the insolvent FCM, would be deemed “commodity contracts.” As a result, neither a clearing member’s bankruptcy nor any order of a bankruptcy court

determination could have a negative competitive impact by increasing market concentration.

See, e.g., Horizontal Merger Guidelines at § 9.2 (entry likely if it would be profitable which is in part a function of “the output level the entrant is likely to obtain”).

71 If an FCM is also registered as a broker-dealer, certain issues related to its insolvency proceeding would also be governed by the Securities Investor Protection Act.

72 The Commission observes that an FCM or DCO also may be subject to resolution under Title II of the Dodd-Frank Act to the extent it would qualify as a covered financial company (as defined in section 201(a)(8) of the Dodd-Frank Act).

73 Claims seeking payment for the administration of customer property would share this priority.

74 Claims seeking payment for the administration of customer property would share this priority.
Europe, or one of such DCOs’ clearing members.

Request for Comment

The Commission requests comment on all aspects of the proposed classes of CDS to be included within the clearing requirement and the proposed determination. The Commission may consider alternatives to the proposed CDS classes and is requesting comment on the following questions:

- Should the Commission include all tenors, such as the 1- or 2-year tenor for Markit indices, for each index included within the class, notwithstanding the fact that these are tenors not currently cleared by a DCO? Will market participants be incentivized to use such contracts to avoid the clearing requirement?

- Should the Commission limit its determination to the most liquid tenors of the CDX.NA.IG such as the 5- and 10-year tenors, and exclude other tenors such as the 3- and 7-year tenors, which are less liquid?

- Is the Commission correct in believing that risk management frameworks and methodologies supporting existing cleared offerings can be adjusted to address additional tenors with limited changes?

- Should the Commission structure its clearing requirement such that indices that become older off-the-run indices are no longer subject to the requirement? In such a proposal, how should the Commission treat those off-the-run indices, such CDX.NA.IG Series 9, that have remained extremely active notwithstanding being off-the-run? Should the Commission establish some type of threshold of trading to exclude off-the-run indices from the requirement? How would the Commission construct a rule to indicate that an off-the-run index is no longer subject to clearing?

- To the extent off-the-run indices were excluded from the clearing requirement, would market participants be incentivized to trade in older off-the-run indices, as opposed to current on-the-run indices?

- The CDS indices proposed to be included within the clearing requirement are currently offered by DCOs and are among the most liquid CDS. Is there any factor within the five statutory that do not support inclusion with the clearing requirement? Are there other factors outside of those five factors with regard to these particular offerings that weigh against inclusion in a clearing determination?

E. Interest Rate Swaps

i. Introduction

Interest rate swaps are agreements wherein counterparties agree to exchange payments based on a series of cash flows over a specified period of time typically calculated using two different rates multiplied by a notional amount. As of June 2011, the BIS estimated that over $550 trillion in notional amount of single currency interest rate swaps were outstanding representing 75 to 80% of the total estimated notional amount of derivatives outstanding. Based on these factors and on the swap submissions received under § 39.5(b), the Commission believes that interest rate swaps represent a substantial portion of the swaps market and warrant consideration by the Commission for required clearing.

The Commission’s consideration of the interest rate swap submissions (IRS submissions) is presented in two parts. The first part, this Section II.E, discusses the Commission’s rationale for determining how to classify and define the interest rate swaps identified in the DCO submissions to be considered for the clearing requirement. The second part, Section II.F, presents the Commission’s consideration of the IRS submissions in accordance with section 2(b)(2)(D) of the CEA.

Unlike certain CDS or futures contracts, there are a large number of different, variable contract specifications available and used in interest rate swap transactions. As an indication of this variability, the Commission notes that over 10,500 different combinations of significant interest rate swap terms were identified for trades executed in a single three month period in 2010. This variability creates a challenge for DCOs to specify the interest rate swaps for which clearing services are available and for the Commission to define what kinds of interest rate swaps will be subject to the clearing requirement. Notwithstanding this variability in swap terms, parties generally seek common economic results when entering into interest rate swaps, and there are common contract definitions and conventions that make classifying and clearing interest rate swaps possible. Identifying and analyzing these commonalities is necessary for effective classification of the swaps that will be subject to a proposed clearing requirement determination for interest rate swaps.

Accordingly, a summary of the DCO submissions received by the Commission is followed by a discussion of how interest rate swaps are traded and risk managed and an analysis of the primary interest rate swap classes that are cleared and the product specifications used to identify interest rate swap products within each class. Thereafter, in Section II.F, the Commission considers each of the interest rate swap classes and the primary specifications that are identified in the IRS submissions using the five factors identified in section 2(b)(2)(D) of the CEA to determine which interest rate swaps shall be required to be cleared.

ii. Submissions Received

The Commission received submissions from three DCOs eligible to clear interest rate swaps (IRS submissions): LCH.Clearnet Limited (LCH), the clearing division of the Chicago Mercantile Exchange Inc. (CME), and International Derivatives Clearinghouse, LLC (IDCH).

The following table summarizes the interest rate swap classes and significant specifications identified in the IRS submissions as currently available for clearing by each DCO. The classes and swap specifications are described in more detail below.

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75 BIS, OTC Derivatives Market Activity in the First Half of 2011, November 2011, Table 1 [hereinafter “BIS data”]. The BIS data provides the broadest market-wide estimates of interest rate swap activity available to the Commission.

76 Id.


78 The IRS submissions received by the Commission are available at http://www.cftc.gov/IndustryOversight/IndustryFilings/index.htm. Submissions materials marked by the submitting DCO for confidential treatment pursuant to §§ 39.5(b)(5) and 145.9(d) are not available for public review.
### TABLE 3—INTEREST RATE SWAP SUBMISSIONS SUMMARY

<table>
<thead>
<tr>
<th>Swap Classes</th>
<th>LCH</th>
<th>CME</th>
<th>IDCH</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed-to-floating, basis, forward rate agreements (FRAs); overnight index swaps (OIS); USD, EUR, GBP, JPY, AUD, CAD, CHF, SEK, CZK, DKK, HKD, HUF, NOK, NZD, PLN, SGD, and ZAR.</td>
<td>Fixed-to-floating</td>
<td>USD–LIBOR, CAD–BA, CHF–LIBOR, GBP–LIBOR, JPY–LIBOR, and EURIBOR.</td>
<td>Fixed-to-floating, basis, FRAs, OIS.</td>
</tr>
<tr>
<td>USD, EUR, GBP out to 50 years, and CAD, JPY, CHF, AUD out to 30 years.</td>
<td>USD, EUR, GBP out to 50 years, and CAD, JPY, CHF, AUD out to 30 years.</td>
<td>For Fixed-to-floating:</td>
<td>For Fixed-to-floating:</td>
</tr>
<tr>
<td>USD, EUR, GBP, and CHF out to two years.</td>
<td>USD, EUR, GBP, and CHF out to two years.</td>
<td>30 years.</td>
<td>30 years.</td>
</tr>
</tbody>
</table>

Each of the IRS submissions provided information specified under § 39.5(b) for such swap submissions or provided references to Web sites or other sources for such information, including, for example, information previously provided to the Commission for other purposes. Each submitter also has described how it provided notice to its members as required by § 39.5(b)(3)(viii).

LCH has been clearing OTC interest rate swaps since 1999 through its SwapClear service. In its IRS submission, LCH indicates that it clears more than 50% of the interest rate swap market by notional amount.\(^{79}\) As of its submission date, February 24, 2012, LCH reported that it had cleared and held outstanding about one million trades with an aggregate notional amount over $283 trillion. LCH accepted for clearing fixed-to-floating and basis swaps in seventeen currencies (including variable notional swaps in three currencies), overnight index swaps in four currencies, and forward rate agreements in 10 currencies. Swaps accepted for clearing must have certain product specifications identified by LCH, which help it administer clearing and manage risk appropriately.\(^{81}\) Of the three interest rate swap submitters, LCH has been clearing the longest, clears the broadest range of interest rate swaps, and clears the largest portion of the interest rate swap market at this time. As of March 2011, LCH implemented client clearing in both Europe and the U.S. Prior to that date, both parties to a swap had to be LCH members to be able to clear a swap with LCH.

CME began clearing interest rate swaps on October 18, 2010. CME’s IRS submission indicates that CME is currently clearing fixed-to-floating swaps in six currencies with an identified set of product specifications and has open interest in three currencies. In its submission, CME recommended a clearing requirement determination for all non-option interest rate swaps denominated in a currency cleared by any qualified DCO.

In September 2010, IDCH amended its rule book to provide for clearing interest rate swaps. IDCH is eligible to clear U.S. dollar denominated fixed-to-floating swaps, overnight index swaps, and forward rate agreements, which have certain product specifications as identified in its submission. IDCH had no outstanding cleared positions for these swaps as of the date of this proposal.

Furthermore, the interest rate swaps identified in the three IRS submissions are all single currency swaps with no optionality, as defined by the applicable DCO.

### Interest Rate Swap Market Conventions and Risk Management

Unlike certain CDS for which highly standardized terms have been developed, or futures, the terms of which are set by the exchanges, interest rate swaps are broad in scope and present a wide range of variable product classes and product specifications within each class. A data set of interest rate swaps electronically recorded over a three month period in 2010 by 14 large dealers for which one of those dealers was a party to each swap, contained over 10,500 different combinations of product classes, currencies, tenors, and forward periods.\(^{82}\) The data set also included eight different general product classes (e.g., fixed-to-floating, basis, forward rate agreements, swaptions, etc.), 28 currencies, 53 different rate indexes, and stated termination dates from one month to 55 years. In addition, dozens of different contract term conventions were identified.

Notwithstanding the large variety of contracts, there are commonalities that make it possible to categorize interest rate swaps for clearing purposes. Firstly, the vast majority of interest rate swaps use the ISDA definitions and contract conventions that allow market participants to agree quickly on common terms for each transaction. In fact, the three DCOs clearing interest rate swaps all use ISDA definitions in their product specifications.

Secondly, counterparties enter into swaps to achieve particular economic results. While the results desired may differ in small ways depending on each

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\(^{79}\)In this proposal, currencies are identified either by their full name or by the three letter ISO currency designation for the currency.

\(^{80}\)LCH letter, dated February 24, 2012, at 1. stating that the market share percentage estimate is based upon BIS statistics and SwapClear volumes as of January 31, 2012.

\(^{81}\)These specifications can be found on LCH’s Web site at http://www.lchclearnet.com/Images/General%20Regulations_lcm6-43737.pdf.

\(^{82}\)See “ODSG data” described below. The ODSG data set, while the broadest available providing trade-by-trade details, is limited in that it excludes trades that needed to be manually confirmed or that did not include a G14 Dealer.
counterparty’s specific circumstances and goals, there are certain common swap conventions that are used to identify and achieve commonly desired economic results when entering into interest rate swaps. For example, a party that is trying to hedge variable interest rate risk may enter into a fixed rate to floating rate swap, or a party that is seeking to fix interest rates for periods in the future may enter into a forward rate agreement.

The IRS submissions classify interest rate swaps on this basis by identifying commonly known classes of swaps that they clear including: fixed rate to floating rate swaps, that are sometimes referred to as plain vanilla swaps (fixed-to-floating swaps); floating rate to floating rate swaps, also referred to as basis swaps (basis swaps); overnight index swaps (OIS); and forward rate agreements (FRAs). These class terms are also being used in industry efforts to develop a taxonomy for interest rate swaps.

Furthermore, within these general classes, certain specifications such as currency, reference interest rate index, and stated termination date (also referred to as maturity date), are essential for defining the economic result that will be achieved. For example, a party located in the United States who seeks to hedge interest rate risk that is in U.S. dollars will most likely enter into a U.S. dollar swap as opposed to a swap in different currency. The party will also enter into a swap whose interest rate index correlates with the floating rate the party is trying to hedge and will specify a termination date that coincides with when the subject interest rate risk terminates. Each of the IRS submissions naturally use these common specifications when identifying the swaps that the DCO clears. Within each of those specifications, there are common terms used by the DCOs, which allows for further classification of the full range of interest rate swaps that are executed.

Accordingly, while there are a wide variety of interest rate swaps when taking into account all possible contract specifications, certain specifications are commonly used by the DCOs and market participants. This allows for the identification of classes of swaps and primary specifications within each class that reflect the economic goals market participants seek to achieve and that are based on market conventions used by the DCOs to define which interest rate swap products they will clear. For example, fixed-to-floating swaps comprise roughly 50% of interest rate swaps, U.S. dollar denominated swaps account for approximately 35% of the total outstanding notional amount of swaps, and U.S. dollar LIBOR is the floating rate index used for approximately 80% of U.S. dollar swaps traded.

The DCOs also risk manage interest rate swaps collectively on a portfolio basis rather than on a transaction or product specific basis. All three DCOs primarily assess risk at the portfolio level. In other words, when looking at the risk posed by an interest rate swap portfolio, DCOs do not assess the risk of any one particular swap or swap class within the portfolio. Instead, the DCOs analyze the cumulative risk of a position’s components. This concept of risk aggregation is also used within the context of the DCOs’ margining methodologies. All three DCOs use margin methodologies based on portfolio margining as opposed to margining individual swaps or swap categories and subsequently developing offsets and charges across different swaps or classes of swaps.

By looking at risk on a portfolio basis, the DCOs take into account how swaps with different attributes, such as underlying currency, stated termination dates, underlying floating rate indexes, swap classes, etc., are correlated and thus can offset risk across attributes. This is possible because, although individual transactions may have unique contract terms, given the commonalities of transactions as discussed above, swap portfolios can be risk managed on a cumulative value basis taking into account correlations among the cleared swaps. Consequently, DCOs can be expected to fairly, rapidly, and efficiently manage the risk of interest rate swaps in a default scenario through a small number of large hedging transactions that hedge large numbers of similarly correlated positions held by the defaulting party. As such, liquidity for specific, individual swaps is not the focus of DCOs from a risk management perspective. Rather, liquidity is viewed as a function of whether a portfolio of swaps has common specifications that are determinative of the economics of the swaps in the portfolio such that a DCO can price and risk manage the portfolio through block hedging and auctions in a default situation.

A real life example of how this works is provided by LCH’s management of the Lehman Brothers cleared interest rate swap portfolio following Lehman’s bankruptcy in September 2008. Upon Lehman’s default, LCH needed to risk manage a portfolio of approximately 66,000 interest rate swaps, which it hedged with approximately 100 new trades in less than five days. Once LCH executed these initial hedges, it was left with a relatively risk neutral portfolio. However, some risk still remained given that the hedges did not match the original trades exactly. Once the portfolio was hedged, LCH asked clearing members to price and bid on all, or subdivided portions, of the original Lehman portfolio with the hedging trades. For example, clearing members with live open positions in U.S. dollar swaps were asked to bid for the relatively hedged U.S. dollar portfolio. Through the bidding process, LCH was able to hedge and auction off all risk related to Lehman’s interest rate swap portfolio existing at the time of its bankruptcy and only used approximately 35% of the initial margin Lehman had posted.

iv. Interest Rate Swap Classification for Clearing Requirement Determinations

Section 2(h)(2)(A) of the CEA provides that the Commission “shall review each swap, or any group, category, type, or class of swaps to make a determination as to whether” any thereof shall be required to be cleared. In reviewing the IRS submissions, the Commission has considered whether its clearing requirement determination should address individual swaps, or categories, types, classes, or other groups of swaps. Based on the market conventions as discussed above, and the DCO recommendations in the IRS submissions, the Commission is proposing a clearing requirement for four classes of interest rate swaps: fixed-to-floating swaps, basis swaps, OIS, and the NY Fed Analysis.

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83 These are sometimes also referred to as "types," "categories," or "groups." For purposes of this determination, the Commission is using the term "class," in order to be consistent with the approach taken by the European Securities and Markets Authority (ESMA) in its Discussion Paper, “Draft Technical Standards for the Regulation on OTC Derivatives, CCPs, and Trade Repositories.” (Feb. 16, 2012), available at http://www.esma.europa.eu/system/files/2012-05.pdf. It is also noted that other categorizations are sometimes used for certain purposes. However, these four classes are common terms used by the DCOs and are common terms used in industry taxonomies.


85 See below for a discussion of available market sources.

86 After putting on these hedging positions, the DCO has the time needed to address any residual risk of the defaulted portfolio through auctioning off the defaulted portfolio together with the hedging transactions.

87 See LCH IRS submission, at 4.
FRAs. According to the IRS submissions, LCH offers all four classes for clearing, IDCH offers three of them for clearing, and CME offers one of them for clearing.88 These four classes represent a substantial portion of the interest rate swap market. The following table provides an indication of the outstanding positions in each class.

<table>
<thead>
<tr>
<th>Swap class</th>
<th>Notional amount (USD BNs)</th>
<th>Gross notional percent of total</th>
<th>Total trade count</th>
<th>Total trade percent of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed-to-Floating</td>
<td>$299,818</td>
<td>52</td>
<td>3,239,092</td>
<td>75</td>
</tr>
<tr>
<td>FRA</td>
<td>67,145</td>
<td>12</td>
<td>202,886</td>
<td>5</td>
</tr>
<tr>
<td>OIS</td>
<td>43,634</td>
<td>8</td>
<td>109,704</td>
<td>3</td>
</tr>
<tr>
<td>Basis</td>
<td>27,593</td>
<td>5</td>
<td>119,683</td>
<td>3</td>
</tr>
<tr>
<td>Other</td>
<td>132,162</td>
<td>23</td>
<td>617,637</td>
<td>14</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>100</td>
<td>4,289,004</td>
<td>100</td>
</tr>
</tbody>
</table>

At this time, there are no standard definitions in federal statutes or existing Commission regulations for these interest rate swap classes. In addition, while various class definitions are used in the derivatives literature, there are no commonly used definitions in the market. Accordingly, for purposes of discussing the clearing requirement determination in this proposal, the Commission has developed the following class definitions based on information provided by the submitting DCOs and market conventions.

To define the four interest rate swap classes in a manner that works across all three DCOs making IRS submissions and for the interest rate swap market generally, it is useful first to summarize how interest rate swaps work. As noted above, in an interest rate swap, the parties exchange payments based on a series of cash flows over a specified period of time calculated using two different interest rates multiplied by a notional amount. One party to the swap agrees to pay the amount equal to one of the interest rates specified multiplied by the notional amount and the other party agrees to pay the amount equal to the other interest rate specified times the notional amount.89 Each such payment stream is typically referred to as one "leg" or "side" of the swap transaction.

Using this background, the four classes of swaps are defined as follows, for purposes of this proposal:

1. "Fixed-to-floating swap": A swap in which the payment or payments owed for one leg of the swap is calculated using a fixed rate and the payment or payments owed for the other leg are calculated using a floating rate.
2. "Floating-to-floating swap" or "basis swap": A swap in which the payments for both legs are calculated using floating rates.
3. "Forward Rate Agreement" or "FRA": A swap in which payments are exchanged on a pre-determined date for a single specified period and one leg of the swap is calculated using a fixed rate and the other leg is calculated using a floating rate that is set on a pre-determined date.
4. "Overnight indexed swap" or "OIS": A swap for which one leg of the swap is calculated using a fixed rate and the other leg is calculated using a floating rate based on a daily overnight rate.

The LCH and CME IRS submissions addressed issues of classification for purposes of the interest rate swap clearing requirement. In its submission, LCH discussed the classification of interest rate swaps and recommended establishing clearing requirements for classes of interest rate swaps. LCH stated:

We believe that it is counterproductive to define every single attribute and combination that could be found in an interest rate swap, and furthermore it would always be possible to create additional attributes that would move a swap outside of the mandate. We do not believe that the Commission should define the almost limitless combination of swap attributes currently used by the market. We recommend defining a subset of easily identifiable features that determine a swap subject to mandatory clearing if that swap is cleared by a registered DCO that satisfies the five factors in the Act and the Commission's regulations.

More specifically, LCH recommended that the Commission use the following specifications to classify interest rate swaps for purposes of making a clearing determination: (i) Swap class (i.e., what the two legs of the swap are (fixed-to-floating, basis, OIS, etc.)); (ii) floating rate definitions used, (iii) the currency in which the notional and payment amounts are specified, (iv) stated final term of the swap (also known as maturity), (v) notional structure over the life of the swap (constant, amortizing, roller coaster, etc.), (vi) floating rate frequency, (vii) whether optionality is included, and (viii) whether a single currency or more than one currency is used for denominating payments and notional amount. In effect, LCH recommended the use of a set of basic product specifications to identify and describe each class of swaps subject to the clearing requirement.

CME recommended a clearing determination for all non-option interest rate swaps denominated in a currency cleared by any qualified DCO. CME's request is similar to LCH's recommendation in that CME identifies currency and optionality as factors to consider. In addition, CME's request focuses on defining swaps subject to the

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88 LCH clears all four classes of swap products; IDCH is eligible to clear fixed-to-floating swaps, OIS, and FRAs; and CME clears fixed-to-floating swaps.
89 TriOptima data, as of March 16, 2012. See Section II.F below for a description of the TriOptima Data. The TriOptima data provides information on nine other classes of swaps, none of which is included in the IRS submissions. Notably, one other type, swaptions, exceeded FRAs and basis swaps in terms of number of transactions completed in the sample. On a notional amount basis, swaptions represented less than half the notional amount of FRAs traded and a little less than the notional amount of basis swaps. Regardless, because swaptions are not being cleared by any DCOs at this time, they are not being considered in this proposal.
90 By contract, the two parties to an OTC swap often (but not always) agree that only one payment is due and owing on each payment date equal to the net positive amount equal to the excess amount of the larger amount due from one party over the smaller amount due from the other party. For cleared swaps, generally speaking, the amount payable to or by a party on any given day is determined based on the aggregate net amount due owed to the party for all of its positions that are cleared.
clearing requirement in a manner that can be used by all DCOs and not by reference to a specific DCO. IDCH did not recommend a particular approach for structuring the clearing determination.

The Commission agrees with the general approach suggested by LCH and is proposing to establish a clearing requirement for classes of swaps, rather than for individual swap products.

As an alternative, the Commission considered whether to establish clearing requirements on a product-by-product basis. Such a determination would need to identify the multitude of legal specifications of each product that would be subject to the clearing requirement. Although the industry uses standardized definitions and conventions, the product descriptions would be lengthy and require counterparties to compare all of the legal terms of their particular swap against the terms of the many different swaps that would be included in a clearing requirement. In this regard, LCH stated that the clearing requirement “would be sub-optimal for the overall market if participants are forced to read pages of rules to decipher whether or not a swap is required to be cleared, or to have to make complex and time consuming decisions at the point of execution.”

The Commission shares this view and believes that for interest rate swaps, a product-by-product determination could be unnecessarily burdensome for market participants in trying to assess whether each swap transaction is subject to the clearing requirement. A class-based approach would allow market participants to determine quickly whether they need to submit their swap to a DCO for clearing by checking initially whether the swap has the basic specifications that define each class subject to the clearing requirement.

A product-by-product designation also would be difficult to administer because the Commission would be required to consider each and every product submitted. On the other hand, designating classes of interest rate swaps for the clearing requirement provides a cost effective, workable method for the Commission to review new swap products that DCOs will submit for clearing determinations on a ongoing forward basis without undertaking a full Commission review of each and every swap product. For each new swap, or group, class, type, or category of swap submitted, the DCO can identify whether it believes the submission falls within a class of swaps already subject to the clearing requirement. For such swaps, as described in greater detail below, the Commission is proposing to delegate to the Director of the Division of Clearing and Risk, with the consultation of the General Counsel, the authority to confirm whether the swap fits within the identified class and is therefore subject to the clearing requirement. In this way, DCOs will not be required to submit lengthy submissions, and the Commission need not review swaps that are already part of a class of swaps that the Commission has determined are subject to a clearing requirement pursuant to section 2(h)(2) of the CEA. Only swaps that are in a new swap class that has not previously been reviewed, because it contains one or more class level specifications that are not contained within a class that has previously been reviewed, would be subject to full Commission review.

Request for Comment

The Commission invites comment on the interest rate swaps class definitions.

- Are the definitions in harmony with industry practice?
- Should the Commission establish a clearing requirement for classes of swaps or for individual swap products?
- Would a product-by-product determination impose a greater burden on market participants than the proposed class-based approach?

v. Interest Rate Swap Specifications

After consideration of the IRS submissions received, the practical considerations of classifying swaps as described in the preceding section, the portfolio-based risk management approaches used by DCOs, and existing market practice for classifying and trading swap products based on common economic results, the Commission has chosen these swap class definitions. The Commission has analyzed the IRS submissions received pursuant to section 2(h)(2)(D) of the CEA and § 39.5, and is proposing to classify the interest rates swaps submitted using the following affirmative specifications for each class: (i) Currency in which the notional and payment amounts are specified; (ii) rates referenced for each leg of the swap; and (iii) stated termination date of the swap. The Commission also is proposing three “negative” specifications for each class: (i) No optionality (as specified by the DCOs); (ii) no dual currencies; and (iii) no conditional notional amounts.

The Commission has chosen these three affirmative specifications because it believes that they are fundamental specifications used by counterparties to determine the economic result of a swap transaction for each party. Counterparties enter into swaps to achieve particular economic results. For example, counterparties may enter into interest rate swaps to hedge an economic risk, to facilitate a purchase, or to take a view on the future direction of an interest rate. The counterparties enter into a swap that they believe will best achieve their desired economic result at a reasonable cost.

The classes of swaps reflect general categories of desired economic results. As noted above, the IRS submissions identified four different classes of swap contracts that are being proposed at this time: Fixed-to-floating swaps, basis swaps, OIS, and FRAs. These classes of interest rates swaps reflect industry categorization and allow counterparties to achieve a particular economic result. For example, a fixed-to-floating swap may be used by a counterparty to hedge interest rate risk related to bonds it has issued or which it owns. Because the categorization of interest rate swaps into one of these basic classes reflects fundamental characteristics of a particular swap, counterparties can immediately assess whether a particular swap they are considering might be of a class that is subject to required clearing.

All three submitters also identified currency as a specification for distinguishing swaps that are subject to clearing.

A swap that requires...
calculation or payment in a currency different than the currency of the related underlying purposes of the swap would introduce currency risk. Thus, the currency designated for the swap is a basic factor in precisely achieving the economic results of the swap desired by each party. For example, if a party wants to hedge a commercial business risk denominated in dollars, then the party is likely to enter into a swap calculated and payable in dollars.

Entering into a swap in a currency that is different from the currency in which the risk to be hedged is denominated would unnecessarily introduce currency risk and reduce the effectiveness of the swap.

The swaps listed by all three DCOs in their IRS submissions all identified the interest rates used for each leg of the swap as a basic term that defines the swap. The rates are basic determinants of the economic value of each stream of payments of an interest rate swap. It is therefore an important determinant for achieving each party’s desired economic result. For example, if a party wants to hedge a loan obligation for which the interest rate is based on the London Interbank Offered Rate (commonly referred to as LIBOR), then the party can accurately hedge that risk by entering into a swap for which it receives LIBOR to offset its variable LIBOR risk. Using a different variable rate index would unnecessarily add basis risk to the swap and inhibit the party’s desired result of hedging the risk inherent in changes in LIBOR over the life of its loan.

Floating rate tenor, or maturity, of a swap is a basic specification for establishing the value of a swap transaction because interest rate swaps are based on an exchange of payments over a specified period of time ending on the stated termination date. The value of a swap at any one point in time depends in part on the value of each payment stream over the remaining life of the swap. For example, if a party wants to hedge variable interest rate risk for bonds it has issued that mature in ten years, it will generally enter into a swap with a stated termination date that matches the final maturity date of the bonds being hedged.

To terminate the swap prior to such date would result in only a partial hedge and to execute a swap with a stated termination date that is later than the final bond maturity date would simply create exposed rate risk during the extended period beyond the final maturity date of the bonds.

As a general matter, the four class-defining specifications identified by the Commission are used by all three submitters when identifying the swaps they clear. By using these basic specifications to identify the swaps subject to the clearing requirement, counterparties contemplating entering into a swap can determine quickly as a threshold matter whether the particular swap may be subject to a clearing requirement. If the swap has the basic specifications of a class of swaps subject to a clearing requirement, the parties will know that they need to verify whether a DCO will clear that particular swap. This will reduce the burden on swap counterparties related to determining whether a particular swap may be subject to the clearing requirement.

The Commission also considered whether to define classes of swaps on the basis of other product specifications. Other potential specifications are numerous because of the nearly limitless alternative interest rate swaps that are theoretically possible. These alternative specifications fall into two general categories: Specifications that are commonly used to address mechanical issues for most swaps, and specifications that are less common and address idiosyncratic issues related to the particular needs of a counterparty.

Examples of specifications that are commonly used to address mechanical issues for most swaps considered by the Commission include: Floating rate reset tenors, floating rate reset dates, reference city for business days, business day convention, day count fraction, spread added or subtracted from the variable rate, compounding method, effective date, averaging method, payment dates, period end dates, upfront payments, and pertinent legal jurisdiction. These specifications are specifically identified for most swap transactions executed today. While these specifications may affect the value of the swap in a mechanical way, they are not, generally speaking, fundamental to determining the economic result the parties are trying to achieve. For example, the day count fraction selected affects calculation periods and therefore the amounts payable for each payment period. However, the parties, and the DCOs, can make mechanical adjustments to period pricing at the time a swap is cleared based on the day count fraction alternative selected by the parties and the day count fraction does not drive the economic result the parties are trying to achieve.

Furthermore, DCOs can provide clearing for the standard alternatives of each of these specifications without affecting risk management. Using the same day count fraction example, LCH will accept U.S. dollar-LIBOR trades for clearing with nine alternative day count fractions based on the common day count fractions used in the market. While this specification, and other specifications of this kind, may affect the amounts owed on a swap, they can be accounted for mechanically in the payment amount calculations and do not change the substantive economic result the parties want to achieve.

Examples of the latter are special representation added to address particular legal issues, unique termination events, special fees, and conditions tied to events specific to the parties. None of the DCOs clear interest rate swaps with terms in the second group. Accordingly, such specifications are not included in the classes of swaps subject to the clearing requirement proposed by this rule, and the Commission considered only the first group of more common specifications that are identified by the submitting DCOs in their product specifications.

In short, the Commission recognizes that these other specifications may have an effect on the economic result to be achieved with the swap. However, it

96 Because every swap has a notional amount. By contrast, the currency in which the notional and payment amounts are specified does distinguish one class of swaps from others.

98 For example, parties seeking to hedge interest rate risk in connection with bonds or to invest funds using swaps are more likely to enter into swaps that designate the same currency in which the bonds are payable or that the funds to be invested are held.

99 Although hedging an economic risk expected to remain outstanding for ten years with a matching ten year swap may generally be the most efficient and precise approach, the Commission recognizes that parties may achieve a similar result by using swaps with different stated termination dates. However, such substitution generally provides a less precise hedge.

97 Each DCO identifies the standard term or range of terms it will accept for each specification. Accordingly, swap counterparties can review the DCO’s product specifications to determine whether a swap will satisfy the DCO’s requirements for these specifications. Additionally, DCOs are likely to develop a screening mechanism by which a party can enter the terms of a specific swap and determine whether the DCO will clear it. It is also likely that third-party vendors will develop or are developing similar screeners to apply to multiple DCOs. If counterparties wanting to enter into a swap that is in a class subject to required clearing and no DCO will clear the swap because it has other specifications that the DCOs will not accept, then the parties can still enter into that transaction on an uncleared basis.

98 LCH recommended in its submission that floating rate tenor (also known as frequency) also be a class level specification and the Commission acknowledges that floating rate tenor can, in some cases, be a fundamental specification for achieving the economic benefits of an interest rate swap. However, it is the Commission’s preliminary view that floating rate tenor is more akin to the other non-class specifications in that it is not fundamental to all economic results that may be
believes that counterparties may account for the effects of such specifications with adjustments to other specifications or in the price of the swap. Furthermore, DCOs account for various alternatives or range of alternatives for these terms without impairing risk management. Finally, as described above in more detail, including these specifications in the description of the swaps subject to a clearing requirement could increase the burden on counterparties when checking whether a swap may be subject to required clearing. Accordingly, the Commission has determined not to include other, non-class defining specifications in the swap class definition.

The Commission also considered whether there are product specifications that the Commission should explicitly exclude from the initial clearing requirement determination. In this regard, the Commission considered swaps with optionality, multiple currency swaps, and swaps with conditional notional amounts. The Commission determined that these three specifications should be included as so-called “negative” specifications.

Optionality and swaps referencing more than one currency for calculation or payment purposes, raise concerns regarding adequate pricing measures and consistency across swap contracts that make them difficult for DCOs to effectively risk manage. LCH, CME, and IDCH currently do not clear interest rate swaps with such specifications. Furthermore, LCH and CME indicated that interest rate swaps with optionality or that reference multiple currencies should not be included for consideration of a clearing requirement at this time. LCH noted that, at this time, there is a lack of reliable market data and no market consensus on valuation models for swaps with these specifications, which significantly impairs a DCO’s ability to set margin levels effectively for such products. Given these factors, the Commission is proposing to exclude swaps with optionality or that reference multiple currencies from this clearing requirement determination.

Finally, LCH recommended that the Commission exclude from the clearing requirement swaps whose notional amount over the term of the swap is conditional, and therefore, at the time of execution, cannot be definitively identified by a number or schedule of numbers for the term of the swap. For example, the parties may agree to a formula for calculating the notional amount based on an index or the occurrence of future events such as prepayments on a pool of mortgages. The IRS submissions indicated that all three submitters would clear swaps with constant notional amounts through the final termination date. LCH also clears amortizing and roller coaster notional schedules for certain classes of swaps so long as the notional amounts for the contract are known at the time the swap is cleared. None of the DCOs clears swaps for which the notional amount throughout the term of the swap is not specifically known at the time the swap is executed. The Commission understands that conditional notional amount swaps are, at this time, difficult for DCOs to price effectively and risk manage. Accordingly, while this may change over time if certain market conventions develop in this area, conditional notional amount swaps cannot be subject to the clearing requirement determination.

To reach a determination as to which interest rate swaps shall be subject to the clearing requirement, the Commission will consider in the following section the IRS submissions received pursuant to section 2(h)(2)(D) of the CEA and § 39.5 within the framework of the classes and specifications identified. In summary, the Commission will consider four classes of interest rate swaps for the clearing requirement: Fixed-to-floating swaps, basis swaps, FRAs, and OIS. Within each class, the Commission will further consider the following product specifications to define which swaps shall be required to be cleared:

- Currency, floating rate indexes referenced, stated termination dates, use of dual currencies, optionality, and notional amount certainty.

Request for Comments

- The Commission invites comment on the six principle swap specifications identified by the Commission as being used by counterparties to determine the economic result of a swap transaction within each class.

- Should more specifications be added? If so, what are they and how are they fundamental to determining the economic result of a swap? Should any of the specifications be eliminated?

F. Proposed Determination Analysis for Interest Rate Swaps

i. Consistency With Core Principles for Derivatives Clearing Organizations

Section 2(h)(2)(D)(i) of the CEA requires the Commission to review whether a swap submission is consistent with the core principles for DCOs in making its clearing determination. LCH, CME, and IDCH already clear all swaps identified in their respective IRS submissions and therefore each is subject to the Commission’s review and surveillance procedures summarized above. Accordingly, the three DCOs already are required to comply with the core principles set forth in section 5b(c)(2) of the CEA with respect to the swaps being considered by the Commission for the clearing requirement.

To monitor compliance, the Commission has conducted periodic examinations of LCH, CME, and IDCH. During an examining, the Commission requests certain data regarding cleared transactions, fund transfers, margin requirement calculations, risk management testing and other issues that is provided as of a specific review date. In this manner, the Commission gets a snap-shot of information that the Commission staff uses to reconcile selected accounts and other information. Subsequently, the Commission goes onsite, typically for several days, to interview relevant parties and to test whether various policies and procedures established by the DCOs in their respective rule books comply with the CEA’s core principles for DCOs and other regulatory requirements.

As discussed above, following the review of data and the onsite visits, the Commission undertakes extensive analysis and discusses any questions and potential deficiencies with staff and management of the DCO to address any deficiencies and improvements that can be implemented by the DCO. To ensure that the DCOs are in compliance with the core principles, a detailed analysis is done to assess the DCO’s policies and procedures regarding pricing, margining, back-testing, and their IRS portfolio risk management procedures. Furthermore, the Commission assesses the DCOs’ procedures and policies regarding: (1) Onboarding new clearing members; (2) establishing the financial resources available to the DCOs and testing the sufficiency of those resources; and (3) assessing the default management and settlement procedures. More specifically, the DCOs provide the Commission documentation that details relevant official policies and
procedures. The DCOs also provide evidence (such as margining, pricing data, and back-testing results) that confirms that the policies and methodologies are effective. Finally, the Commission goes onsite to the DCOs and interviews relevant parties and observes the procedures real-time to confirm that the DCOs are in effect following their stated policies. Additionally, the Commission, if feasible, will independently verify the analysis of any data provided by the DCOs.

The Commission’s Risk Surveillance Group (RSG) conducts daily risk management surveillance of all DCOs.\(^9\) If any issues arise, the RSG and the DCOs work in concert to understand and quickly address those issues. CME, LCH, and IDCH have worked collaboratively with the Commission in this regard and have provided accessible points of contact within the DCOs’ respective organizations to expedite information flow.

All three submitting DCOs have asserted that they are capable of maintaining compliance with the core principles following a clearing requirement determination for the swaps that they clear, and the Commission has no reason to believe such assertions are not accurate at this time. The Commission does not believe that subjecting any of the interest rates swaps identified in the IRS submissions to a clearing requirement would alter compliance by the respective DCOs with the core principles. Accordingly, the Commission believes that each of the IRS submissions are consistent with section 5b(c)(2) of the CEA.

Request for Comment
- The Commission requests comment on whether the proposed interest rate swaps clearing requirement determination would alter any DCO’s ability to comply with the DCO core principles.

ii. Consideration of the Five Statutory Factors for Clearing Requirement Determinations

As explained above, section 2(h)(2)(D)(ii) of the CEA identifies five factors the Commission shall take into account in making a clearing requirement determination. The process for submission and review of swaps for a clearing requirement determination is further detailed in § 39.5. This section provides the Commission’s consideration of the five factors in the context of the requirements of § 39.5 for interest rate swaps.

a. Outstanding Notional Exposures, Trading Liquidity, and Adequate Pricing Data

Section 2(h)(2)(D)(ii) of the CEA requires the Commission to take into account the existence of outstanding notional exposures, trading liquidity, and adequate pricing data. For purposes of this factor, the Commission
can provide all parties with the market data regarding outstanding notional amounts, trade liquidity, and pricing. Unlike CDS for which substantially all of the trading data has been collected and is stored in one place, there is no single data source for notional exposures and trading liquidity for the entire interest rate swap market.\(^10\) However, the Commission considered several sources of data on the interest rate swap market that collectively provides the information the Commission needs to make a clearing requirement determination. The data sources considered include: general quarterly estimates published by the Bank for International Settlements (BIS data); market data published weekly by TriOptima (TriOptima data) covering swap trade information submitted voluntarily by 14 large derivatives dealers (G14 Dealers); trade-by-trade data provided voluntarily by the G14 Dealers to the OTC Derivatives Supervisors Group for a three month period between June and August 2010 (ODSG data); and trade-by-trade data provided by LCH for the first calendar quarter of 2012 and summary cleared swap open interest information (LCH data).\(^10\) The G14 Dealers and LCH trade-by-trade data was provided to the Commission on a confidential basis and consent was granted for publication of the summary information in this proposal.

Each of these data sources has a number of limitations that are important to understand when considering the data. The following is a brief discussion of these limitations and how the data sets, when considered together, provide a more complete picture of outstanding notional amounts, trade liquidity, and pricing for the Commission’s consideration of the swaps submitted.

The BIS data set covers the largest portion of the interest rate swap market over time and therefore is useful for reaching general conclusions regarding full market size and longer term market trends. However, the BIS data provides only summary information that is not granular enough to inform the clearing requirement considerations at the proposed class level.

TriOptima’s data set updates are published weekly and provide more detail than the BIS data covering most of the class level specifications considered by the Commission. The TriOptima data is limited to the extent it only contains information gathered by TriOptima and therefore does not include all OTC interest rate swaps. Also, the TriOptima data shows outstanding notional and trade numbers as of a set date and does not provide an indication of trade liquidity over time.\(^102\)

The ODSG data provided detailed information on a trade-by-trade basis, thereby providing sufficient information for class-level consideration. This information is useful for considering trading liquidity. However, the ODSG data set is limited in several ways that can skew analysis of the data. The ODSG data covered transactions confirmed on the MarketWire platform, a trade confirmation service offered by MarketSERV, between June 1, 2010 and August 31, 2010, where at least one party was a G14 Dealer. The dataset does not include transactions that took place between two non-G14 Dealer parties, with such parties representing an estimated 11% of the notional volume activity in MarketSERV.\(^103\) The number of non-G14 Dealer swap trades that are not entered on MarketSERV has not been estimated and could be significant. The omission of certain classes of participants and trades in

\(^9\) The only exception is IDCH. At this time, RSG does not actively monitor the risk posed by IDCH and its participants because IDCH does not have any open interest.


\(^101\) All DCOs are required to begin providing daily trade-by-trade data to the Commission as of November 8, 2012. CME also provided some information in this area, but because CME clears a small set of interest rate swaps for a relatively short period of time, CME’s data is considered too limited to provide any indication of the complete interest rate swap market. The Commission recognizes that the LCH data also has limited value for its consideration of the first factor because it includes only cleared swaps, and not uncleared swaps. However, because LCH clears a large portion of the swaps products it offers clearing for (based on available information, LCH has cleared approximately 50 to 90 percent of the dealer open interest in the different interest rate swap products that it clears), its data provides some indication of the possible notional exposures and liquidity in the products submitted by LCH that the Commission is considering. Given the limitations on other available data, the Commission believes it is useful to consider the LCH data along with the market-wide BIS data, ODSG data, and TriOptima data.

\(^102\) The TriOptima data does not indicate how many trades are new for each reporting period rather than carry-over trades from the prior period. Accordingly, it is not possible to determine the amount of new trading activity from one reporting period to the next.

\(^103\) NY Fed Analysis at 6.
sample will bias transaction and notional volume statistics downward. It may also distort the proportions of products seen relative to each other. The ODSG dataset also does not include transactions that were manually confirmed either by choice or necessity. It is estimated that the data set represents roughly 78% of G14 Dealer interest rate transaction activity. The three-month time frame in 2010 also introduces limitations into analysis of the data set. This time frame represented a period in the midst of historically low central bank interest rate policy across major currencies and novel liquidity measures taken in response to the 2008 financial crisis. The short period also could be affected by seasonal patterns, and the possibility exists that the markets have fundamentally changed since the data was gathered. The lack of manually confirmed trades in the data suggests an overrepresentation of standardized transactions such as OIS and plain vanilla interest rate swaps and underrepresentation of non-standard classes such as exotics and basis swaps. For instance, exotic product structures not eligible for electronic matching are estimated to make up 2% of the OTC interest rate derivative market.

The LCH data provides summary data on notional amounts of different classes of swaps and the first quarter 2012 data provide detailed information on a trade-by-trade basis thereby providing sufficient information for class-level consideration. The LCH data is limited in that it only includes swaps cleared by LCH. It is noted, however, that LCH has cleared about 50% of the interest rate swap market and higher levels of certain kinds of swaps indicating a reasonably high inclusion rate. This data set also has the advantage of being more current than the ODSG data and BIS data and is specific to the swaps that are under consideration in this Commission determination. The TriOptima data and ODSG data are both based, in large part, on data provided by the G14 Dealers. Additionally, the TriOptima data is published by TriOptima in formats that, for the class specifications considered by the Commission, can be analyzed in a manner similar to the analysis of the ODSG data. In fact, the Commission has found the TriOptima data and the ODSG data to be complementary in some ways. The TriOptima data is current and provides fairly detailed information about the gross notional amounts and total trade numbers for each class specification considered in this proposal. However, the TriOptima data does not provide enough information to assess periodic trade liquidity for each specification. Because the ODSG data is provided on a trade-by-trade basis, the Commission and other regulators have been able to make more granular assessments of this information, particularly for purposes of considering trading liquidity. Accordingly, although the ODSG data is nearly two years old, it is useful for confirming whether observations based on the current TriOptima data are consistent with historical trends and also to indicate trading liquidity.

The Commission first considered data relevant to the different interest rate swap classes included in the IRS submissions starting with the BIS data.

### Table 5—Bank for International Settlements Interest Rate Swaps Outstanding Notional by Class

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>All Derivatives</td>
<td>$594,553</td>
<td>$603,900</td>
<td>$583,685</td>
<td>$601,046</td>
<td>$706,884</td>
<td>$647,762</td>
</tr>
<tr>
<td>Interest Rate Swaps</td>
<td>341,903</td>
<td>349,288</td>
<td>347,508</td>
<td>364,377</td>
<td>441,201</td>
<td>402,611</td>
</tr>
<tr>
<td>FRAs</td>
<td>46,812</td>
<td>51,779</td>
<td>56,242</td>
<td>51,587</td>
<td>55,747</td>
<td>50,576</td>
</tr>
<tr>
<td>Options</td>
<td>48,513</td>
<td>48,808</td>
<td>48,081</td>
<td>49,295</td>
<td>56,291</td>
<td>50,911</td>
</tr>
<tr>
<td>Total interest rate swaps</td>
<td>437,228</td>
<td>449,875</td>
<td>451,831</td>
<td>465,260</td>
<td>553,240</td>
<td>504,098</td>
</tr>
</tbody>
</table>

The BIS data shows only notional amounts for three large categories: FRAs, swaps with options, and other interest rate swaps. It does not provide information on daily trading liquidity or break out other kinds of interest rate swaps such as basis swaps, OIS, or inflation swaps.

However, the BIS data is useful in providing certain big picture information. It indicates that interest rate swaps in total constitute nearly 80% of the derivatives market and interest rate swap notional amounts generally increased for all three kinds of swaps between 2008 and 2011. Additionally, all three classes of swaps identified by the BIS data have substantial notional amounts outstanding. As of December 2011, FRAs had about $50.5 trillion outstanding, options had about $51 trillion outstanding, and other interest rate swap had about $403 trillion outstanding.

104 Id. at 6.
105 Id. at 5.
106 The NY Fed Analysis noted that for the ODSG interest rate swap data set the number and volume of non-price-forming trades were significantly greater than the number and volume of trades that were new economic activity. NY Fed Analysis, at 8.
107 BIS data.
108 This row excludes FRAs and options.
outstanding. Furthermore, the BIS data shows that over the three year period covered in Table 5, total interest rate swaps reported grew by about 15%. Given this information, none of the kinds of swaps identified by the BIS should be eliminated from consideration by the Commission for a clearing requirement based on the BIS data alone. However, the BIS data does not provide enough detail to reach further determinations regarding the swaps identified in the IRS submissions.

### Table 6—TriOptima Data Interest Rate Swaps Outstanding Notional and Trade Count by Class

<table>
<thead>
<tr>
<th>Swap class</th>
<th>Notional amount (USD Bns)</th>
<th>Percent of total notional</th>
<th>Total trade count</th>
<th>Percent of total trade count</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed-to-Floating</td>
<td>$299,818</td>
<td>52</td>
<td>3,239,092</td>
<td>75</td>
</tr>
<tr>
<td>FRA</td>
<td>67,145</td>
<td>12</td>
<td>202,888</td>
<td>5</td>
</tr>
<tr>
<td>OIS</td>
<td>43,634</td>
<td>5</td>
<td>109,704</td>
<td>3</td>
</tr>
<tr>
<td>Basis Swap</td>
<td>27,593</td>
<td>5</td>
<td>119,683</td>
<td>3</td>
</tr>
<tr>
<td>Other</td>
<td>132,162</td>
<td>23</td>
<td>617,637</td>
<td>14</td>
</tr>
<tr>
<td>Total</td>
<td>570,352</td>
<td>100.00</td>
<td>4,289,004</td>
<td>100</td>
</tr>
</tbody>
</table>

### Table 7—ODSG Data Interest Rate Swaps Trading Activity by Class

<table>
<thead>
<tr>
<th>Swap class</th>
<th>Notional amount traded in quarter (USD BNs)</th>
<th>Trade count in quarter</th>
<th>Average weekly notional traded (USD BNs)</th>
<th>Average weekly number of trades</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed-to-Floating</td>
<td>$15,858</td>
<td>123,337</td>
<td>$1,201</td>
<td>9,344</td>
</tr>
<tr>
<td>OIS</td>
<td>16,563</td>
<td>12,792</td>
<td>1,255</td>
<td>969</td>
</tr>
<tr>
<td>FRA</td>
<td>6,931</td>
<td>5,936</td>
<td>525</td>
<td>450</td>
</tr>
<tr>
<td>Basis Swap</td>
<td>2,307</td>
<td>3,173</td>
<td>175</td>
<td>240</td>
</tr>
<tr>
<td>Other</td>
<td>2,820</td>
<td>16,073</td>
<td>214</td>
<td>1,218</td>
</tr>
<tr>
<td>Total</td>
<td>44,479</td>
<td>161,311</td>
<td>3,370</td>
<td>12,221</td>
</tr>
</tbody>
</table>

The TriOptima data and the ODSG data identify notional amounts and trade counts for all four classes of swaps identified in the IRS submissions. Outstanding notional amounts are provided in the TriOptima data and BIS data. Trading liquidity as an indication of how effectively DCOs can risk manage a portfolio of swaps can be evidenced in several ways. The data available for this purpose includes total notional amount outstanding, total number of swaps outstanding, and the average number of transactions over a given period of time. The TriOptima data indicates liquidity through the total notional amount outstanding and total number of trades outstanding at a given time. The ODSG data provides an indication of liquidity in terms of the number of trades during the calendar quarter covered by the data and the average weekly number of trades during the period.

The TriOptima data shows that all four classes have significant outstanding notional amounts with basis swaps being the lowest at about $27.6 trillion and the highest being fixed-to-floating swaps at $288.8 trillion. Total trade counts for each type are also significant with the lowest being 109,704 for OIS and the highest being fixed-to-floating swaps at 3,239,092. The ODSG data confirms these observations historically.

The average number of swap trades per week for each class of swaps is shown in the last column of Table 7. According to the ODSG data set, basis swaps were traded at the lowest frequency compared to the other three classes at 240 times on average each week during the ODSG data period. Because the ODSG data is from the summer of 2010 and gross notional amounts and trading activity in interest rate swaps have both increased generally, the Commission believes that trading activity has likely increased for all classes.

### Table 8—LCH Data Interest Rate Swaps Notional Outstanding and Trade Count Cleared by Classes

<table>
<thead>
<tr>
<th>Swap class</th>
<th>Notional cleared in Quarter (USD BNs)</th>
<th>Number of swaps cleared in quarter</th>
<th>Average weekly notional traded (USD BNs)</th>
<th>Average weekly number of trades</th>
<th>Total notional outstanding (USD BNs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed-to-Floating</td>
<td>$17,022</td>
<td>117,780</td>
<td>$1,309</td>
<td>9,060</td>
<td>$226,016</td>
</tr>
<tr>
<td>FRA</td>
<td>11,271</td>
<td>31,630</td>
<td>867</td>
<td>2,433</td>
<td>27,707</td>
</tr>
<tr>
<td>OIS</td>
<td>8,731</td>
<td>6,848</td>
<td>672</td>
<td>527</td>
<td>36,510</td>
</tr>
</tbody>
</table>

109 TriOptima data, as of March 16, 2012. The TriOptima data provides information on nine other classes of swaps, none of which is included in the submissions. Notably, one other type, swaptions, exceeded FRAs and basis swaps in terms of number of transactions completed in the sample. On a notional amount basis, swaptions represented less than half the notional amount of FRAs traded and a little less than the notional amount of basis swaps. Regardless, because swaptions were not included in the list of swaps cleared in the IRS submissions, swaptions are not being considered for the clearing requirement determination because no DCO is clearing swaptions at this time.

110 NY Fed Analysis at 7. The ODSG data includes swaps entered into between June and August, 2010 as voluntarily reported by the G14 Dealers. The ODSG data provides information on other classes of swaps, none of which is included in the submissions.

111 The data covers swaps cleared by LCH during the first calendar quarter, 2012. Total Notional Outstanding Cleared is as of March 31, 2012.
The LCH data generally confirms the assessment of market-wide data. There is substantial outstanding notional volumes and trade liquidity for each of the four classes already being cleared at LCH.

LCH cleared the following percentage of each class of swap as reported by TriOptima: 112

- 75% of the Fixed-to-Floating swaps,
- 41% of FRAs, 113
- 84% of OIS, and
- 41% of Basis Swaps.

Accordingly, a substantial portion of each class is already being cleared voluntarily.

Swap Class Conclusion

The Commission concludes that the four classes of swaps currently being cleared have significant outstanding notional amounts and trading liquidity.

The Commission further notes that a substantial percentage of each of the four classes is already cleared by DCOs.

2. Currency

As discussed above in Section II.E, the currency in which the notional and payment amounts are specified is a primary product specification and all four data sources provide interest rate swap data by currency.

The BIS data addresses seven of the seventeen currencies identified in the submissions individually. All seven currencies have substantial outstanding notional amounts as of December 2011, ranging from nearly $5.4 trillion for the Swiss franc to about $185 trillion in euro. Although several currencies showed decreases in total notional outstanding from one reporting period to the next, most such decreases were around ten percent or less, and, after such decreases, total notional amounts for those currencies generally rebounded. 115 For all currencies, the outstanding notional amounts were higher at the end of the most recent three-year period as compared to the beginning of the period.

The Commission believes that the BIS data supports the conclusion that there exists significant outstanding notional amounts in each currency identified in the BIS data and that there is no indication that notional amounts in those currencies are decreasing at a rate that would warrant elimination of those currencies from consideration for a clearing requirement.

The LCH data is used because it is the most notional outstanding as reported by TriOptima. The notional amount cleared by LCH divided by total notional outstanding as reported by TriOptima. The TriOptima data is used because it is the most current data set that provides data broken out according to the classes currently being cleared.

The beginning of the period.

As of March 16, 2012.
The TriOptima data shows that total outstanding notional amounts as of March 16, 2012, ranged from $400 billion for Czech koruna to over $176 trillion notional amount for euros. While there may be sufficient outstanding notional amounts in all seventeen currencies, the Commission takes note that there is a clear demarcation between the four currencies with the highest outstanding notional amounts: euro, U.S. dollar, British pound, and yen, and all other currencies. As Table 10 shows, the top four currencies range from about 9% to 36% of the total notional amount of all interest rate swaps outstanding and 11% to 33% of the total number of trades. The remaining currencies range from about 2% down to 0.1% of the total notional amount traded and 3% down to 0.2% of total number of trades. In fact, the four major currencies accounted for about 93% of the total notional amount outstanding in the TriOptima data set.

The ODSG data provides an indication of trading liquidity in terms of average weekly notional amount traded and number of new trades completed during the period covered by the data set. Of the four major currencies, Japanese yen had the lowest weekly average notional at $323 billion and the British pound had the lowest average number of trades each week at 1,233.

The TriOptima data provides an overall, more current view of trades outstanding, which provides a broader picture of the trading potential for each currency for purposes of DCO risk management. As of March 16, 2012, all but one of the seventeen currencies had outstanding trade counts in excess of 14,000 with the exception being the Danish krone at 6,849. Again, the four highest currencies by trade count: euro, U.S. dollar, British pound, and yen, accounted for about 85% of the total number of trades recorded and outstanding at the time the data was collected.

The LCH data shows that the relative notional amount and number of swaps in each currency cleared is generally correlated with the notional amount and number of swaps of each currency reported by the more general market data sets. As a percentage of the total notional amount outstanding as reported by TriOptima, LCH cleared the following percentages: 66% of euro, 61% of U.S. dollars.

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117 Thirteen other currencies are cleared by LCH: AUD, CHF, SEK, CAD, ZAR, NZD, NOK, HKD, PLN, SGD, HUF, DKK, and CZK.
118 The ODSG data includes swaps entered into between June and August 2010 as voluntarily reported by the G14 Dealers.
119 Includes the 13 other currencies cleared by LCH identified in its IRS submission. The ODSG data identified an additional 11 other currencies that were not cleared by any of the submitters.
120 TriOptima data, as of March 16, 2012.
121 The data covers swaps cleared by LCH during the first calendar quarter, 2012. Total Notional Outstanding is as of March 31, 2012.

122 The TriOptima data is used for this calculation because it is the most current data set that provides data broken out according to the classes currently being cleared.
58% of British pounds,
59% of Japanese yen, and
42% of other currencies.

Of the interest rate swaps identifying U.S. dollars, euro, British pounds, yen as the applicable currency, significantly more than half are already being cleared by LCH. While the level of clearing of other currencies is, on a combined basis reasonably high at 42%, the Commission notes that the level is noticeably lower than the percentage of swaps being cleared for the top four currencies.

Currency Specification Conclusion

The Commission believes that all of the data sets demonstrate the existence of significant outstanding notional amounts and trading liquidity in the seventeen currencies identified in the submissions. However, the Commission notes that swaps using the four currencies with the highest outstanding notional amounts and trade frequency: euro, U.S. dollar, British pound, and yen, account for an outsized portion of both notional amounts outstanding and trading volumes. Furthermore, the Commission notes that these four currencies are already being cleared more than the other currencies generally.

While it is important that this determination include a substantial portion of the interest rate swaps traded to have a substantive, beneficial impact on systemic risk, the Commission also recognizes that the proposed rule is the Commission’s first swap clearing requirement determination. As noted in the phased implementation rules for the clearing requirement, the Commission believes that introducing too much required clearing too quickly could unnecessarily increase the burden of the clearing requirement on market participants. In recognition of these considerations, the Commission will focus the remainder of this initial clearing requirement determination analysis on swaps referencing the four most heavily traded currencies. The Commission notes that the decision not to include the other thirteen currencies at this time does not limit the Commission’s authority to reconsider required clearing of those currencies in the future.

The Commission requests comment on whether any of the other thirteen currencies identified above should be included in the initial clearing requirement determination for interest rate swaps.

3. Floating Rate Index Referenced

The ODSG data and LCH data provide an indication of the rate indices used on a transaction-by-transaction basis. Rate indexes are currency specific. However, the BIS data and the TriOptima data do not provide information on the different rate indexes referenced in interest rate swaps. The following tables present trading activity data for each rate index identified in the IRS submissions as being cleared for each of the four currencies the Commission is proposing to include in the clearing requirement determination.

### TABLE 13—ODSG DATA INTEREST RATE SWAPS TRADING ACTIVITY BY RATE INDEX

<table>
<thead>
<tr>
<th>Rate Index</th>
<th>Notional traded in quarter (USD BNs)</th>
<th>Trade count for quarter</th>
<th>Average weekly notional traded (USD BNs)</th>
<th>Average weekly number of trades</th>
</tr>
</thead>
<tbody>
<tr>
<td>EUR–EURIBOR</td>
<td>$9,366</td>
<td>38,213</td>
<td>$710</td>
<td>2,895</td>
</tr>
<tr>
<td>USD–LIBOR</td>
<td>9,080</td>
<td>46,620</td>
<td>688</td>
<td>3,532</td>
</tr>
<tr>
<td>EUR–EONIA*</td>
<td>9,022</td>
<td>6,496</td>
<td>684</td>
<td>492</td>
</tr>
<tr>
<td>GBP–SONIA*</td>
<td>4,934</td>
<td>2,011</td>
<td>374</td>
<td>152</td>
</tr>
<tr>
<td>JPY–LIBOR</td>
<td>4,015</td>
<td>18,491</td>
<td>304</td>
<td>1,401</td>
</tr>
<tr>
<td>GBP–LIBOR</td>
<td>2,296</td>
<td>12,417</td>
<td>174</td>
<td>941</td>
</tr>
<tr>
<td>USD–FedFunds*</td>
<td>1,887</td>
<td>1,951</td>
<td>143</td>
<td>148</td>
</tr>
<tr>
<td>EUR–LIBOR</td>
<td>1</td>
<td>5</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>40,602</td>
<td>126,204</td>
<td>3,076</td>
<td>9,561</td>
</tr>
</tbody>
</table>

### TABLE 14—LCH DATA INTEREST RATE SWAPS NOTIONAL OUTSTANDING AND TRADE COUNT BY RATE INDEX

<table>
<thead>
<tr>
<th>Rate index (by currency)</th>
<th>Notional cleared in quarter (USD BNs)</th>
<th>Number of swaps cleared in quarter</th>
<th>Average weekly notional traded (USD BNs)</th>
<th>Average weekly number of trades</th>
</tr>
</thead>
<tbody>
<tr>
<td>EURO</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EURIBOR</td>
<td>$13,444</td>
<td>57,157</td>
<td>$1,034</td>
<td>4,397</td>
</tr>
<tr>
<td>EONIA</td>
<td>5,763</td>
<td>3,882</td>
<td>443</td>
<td>299</td>
</tr>
<tr>
<td>US Dollar</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LIBOR</td>
<td>10,905</td>
<td>50,197</td>
<td>839</td>
<td>3,861</td>
</tr>
<tr>
<td>FEDFUND</td>
<td>1,206</td>
<td>1,513</td>
<td>93</td>
<td>116</td>
</tr>
<tr>
<td>GBP</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LIBOR</td>
<td>1,067</td>
<td>11,550</td>
<td>82</td>
<td>888</td>
</tr>
<tr>
<td>SONIA</td>
<td>1,734</td>
<td>1,426</td>
<td>134</td>
<td>110</td>
</tr>
<tr>
<td>Yen</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LIBOR</td>
<td>2,799</td>
<td>12,374</td>
<td>215</td>
<td>952</td>
</tr>
<tr>
<td>Other Indexes</td>
<td>1,716</td>
<td>21,099</td>
<td>132</td>
<td>1,623</td>
</tr>
<tr>
<td>Total</td>
<td>38,634</td>
<td>159,198</td>
<td>2,972</td>
<td>12,246</td>
</tr>
</tbody>
</table>

123 The ODSG data includes swaps entered into between June and August, 2010 as voluntarily reported by the G4 Dealers. This table includes only rate indexes used for the G4 currencies and that are cleared by LCH.
124 “Eur-Euribor” category includes both Eur-Euribor-Reuters and Eur-Euribor-Telerate, which are both cleared by LCH.
125 The LCH data includes swaps cleared by LCH during the first calendar quarter, 2012.
The ODSG data shows minimal activity for EUR–LIBOR with about 1 billion of notional amount and five trades made for the three-month period in 2010 that the ODSG data covers. EUR–LIBOR does not appear on the LCH data table because, although swaps referencing that index can be cleared at LCH, LCH had no open interest for that index as of March 31, 2012. Given the minimal notional amounts and trading liquidity for the EUR–LIBOR index, the Commission has determined not to include EUR–LIBOR under the clearing requirement.

The other rate indexes all show significant notional amounts and trading liquidity. The rates with the least activity, the U.S. dollar Fedfund index and British pound-LIBOR index, each have over one trillion dollars in notional outstanding already cleared at LCH and on a weekly basis, $93 billion and $82 billion in notional amount, respectively, were cleared per week on average. In terms of number of trades cleared at LCH, swaps referencing Fedfunds were cleared on average 116 times per week and swaps referencing British pound-LIBOR were cleared 888 times per week on average. All of the other indices currently cleared have similar or substantially higher number of trades and notional amounts cleared.126

The rate indexes used for OTC interest rate swaps and the interest rate swaps identified for clearing by the DCOs reference not only the generic index, but a reference definition for the index such as the ISDA definition or Reuters definition. These reference definitions refer to the generic index and in addition, typically identify specifically where the calculating party shall look up the index and sometimes at what time the calculating party shall look up the index for calculation purposes. Additionally, these reference indices provide a standard alternative if the index is not available from the designated source at the designated time. While the Commission recognizes the importance of these features of the reference definitions and that each swap, both cleared and uncleared, should have these features, such features need not be included in the index rate specification for the Commission’s clearing requirement determination because they are not definitive for the economic result achieved. Rather, the generic index itself is. If the parties to a swap identify a specific reference definition for an index, they need only confirm whether the DCO accepts that reference definition. If it does not, then the swap in question is not accepted for clearing and it is not subject to the clearing requirement.

Rate Index Specification Conclusion

The Commission concludes that with the exception of the EURO–LIBOR index, all of the rate indexes identified in the IRS submissions have significant outstanding notional amounts and trading liquidity. The Commission further notes that significant notional amounts of these rate indexes are already cleared by DCOs.

4. Stated Termination Dates

Stated termination date (sometimes referred to as “maturities”) data is often presented by aggregating stated termination dates for swaps into specified term periods or “buckets.” The IRS submissions show that the DCOs have been clearing interest rate swaps with final termination dates out to at least ten years for all seventeen currencies and out to 50 years for some classes and currencies cleared.

The use of maturity buckets eases the discussion of the range of termination dates. As the tables below show, interest rate swaps can be multi-year contracts with termination dates out to fifty years or more depending on the class and currency of the swap. Also, stated termination dates can fall on any day of the year. Given this continuum of termination dates, the DCOs have indicated that they manage the cleared swap portfolio risk using a swap curve.127 Swap curves are also used by market participants to price interest rate swaps. By pricing swaps in this way, the economic results of an interest rate swap can be fairly closely approximated, and therefore hedged, using two or more other swaps with different maturities principally by matching the weighted average duration of those swaps with the duration of the swap being hedged.128 In the same manner, a large portfolio of interest rate swaps can be hedged fairly closely with a small number of hedging swaps that have the same duration as the entire portfolio or subsets of related swaps within the portfolio. In effect, for DCO risk management purposes, the termination dates of interest rate swaps are assessed based on how they affect the overall duration aspects of the portfolio of swaps cleared.129 Accordingly, the primary determination with respect to the stated termination date specification is, for each class and currency, at what point, if any, along the continuum of swap maturities is there insufficient notional outstanding and trading liquidity to structure the swap curve effectively for DCO risk management purposes.

The TriOptima data provided sufficient detail to discern notional amounts and trade counts only for each swap class. The ODSG data provided sufficient detail to discern notional amounts and trade counts only for each currency. The LCH data provided sufficient detail for both swap class and currency.

Regarding maturity buckets, the BIS data only provides information for interest rate swaps in three periods: up to one year, between one year and five years, and more than five years. Because the BIS data does not provide granular detail beyond the five year maturity date, it does not provide enough detail to inform the Commission’s determination regarding the IRS submissions under consideration. Accordingly, the BIS data was not considered for the stated termination date specification.

TABLE 15—TriOptima Data Interest Rate Swaps Notional by Maturity Period and Class

<table>
<thead>
<tr>
<th>Product type</th>
<th>Maturity 0≤2 years</th>
<th>Maturity 2≤5 years</th>
<th>Maturity 5≤10 years</th>
<th>Maturity 10≤20 years</th>
<th>Maturity 20≤30 years</th>
<th>Maturity 30+ Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed-to-Floating:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>—Notional</td>
<td>$118,523</td>
<td>$80,101</td>
<td>$66,049</td>
<td>$19,872</td>
<td>$13,207</td>
<td>$2,067</td>
</tr>
</tbody>
</table>

126 British pound-SONIA has about the same number of trades and per week trading average as Fedfunds, but has a higher outstanding notional amount at $1,734 trillion.

127 The “swap curve” is the term generally used by market participants for interest rate swap pricing and is similar to, and is sometimes established, in part, based on, “yield curves” used for pricing bonds.

128 Other factors, such as convexity, may also be taken into account in determining the appropriate hedge ratio between the initial swap and the other swaps used to hedge its exposure.

129 For further discussion of the use of portfolio risk management by DCOs, see the discussion of interest rate swap market conventions and risk management in Section I.E above.

[U.S. dollar equivalent in billions]
The TriOptima data and LCH data presented above is useful in considering the distribution of final termination dates based on swap class. For fixed-to-floating swaps and basis swaps, there was significant outstanding notional amounts and number of trades for all maturity buckets.

For FRAs, the TriOptima data shows a steep drop off after two years, although there is still over $1 trillion dollars of outstanding notional amount in the 2≤5 year bucket and 1,646 trades. The notional amount outstanding falls below $50 billion after the five year maturity. The LCH data shows substantial outstanding notional amounts out to two years and none thereafter. The IRS submissions provide that the DCOs do not clear FRAs with payment dates beyond three years. Accordingly, the Commission need not consider FRAs with maturities beyond three years until such time as a DCO submits such swaps for clearing.

For OIS, the TriOptima data shows notional amounts for all maturity buckets, but the drop off was steep beyond two years. After ten years, outstanding notional amounts drop below $100 billion for each maturity bucket. The LCH data shows no outstanding notional amounts cleared beyond two years. The IRS submissions provide that the DCOs do not accept for clearing OIS swaps beyond two years. Accordingly, the Commission is not considering OIS swaps beyond two years in this clearing requirement determination.

Table 15—TriOptima Data Interest Rate Swaps Notional by Maturity Period and Class[130]—Continued

<table>
<thead>
<tr>
<th>Product type</th>
<th>Maturity 0≤2 years</th>
<th>Maturity 2≤5 years</th>
<th>Maturity 5≤10 years</th>
<th>Maturity 10≤20 years</th>
<th>Maturity 20≤30 years</th>
<th>Maturity 30+ Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>FRA:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>—Trade Count</td>
<td>823,434</td>
<td>890,622</td>
<td>908,880</td>
<td>303,927</td>
<td>270,074</td>
<td>42,155</td>
</tr>
<tr>
<td>—Notional</td>
<td>$66,040</td>
<td>$1,060</td>
<td>$45</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>OIS:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>—Trade Count</td>
<td>201,164</td>
<td>1,646</td>
<td>78</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Basis Swap:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>—Trade Count</td>
<td>39,832</td>
<td>34,080</td>
<td>24,590</td>
<td>12,638</td>
<td>8,197</td>
<td>546</td>
</tr>
</tbody>
</table>

Table 16—LCH Data: Interest Rate Swaps Notional Outstanding Cleared by Maturity Period and Class[131]

<table>
<thead>
<tr>
<th>Product type</th>
<th>Maturity 0≤2 years</th>
<th>Maturity 2≤5 years</th>
<th>Maturity 5≤10 years</th>
<th>Maturity 10≤20 years</th>
<th>Maturity 20≤30 years</th>
<th>Maturity 30≤50 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed-to-Floating:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>—Trade Count</td>
<td>22,431</td>
<td>34,930</td>
<td>40,086</td>
<td>8,551</td>
<td>10,701</td>
<td>1,127</td>
</tr>
<tr>
<td>—Notional</td>
<td>$11,184</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>OIS:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>—Trade Count</td>
<td>6,848</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Basis Swap:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>—Trade Count</td>
<td>1,485</td>
<td>736</td>
<td>394</td>
<td>226</td>
<td>84</td>
<td>15</td>
</tr>
</tbody>
</table>

The ODSG data includes swaps entered into between June and August, 2010 as voluntarily reported by the G14 Dealers. Only currencies and swap classes identified in the IRS submissions are included.

Table 17—ODSG Data: Interest Rate Swaps Trading Activity by Maturity Period and Currency[132]

<table>
<thead>
<tr>
<th>Currency</th>
<th>Maturity 0≤2 years</th>
<th>Maturity 2≤5 years</th>
<th>Maturity 5≤10 years</th>
<th>Maturity 10≤20 years</th>
<th>Maturity 20≤30 years</th>
<th>Maturity 30≤50 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>EUR</td>
<td>$14,596</td>
<td>$1,699</td>
<td>$1,510</td>
<td>$447</td>
<td>$287</td>
<td>$34</td>
</tr>
<tr>
<td>USD</td>
<td>6,796</td>
<td>1,991</td>
<td>1,999</td>
<td>247</td>
<td>220</td>
<td>5</td>
</tr>
<tr>
<td>GBP</td>
<td>6,521</td>
<td>348</td>
<td>263</td>
<td>72</td>
<td>54</td>
<td>17</td>
</tr>
<tr>
<td>JPY</td>
<td>2,970</td>
<td>782</td>
<td>448</td>
<td>91</td>
<td>16</td>
<td>0</td>
</tr>
<tr>
<td>Other</td>
<td>2,597</td>
<td>325</td>
<td>142</td>
<td>16</td>
<td>3</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>33,480</td>
<td>5,143</td>
<td>4,362</td>
<td>872</td>
<td>580</td>
<td>56</td>
</tr>
</tbody>
</table>

[131]The data covers swaps cleared by LCH during the first calendar quarter, 2012.
[132]The ODSG data includes swaps entered into between June and August, 2010 as voluntarily reported by the G14 Dealers. Only currencies and swap classes identified in the IRS submissions are included.
The ODSG data and LCH data in the two preceding tables show notional amounts traded for maturity buckets by currency. As shown, there were traded and cleared notional amounts for euro, U.S. dollars and British pounds out to the 30 to 50 year bucket and for yen out to the twenty to thirty year bucket. The LCH data confirms that substantial notional amounts of euros, U.S. dollars and British pounds are being cleared out to fifty years and yen out to 30 years.

Stated Termination Date Specification

For the classes of swaps, the TriOptima data show that there is significant outstanding notional amounts and number of trades out to 50 years for fixed-to-floating swaps and basis swaps, out to three years for OIS, and out to two years for FRAs. With respect to currencies, the ODSG data set and LCH data show significant outstanding notional amounts and number of trades out to 50 years for U.S. dollars, euros, and British pounds and out to 30 years for yen.

5. Adequate Pricing Data

In reaching its proposed determination, the Commission also is taking into account the adequacy of the pricing data for the four classes of interest rate swaps. LCH submits there is adequate pricing data for its risk and default management. It explains that its risk and default management is based on the following factors under normal and stressed conditions:

- Outstanding notional, by maturity bucket and currency;
- Number of participants with live open positions, by maturity bucket and currency;
- Notional throughput of the market, by maturity bucket and currency;
- Size tradable by maturity bucket that would not adjust the market price;
- Number of potential direct clearing members clearing the products that are part of the mutualized default fund and default management process;
- Interplay between on-the-run and off-the-run contracts; and
- Product messaging components and structure.

LCH carries out a fire drill of its default management procedures and readiness twice a year. According to LCH, the fire drill presents an opportunity to further benchmark market liquidity and behavior and for models and assumptions to be recalibrated based on practitioner input. LCH also tests liquidity assumptions from the outset when developing clearing capabilities for a new product and thereafter, on a daily basis. This testing informs how LCH develops and modifies its risk management framework to provide adequate risk coverage in compliance with the core principles applicable to DCOs. Based on this framework, LCH contends that there is adequate pricing data for the swaps offered for clearing.

IDCH submits that there is adequate pricing data to produce the IDCH-generated discount curve (the IDCH Curve). IDCH values each open position at the end of each trading day by valuing each leg of the cash flows of the contract (fixed and floating) according to discount factors produced by the IDCH Curve. The IDCH Curve is a zero-coupon yield curve that is updated on a continual basis and includes a composite of swap rates. IDCH generates a unique IDCH Curve for each reference rate that is available for clearing and calibrates each of these IDCH Curves to the discount curve to value at-market instruments at par.

CME publicly represents that its interest rate swap valuations are fully transparent and rely on pricing inputs obtained from wire service feeds. Further, CME uses conventional pricing methodologies, including OIS discounting, to produce its zero coupon curve. In addition, customers are provided with direct access to daily reports showing curve inputs, daily discount factors, and valuations for each cleared swap position.

It is also worth noting that those interest rate swaps that are the subject of this proposal are capable of being priced off of deep and liquid debt markets. Because of the stability of access to pricing data from these markets, the pricing data for non-exotic interest rate swaps that are currently being cleared is generally viewed as non-controversial.

Based on consideration of the existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data, the Commission preliminarily has determined to include interest rate swaps with the following specifications in the clearing requirement rule.

### Table 19—Interest Rate Swap Determination

<table>
<thead>
<tr>
<th>Specification</th>
<th>Fixed-to-Floating Swap Class</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Currency</td>
<td>U.S. Dollar (USD)</td>
</tr>
<tr>
<td>2. Floating Rate Indexes</td>
<td>LIBOR</td>
</tr>
<tr>
<td>3. Stated Termination Date Range</td>
<td>28 days to 50 years</td>
</tr>
<tr>
<td></td>
<td>Euro (EUR)</td>
</tr>
<tr>
<td></td>
<td>28 days to 50 years</td>
</tr>
<tr>
<td></td>
<td>EURIBOR</td>
</tr>
<tr>
<td></td>
<td>28 days to 50 years</td>
</tr>
<tr>
<td></td>
<td>Sterling (GBP)</td>
</tr>
<tr>
<td></td>
<td>28 days to 50 years</td>
</tr>
<tr>
<td></td>
<td>LIBOR</td>
</tr>
<tr>
<td></td>
<td>Yen (JPY)</td>
</tr>
<tr>
<td></td>
<td>LIBOR</td>
</tr>
</tbody>
</table>

133 The data covers swaps cleared by LCH during the first calendar quarter, 2012.
TABLE 19—INTEREST RATE SWAP DETERMINATION—Continued

<table>
<thead>
<tr>
<th>Specification</th>
<th>Basis Swap Class</th>
<th>Forward Rate Agreement Class</th>
<th>Overnight Index Swap Class</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Floating Rate Indexes</td>
<td>LIBOR</td>
<td>EURIBOR</td>
<td>LIBOR</td>
</tr>
<tr>
<td>3. Stated Termination Date Range</td>
<td>28 days to 50 years</td>
<td>28 days to 50 years</td>
<td>28 days to 50 years</td>
</tr>
<tr>
<td>4. Optionality</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>5. Dual Currencies</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>6. Conditional Notional Amounts</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

Request for Comments

- Should the Commission consider other data to determine whether there are outstanding notional exposures, trading liquidity, or adequate pricing data to support the proposed clearing requirements? If so, please provide or identify any additional data that may assist the Commission in this regard.
- Do the four classes of interest rate swaps that would be subject to the proposed clearing requirement have significant outstanding notional amounts and trading liquidity?
- Should the Commission include the other thirteen currencies currently being cleared in its initial clearing requirement determination?
- Should the Commission include stated termination dates that are shorter than those that are listed, particularly for the fixed-to-floating and basis swaps?
- If the option in an interest rate swap is exercised and not cash settled, should the resulting swap be subject to the clearing requirement if it meets the specifications included in the proposed clearing requirement?
- Is there adequate pricing data for DCO risk and default management of the interest rate swaps that would be subject to the proposed rule?

b. Availability of Rule Framework, Capacity, Operational Expertise and Resources, and Credit Support Infrastructure

Section 2(h)(2)(D)(ii)(II) of the CEA requires the Commission to take into account the availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the proposed classes of swaps on terms that are consistent with the material terms and trading conventions on which they are now traded. The Commission believes that LCH, CME, and IDCH have developed rule frameworks, capacity, operational expertise and resources, and credit support infrastructure to clear the interest rate swaps they currently clear on terms that are consistent with the material terms and trading conventions on which those swaps are being traded. The Commission notes that LCH already clears more than half the global interest rate swaps in the four proposed classes of the clearing requirement and that CME and IDCH also already clear the more commonly traded swaps under this clearing requirement proposal.

Importantly, the Commission notes that the three DCOs each developed their interest rate swap clearing offerings in conjunction with market participants and in response to the specific needs of the marketplace. In this manner, the clearing services of each DCO are designed to be consistent with the material terms and trading conventions of a bilateral, uncleared market.

LCH submits that it has the capability and expertise to not only manage the risks inherent in the current book of interest rate swaps cleared, but also the capability to manage the increased volume that the clearing requirement for all of its currently clearable products could generate. LCH states that its clearing model seamlessly allows interest rate swaps to be cleared on identical terms for both new and existing, bilateral OTC swaps. Existing bilateral swaps are regularly back loaded into LCH’s cleared swaps book. In order to be able to securely risk manage, and technologically and operationally process this volume of trades and diversity of underlying product (i.e., all of the unique underlying features of every single swap), LCH has developed operational models, controls, and risk algorithms to ensure that it can process trades, and is capable of calculating the level of risk it has with any counterparty—both direct clearing members and their customers. LCH believes its SwapClear service is proof that the interest rate swap market and all of its features can
be safely cleared with the right systems, controls, risk management, operational framework, and expertise, and it points to the orderly and successful close out of the Lehman Brothers International Europe’s interest rate swap portfolio. LCH notes that in so doing, no other clearing member or clearing member’s customer was harmed and, less than half of the defaulter’s initial margin was used.

CME’s submission cites to its rule books to demonstrate the availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear qualified, interest rate swap contracts on terms that are consistent with the material terms and trading conventions on which the contracts are then traded.

IDCH submits that its rule book provides a rule framework for clearing members and customers of clearing members to clear U.S. dollar interest rate swaps on terms that are consistent with the material terms and trading conventions on which they would trade interest rate swaps and forward rate agreements in the OTC market. The IDCH rule book also sets forth clearing member criteria and obligations, and the default process.

IDCH also claims that it has the capacity, operational expertise and resources, and credit support infrastructure to clear U.S. dollar interest rate swaps on terms that are consistent with the material terms and trading conventions on which interest rate swaps and forward rate agreements are traded in the OTC market. IDCH states that it has the financial capacity to clear such swaps as demonstrated by the financial resources backing its obligations under the cleared contracts, which includes initial margin posted by clearing members (for their proprietary account and customer accounts), guaranty fund deposits posted by clearing members, and assessment powers against clearing members. IDCH notes that it has been registered as a DCO since 2008 and has dedicated tremendous resources to developing its operational capacity to clear interest rate swaps. It claims that the capacity of the IDCH clearing systems is scalable and has been tested to manage the anticipated volume of interest rate contracts. IDCH also says that its clearing systems presently have the capacity to manage the clearing of up to 220,000 contracts with 550 value-at-risk (VaR) scenarios being used for portfolio revaluation. The architecture of the systems is designed to be scalable with hardware and has been tested to manage the clearing of up to two million interest rate swaps using the same 550 VaR scenarios for revaluation.

Having taken into account the three DCOs’ availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure, the Commission is proposing the determination and rules described below.

Request for Comments
- The Commission requests comment on all aspects of this factor, including whether or not commenters agree that the three DCOs clearing interest rate swaps can satisfy the factor’s requirements.
- Has the Commission sufficiently taken into account the three DCOs’ availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure? Are there additional or alternative considerations that should be reviewed by the Commission?

c. Effect on the Mitigation of Systemic Risk

Section 2(h)(2)(D)(ii)(III) of the CEA requires the Commission to take into account the effect on the mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the DCO available to clear the contract. CME, LCH, and IDCH submit that subjecting interest rate swaps to central clearing would help mitigate systemic risk. As noted above, the Commission believes that the market for these swaps is significant and mitigating counterparty risk through clearing likely would reduce systemic risk in that market and in the industry, generally.

According to LCH, if all clearable swaps are required to be cleared, the inevitable result will be a less disparate marketplace from a systemic risk perspective. CME submits that the 2008 financial crisis demonstrated the potential for systemic risk arising from the interconnectedness of OTC derivatives market participants and submits that centralized clearing will reduce systemic risk.

IDCH submits that, given the tremendous size of the interest rate derivatives market, the potential mitigation of systemic risk through centralized clearing of interest rate swaps is significant. IDCH argues that clearing such swaps brings the risk mitigation and collateral and operational efficiency afforded to cleared and exchange-traded futures contracts to bilaterally negotiated OTC interest rate derivatives. The submission of interest rate swaps for clearing affords the parties the credit, risk management, capital, and operational benefits of central counterparty clearing of such transactions, and facilitates collateral efficiency. Cleared swaps allow market participants to free up counterparty credit lines that would otherwise be committed to open bilateral contracts. Additionally, according to IDCH, an efficient system for centralized clearing allows parties to mitigate the risk of a bilateral OTC derivative. Instead of holding offsetting positions with different counterparties and being exposed to the risk of each counterparty, a party may enter into an economically offsetting position that is cleared.

Although the positions are not offset, the initial margin requirement will be reduced to close to zero. To eliminate risk without using centralized clearing, the party must enter into a tear-up agreement with the counterparty, or enter into a novation.

While the clearing requirement would remove a large portion of the interconnectedness of current OTC markets that leads to systemic risk, the Commission notes that central clearing, by its very nature, concentrates risk in a handful of entities. However, the Commission observes that central clearing was developed and designed to handle such concentration of risk.

LCH has extensive experience risk managing very large volumes of interest rate swaps; as noted above, it is believed that about half of the interest rate swaps are cleared by LCH. CME submits that it has the necessary resources available to clear the swaps that are the subject of its submission. The Commission notes that LCH or its predecessors have cleared futures since 1898 and is the largest futures clearinghouse in the world. CME has not defaulted during that time. IDCH submits that the IDCH framework provides IDCH with scalable financial resources sufficient to clear a large volume of interest rate swaps.

Accordingly, the Commission believes that LCH, CME, and IDCH would be able to manage the risk posed by clearing swaps that are required to be cleared. In addition, the Commission believes that the central clearing of the interest rate swaps that are the subject of this proposal would serve to mitigate counterparty credit risk thereby having a positive effect on the reducing systemic risk. Having taken into account the effect on the mitigation of systemic risk, the Commission is proposing the determination and rules described below.
Any competitive import would likely stem from the fact that the proposed determination would remove the alternative of not clearing for interest rate swaps subject to this proposal. The proposed determination would not specify who may or may not compete to provide clearing services for the interest rate swaps subject to this proposal (as well as those not required to be cleared).

To the extent that parties to interest rate swaps subject to this proposal consider clearing the swaps reasonably interchangeable with not clearing them, the proposed determination would eliminate at least one competitive substitute within the clearinghouse services market for the interest rate swaps identified in this proposal. Given the risk-mitigation purpose and benefit of migration to clearing, the proposed determination would consider the alternative of not clearing interest rate swaps subject to this proposal as a reasonable substitute to a degree sufficient that they should be viewed as populating the same relevant market. Furthermore, if the alternative of not clearing the interest rate swaps subject to this proposal falls outside of the relevant services market that includes clearing, the proposed determination should not impact competition in the clearing services market. The Commission requests comment on the extent to which the foregoing clearing is considered reasonably interchangeable with clearing the interest rate swaps subject to this proposal and, in particular, if parties transacting interest rate swaps subject to this proposal would forego clearing if clearinghouses raised the price of clearing five percent. The Commission also requests comment on whether a different percentage than five percent should be used.

Moreover, even if cleared and non-cleared transactions of the type subject to this proposal are now within the same relevant market, removing the uncleared option through this proposed rulemaking is not determinative of negative competitive impact. Other factors—including the availability of substitute within the market or potential for new entry into the market—may constrain market power.

Additionally, the potential for new entry may constrain market power in an otherwise concentrated clearing services market. The Commission does not foresee that the proposed determination construits barriers that would deter or impede new entry into a clearing services market. Indeed, there is some basis to expect that the determination could foster an environment conducive to new entry. For example, the proposed clearing determinations, and the prospect that more may follow, is likely to reinforce, if not encourage, growth in demand for clearing services. Demand growth, in turn, can enhance the sales opportunity, a condition hospitable to new entry. The Commission requests comment on the extent to which: (1) Entry barriers currently do or do not exist with respect to a clearing services market for the interest rate swaps subject to this proposal; (2) the proposed determinations may lessen or increase these barriers; and (3) the proposed determinations otherwise may encourage, discourage, facilitate, and/or dampen new entry into the market.

Request for Comments

In addition to what is noted above, the Commission requests comment, and quantifiable data, on whether the required clearing of any or all of these swaps will create conditions that create, increase, or facilitate an exercise of: (1) Clearing services market power in LCH, CME, and IDCH, and/or any other clearing service market participant, including conditions that would dampen competition for clearing services and/or increase the cost of clearing services; and/or (2) market power in any product markets for interest rate swaps, including conditions that would dampen competition for these product markets and/or increase the cost of interest rate swaps involving the interest rate swaps identified in this proposal. The Commission seeks comment, and quantifiable data, on the likely cost increases associated with clearing, particularly those fees and charges.

136 That said, the Commission recognizes that (1) to the extent the clearing services market for the interest rate swaps identified in this proposal, after foreclosing uncleared swaps, would be limited to a concentrated few participants with highly aligned incentives, and (2) the clearing services market is insulated from new competitive entry through barriers—e.g., high sunk capital cost requirements; high switching costs to transition from embedded, incumbents; and access restrictions—the proposed determination could have a negative competitive impact by increasing market concentration.

137 See, e.g., Horizontal Merger Guidelines at § 9.2 (entry likely if it would be profitable which is in part a function of “the output level the entrant is likely to obtain”).
imposed by DCOs, and the effects of such increases on counterparties currently participating in the market. The Commission also seeks comment regarding the effect of competition on DCO risk management. The Commission also welcomes comment on any other aspect of this factor.

e. Legal Certainty in the Event of the Insolvency

Section 2(h)(2)(D)(ii)(V) of the CEA requires the Commission to take into account the existence of reasonable legal certainty in the event of the insolvency of the relevant DCO or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property. The Commission is proposing this clearing requirement based on its view that there is reasonable legal certainty with regard to the treatment of customer and swap counterparty positions, funds, and property in connection with cleared swaps, namely the interest rate swaps subject to this proposal, in the event of the insolvency of the relevant DCO (CME, LCH, or IDCH) or one or more of the DCO’s clearing members.

The Commission concludes that, in the case of a clearing member insolvency at CME or IDCH, subchapter IV of Chapter 7 of the U.S. Bankruptcy Code (11 U.S.C. 761–767) and Part 190 of the Commission’s regulations would govern the treatment of customer positions. Pursuant to section 4d(f) of the CEA, a clearing member accepting funds from a customer to margin a cleared swap, must be a registered FCM. Pursuant to 11 U.S.C. 761–767 and Part 190 of the Commission’s regulations, the customer’s interest rate swap positions, carried by the insolvent FCM, would be deemed “commodity contracts.” As a result, neither a clearing member’s bankruptcy nor any order of a bankruptcy court could prevent either CME or IDCH from closing out/liquidating such positions. However, customers of clearing members would have priority over all other claimants with respect to customer funds that had been held by the defaulting clearing member to margin swaps, such as the interest rate swaps subject to this proposal. Thus, customer claims would have priority over proprietary claims and general creditor claims. Customer funds would be distributed to swap customers, including interest rate swap customers, in accordance with Commission regulations and section 766(h) of the Bankruptcy Code. Moreover, the Bankruptcy Code and the Commission’s rules thereunder (in particular 11 U.S.C. 764(b) and 17 CFR 190.06) permit the transfer of customer positions and collateral to solvent clearing members.

Similarly, 11 U.S.C. 761–767 and Part 190 would govern the bankruptcy of a DCO, in conjunction with DCO rules providing for the termination of outstanding contracts and/or return of remaining clearing member and customer property to clearing members.

With regard to LCH, the Commission understands that the default of a clearing member of LCH would be governed by the rules of that DCO. LCH, a DCO based in the United Kingdom, has represented that under English law its rules would supersede English insolvency laws. Under its rules, LCH would be permitted to close out and/or transfer positions of a defaulting clearing member that is an FCM pursuant to the U.S. Bankruptcy Code and Part 190 of the Commission’s regulations. According to LCH’s submission, the insolvency of LCH itself would be governed by both English insolvency law and Part 190.

LCH has obtained legal opinions that support the existence of such legal certainty in relation to the protection of customer and swap counterparty positions, funds, and property in the event of the insolvency of one or more of its clearing members. In addition, LCH has obtained a legal opinion from U.S. counsel regarding compliance with the protections afforded to FCM customers under New York law.

Request for Comments

The Commission invites comment regarding whether there is reasonable legal certainty in the event of an insolvency of a DCO or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property.

III. Proposed Rule

The Commission is proposing the following rules under section 2(h)(2), as well as its authority under section 5b(c)(2)(L) and 8a(5) of the CEA. In issuing a determination regarding whether a swap or class of swaps is required to be cleared, “the Commission may require such terms and conditions to the requirement as the Commission determines to be appropriate.”

A. Proposed § 50.1 Definitions

Proposed § 50.1 sets forth two defined terms: “business day” and “day of execution.” The definition of business day would exclude Saturdays, Sundays, and legal holidays. This definition is being proposed as a means of addressing situations where executing counterparties are located in different time zones. It is intended to avoid difficulties associated with end-of-day trading by deeming swaps executed after 4:00pm, or on a day other than a business day, to have been executed on the immediately succeeding business day. The Commission recognizes that market participants should not be required to maintain back-office operations 24 hours a day or 7 days a week in order to meet the proposed deadline for submitting swaps that are required to be cleared to a DCO. The Commission also is attempting to be sensitive to possible concerns about timeframes that may discourage trade execution late in the day. To account for time-zone issues, the “day of execution” has been defined to be the calendar day of the party to the swap that ends latest, giving the parties the maximum amount of time to subject their swaps to a DCO while still requiring such submission on a same-day basis.

B. Proposed § 50.2 Treatment of Swaps Subject to a Clearing Requirement

Proposed § 50.2(a) would require all persons, other than those who elect the exception for non-financial entities in accordance with § 39.6, to submit a swap that is part of the class described in § 50.4 for clearing by a DCO as soon as technologically practicable and no later than the end of the day of execution. The objective of this provision is to ensure that swaps subject to a clearing requirement are submitted to DCOs for clearing in a timely manner. The Commission notes that this proposal regarding timing of submission to a DCO is consistent with the real-time public reporting rules and the rules mandating deadlines for the reporting of swap data to SDRs, both of which use “as soon as technologically practicable” as the applicable standard.

For purposes of this rule, the Commission clarifies that submission of a swap by a market participant to its FCM clearing member would be deemed

139 The Commission observes that an FCM or DCO also may be subject to resolution under Title II of the Dodd-Frank Act to the extent it would qualify as covered financial company (as defined in section 201(a)(6) of the Dodd-Frank Act).
140 If an FCM is also registered as a broker-dealer, certain issues related to its insolvency proceeding would also be governed by the Securities Investor Protection Act.
141 Claims seeking payment for the administration of customer property would share this priority.
to meet the requirements for submitting the swap to a DCO. Once a customer submits a swap to its FCM, the timeliness considerations are governed by other straight-through-processing rules recently finalized by the Commission.\footnote{Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management, 77 FR 21278, 21307 (Apr. 9, 2012).} Under § 1.74(a), FCMs that are clearing members of DCOs shall coordinate with DCOs to establish systems that enable the FCM or DCO to accept or reject each trade submitted for clearing by a customer of the FCM as quickly as would be technologically practicable if fully automated systems were used. Similarly, under § 1.74(b), FCM clearing members must accept or reject each trade submitted to it by a customer as quickly as would be technologically practicable if fully automated systems were used. Those market participants that clear on their own behalf would be required to submit their swaps to a DCO directly and pursuant to the proposed timeframe. Proposed § 50.2(b) would require persons subject to § 50.2(a) to undertake reasonable efforts to determine whether a swap is required to be cleared. The Commission would consider such reasonable efforts to include checking the Commission’s Web site or the DCO’s Web site for verification of whether a swap is required to be cleared. Similarly, market participants could consult third-party service providers for such verification. This reasonable efforts standard is intended to provide market participants with clarity as to what is expected of them when they enter into a swap that has the specifications of one of the classes identified in proposed § 50.4.

Ideally, DCOs will design and develop systems that will enable market participants and trading platforms to check whether their swap is subject to a clearing requirement and be provided with an answer within seconds (or faster). This technology would provide a single-stop solution for the market with regard to checking eligibility under a required clearing regime.

C. Proposed § 50.3 Notice to the Public

Proposed § 50.3(a) would require each DCO to post on its Web site a list of all swaps that it will accept for clearing and clearly indicate which of those swaps the Commission has determined are required to be cleared pursuant to part 50 of the Commission’s regulations and section 2(h)(1) of the CEA. The proposed rule builds upon the requirements of § 39.21(c)(1), which requires each DCO to disclose publicly information concerning the terms and conditions of each contract, agreement, and transaction cleared and settled by the DCO. Proposed § 50.3(b) would require the Commission to post on its Web site a list of those swaps it has determined are required to be cleared and all DCOs that are eligible to clear such classes of swaps. The Commission believes that this will provide market participants with sufficient notice regarding which swaps are subject to a clearing requirement.

D. Proposed § 50.4 Classes of Swaps Required To Be Cleared

As discussed at length above, proposed § 50.4 sets forth the classes of interest rate swaps and CDS that the Commission has determined are required to be cleared. Proposed § 50.4(a) includes a table listing those types of interest rate swaps the Commission would require to be cleared; proposed § 50.4(b) includes a table listing those types of CDS indices the Commission would require to be cleared. The Commission believes that this format provides market participants with a clear understanding of which swaps are required to be cleared. By using basic specifications to identify the swaps subject to the clearing requirement, counterparties contemplating entering into a swap can determine quickly as a threshold matter whether or not the particular swap may be subject to a clearing requirement. If the swap has the basic specifications of a class of swaps determined to be subject to a clearing requirement, the parties will know that they need to verify whether a DCO will clear that particular swap. This will reduce the burden on swap counterparties related to determining whether a particular swap may be subject to the clearing requirement.

E. Proposed § 50.5 Clearing Transition Rules

Proposed § 50.5 would codify section 2(h)(6) of the CEA. Under proposed § 50.5(a), swaps that are part of a class described in § 50.4 but were entered into before the enactment of the Dodd-Frank Act would be exempt from clearing so long as the swap is reported to an SDR pursuant to § 44.02 and section 2(h)(5)(A) of the CEA. Similarly, under proposed § 50.5(b), swaps entered into after the enactment of the Dodd-Frank Act but before the application of the clearing requirement would be exempt from the clearing requirement if reported pursuant to § 44.03 and section 2(h)(5)(B) of the Act.

F. Proposed § 50.6 Delegation of Authority

Proposed § 50.6(a) would delegate to the Director of the Division of Clearing and Risk, or the Director’s designee, with the consultation of the General Counsel or the General Counsel’s designee, the authority to determine whether a swap falls within a class of swaps described in § 50.4 and to communicate such a determination to the relevant DCOs. The Commission believes that the Division of Clearing and Risk has the requisite expertise to make such a determination and that the most expeditious way for the marketplace to be apprised of such a determination would be for the Division of Clearing and Risk to make the determination itself and to communicate it directly to the relevant DCOs.

Swaps that contain the specifications described in § 50.4 would be presumed to fall within a class of swaps already subject to a clearing requirement. In this manner, the Commission hopes to facilitate DCOs’ ability to add new swaps to particular classes without undue burden.

G. Proposed § 50.10 Prevention of Evasion of the Clearing Requirement and Abuse of an Exception or Exemption to the Clearing Requirement

The Commission is proposing § 50.10 to prevent evasion of the clearing requirement and prevent abuse of any exemption or exception to the clearing requirement under the Commission’s new rulemaking authority provided in the Dodd-Frank Act amendments to sections 2(h)(4)(A)\footnote{Section 2(h)(4) of the CEA, 7 U.S.C. 2(h)(4).} (Prevention of Evasion) and 2(h)(7)(F)\footnote{Section 2(h)(7)(F) of the CEA, 7 U.S.C. 2(h)(7)(F).} (Abuse of the End-User Exception) of the CEA and under the Commission’s existing rulemaking authority in section 8a(a)(1)\footnote{Section 8a(a)(5) of the CEA, 7 U.S.C. 8a(5).} (General Rulemaking Authority) of the CEA. Proposed § 50.10 would prohibit (a) evasions of the requirements of section 2(h), (b) abuse of the end-user exception to the clearing requirement, and (c) abuse of any exemption or exception to the requirements of section 2(h), including any exemption or exception that the Commission may provide by rule, regulation, or order.

Section 2(h) of the CEA provides two express rulemaking provisions specifically addressing prevention of evasion and prevention of abuse of the clearing requirement. Section 2(h)(4)(A) of the Act states that the Commission shall prescribe rules and issue interpretations

\footnote{Section 2(h)(4) of the CEA, 7 U.S.C. 2(h)(4).}
of rules as determined by the Commission to be necessary to prevent evasions of the clearing requirements under section 2(h) of the CEA. Section 2(h)(7)(F) provides that the Commission may prescribe such rules or issue interpretations of the rules as the Commission determines to be necessary to prevent abuse of the exceptions to the clearing requirement. The Commission preliminarily views evasion of the clearing requirement and abuse of an exemption or exception to the clearing requirement, including the end-user exception, to be related concepts and are informed by new enforcement authority under the Dodd-Frank Act, which added new sections 6(e)(4)–(5) and 9(a)(6) to CEA.

Proposed § 50.10(a) would make it unlawful for any person to knowingly or recklessly evade, participate in, or facilitate an evasion of any of the requirements of section 2(h) of the CEA. Proposed § 50.10(a) is informed by and consistent with section 6(e)(4) and (5) of the CEA, which states that any DCO, SD, or MSP that “knowingly or recklessly evades or participates in or facilitates an evasion of the requirements of section 2(h) shall be liable for a civil monetary penalty in twice the amount otherwise available for a violation of section 2(h).” Proposed § 50.10(a), however, would apply to any person. In addition, proposed § 50.10(a) would apply to any requirement under section 2(h) of the CEA or any Commission rule or regulation promulgated thereunder. These requirements include the clearing requirement under section 2(h)(1), reporting of data under section 2(h)(5), and the trade execution requirement under section 2(h)(6), among other requirements.

The Commission notes, however, that section 2(h)(1)(A) of the CEA provides that it “shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing” to a DCO if the swap is required to be cleared. Unlike the knowing or reckless standard under proposed § 50.10(a), section 2(h)(1)(A) imposes a non-scienter standard on swap market participants. Therefore, any person engaged in a swap that is required to be cleared under section 2(h) and proposed Part 50 of the Commission’s Regulations, and such person did not submit the swap for clearing, absent an exemption or exception, would be subject to a Commission enforcement action regardless of whether the person knowingly or recklessly failed to submit the swap for clearing.

Proposed § 50.10(b) makes it unlawful for any person to abuse the end-user exception to the clearing requirement as provided under section 2(h)(7) of the CEA and § 39.6. Proposed § 50.10(b) is adopted under the authority in both section 2(h)(4)(A) and section 2(h)(7)(F). The Commission preliminarily believes that an abuse of the end-user exception to the clearing requirement may also, depending on the facts and circumstances, be an evasion of the requirements of section 2(h). The Commission’s view is informed by section 9(a)(6) of the CEA, which cross-references both the prevention of evasion authority in section 2(h)(4) and prevention of abuse of the exception to the clearing requirement in section 2(h)(7)(F). Section 9(a)(6) states that it “shall be a felony punishable by a fine of not more than $1,000,000 or imprisonment for not more than 10 years, or both, together with the costs of prosecution, for * * * [a]ny person to abuse the end user clearing exemption under section 2(h)(4), as determined by the Commission.” Therefore, the Commission is proposing to interpret a violation of section 9(a)(6) of the CEA to also be a violation of proposed § 50.10(b).

Proposed § 50.10(c) makes it unlawful for any person to abuse any exemption or exception to the requirements of section 2(h) of the CEA, including any exemption or exception, as the Commission may provide by rule, regulation, or order. This provision is informed by the Dodd-Frank Act amendments in section 2(h)(4)(A) to prescribe rules necessary to prevent evasions of the clearing requirements, section 2(h)(7)(F) to prescribe rules necessary to prevent abuse of the exceptions to the clearing requirements, and the Commission’s general rulemaking authority in section 8a(5) to promulgate rules that, in the judgment of the Commission, are reasonably necessary to accomplish any purposes of the CEA. Therefore, the Commission preliminarily believes that proposed § 50.10(c) is necessary to prevent abuses of any exemption or exception to the requirements of section 2(h).

The Commission believes a “principles-based” approach to proposed § 50.10 is appropriate. The Commission is not proposing to provide a bright-line test of non-evasive or abusive conduct, because such an approach may be a roadmap for engaging in evasive or abusive conduct or activities. Nevertheless, the Commission is proposing additional guidance regarding evasion and abuse in order to provide clarity to market participants.

The Commission proposes to interpret these rules in a manner similar to its interpretation of the anti-evision rules that it recently adopted in its rulemaking to further define the term swap. The Commission proposes to determine on a case-by-case basis, whether particular transactions or other activities constitute an evasion of the requirements of section 2(h) of the CEA or the regulations promulgated thereunder or an abuse of any exemption or exception to the requirements of section 2(h). Each such transaction or activity would be evaluated on a case-by-case basis with consideration given to all the facts and circumstances.

Similar to its approach in the rules further defining the term “swap,” the Commission proposes that it would not consider transactions or other activities structured in a manner solely motivated by a legitimate business purpose to constitute evasion or abuse. Additionally, when determining whether particular conduct is an evasion of the requirements of section 2(h) or an abuse of any exemptions or exceptions to those requirements, the Commission will consider the extent to which the conduct involves deceit, deception, or other unlawful or illegitimate activity.

The Commission recognizes that market participants may engage in conduct or activities, such as structuring a transaction in a particular way, for legitimate business purposes, without any intention to evade the requirements of section 2(h) of the CEA or abuse any exemptions or exceptions thereunder. Thus, in evaluating whether a person has evaded such requirements or abused...
an exemption or exception, the Commission proposes to consider the extent to which a person has a legitimate business purpose in connection with the relevant conduct or activities. This proposed analytical method will be useful in the overall analysis of potentially knowingly or recklessly evasive conduct or abusive conduct. The Commission proposes to view legitimate business purpose considerations on a case-by-case basis in conjunction with all other relevant facts and circumstances.

Moreover, the Commission recognizes that it is possible that a person intending to evade the requirements of section 2(h) or abuse an exemption or exception thereunder may attempt to justify its actions by claiming that such actions are legitimate business practices in its industry. Therefore, the Commission proposes to retain the flexibility, via an analysis of all relevant facts and circumstances, to confirm not only the legitimacy of the business purpose of those actions but whether the actions could still be determined to be evasive or abusive. Because market participants engage in conduct and activities, such as structuring transactions and instruments, in a particular way for various reasons, it is essential that all relevant facts and circumstances be considered, including legitimate business purposes, before reaching any conclusion as to evasion or abuse.

When determining whether a particular activity constitutes an evasion of the requirements of section 2(h) or an abuse of any exemption or exception to such requirements, the Commission proposes to consider the extent to which the activity involves deceit, deception, or other unlawful or illegitimate activity. The Commission believes that although it is likely that fraud, deceit, or unlawful activity will be present where evasion or abuse has occurred, these factors are not prerequisites to finding a violation of proposed rule § 50.10. Rather, fraud, deceit, or unlawful activity is one circumstance the Commission proposes to consider when evaluating a person’s conduct or activities.

Finally, when considering all the relevant facts and circumstances under a potential violation of proposed rule § 50.10, the Commission would not consider the form, label, or written documentation of any relevant agreement, contract or transaction to be dispositive. This approach is intended to prevent evasion and abuse through clever draftsmanship of a form, label, or other written documentation. Therefore, the Commission proposes to look beyond the form of the agreement, contract or transaction to examine its actual substance and purpose to prevent any evasion or abuse through clever draftsmanship.

In addition to the prohibitions under proposed § 50.10, the Commission notes that additional provisions of the CEA may also be applicable to evasive or abusive practices. For example, the Commission notes that swaps, whether cleared or uncleared, must be reported to a registered SDR, or if no SDR will accept the swap, to the Commission. In that regard, the Commission has proposed that to be eligible to qualify for certain exceptions or to be able to rely on certain exemptions, at least one party to the swap must report certain information to an SDR or to the Commission. Regulation 39.6(b)(4), for example, requires at least one party to a swap that has elected to use the end-user exception to the clearing requirement to report whether the swap is used to hedge or mitigate commercial risk.

Considering this regulatory regime, certain evasive or abusive practices, such as making false statements or submission in connection with the clearing requirement, may also violate other provisions of the CEA. For example, section 6(c)(2) of the CEA, which makes it unlawful for any person to make any false or misleading statement of material fact to the Commission, including in any report filed with the Commission or any other information relating to a swap. Furthermore, section 9(a)(4) of the CEA makes it a felony for any person to willfully falsify a material fact, make any false or fraudulent statements or representations, or make or use any false writing or document or fraudulent statement or entry to an SDR. Thus, the Commission may bring enforcement actions under proposed § 50.10, section 6(c)(2), and section 9(a)(4), among other statutory provisions and rules, to prevent evasions of the requirements of section 2(h) and abuses of any exemption or exception to such requirements.

The Commission requests comment on all aspects of the proposed rules and specifically on:

• Should the Commission clarify in the proposed rules that the clearing requirement applies to all new swaps and all changes in the ownership of a swap, such as assignment, novation, exchange, transfer, or conveyance?

• Is proposed § 50.10 and the guidance set forth in this section sufficient to address concerns of evasion of the requirements of section 2(h) or an abuse of any exemption or exception to such requirements? Is further guidance necessary? If so, what further guidance would be appropriate?

• Should the Commission prohibit certain specific practices that would be evasions of the requirements of section 2(h)?

• Should the Commission prohibit certain specific practices that would be an abuse of the end-user exception?

• Should the Commission prohibit certain specific practices that would be an abuse of any other exemption or exception to the requirements of section 2(h)?

IV. Implementation

The Commission is proposing to require compliance with the clearing requirement for the classes of swaps identified in proposed § 50.4 according to the compliance schedule contained in § 50.25. Under this schedule, compliance with the clearing requirement will be phased by type of market participant entering into a swap subject to the clearing requirement.

V. Cost Benefit Considerations

A. Statutory and Regulatory Background

The regulations contained in this proposal identify certain classes of swaps that are required to be cleared pursuant to the Dodd-Frank Act’s clearing requirement incorporated within amended section 2(h)(1)(A) of the CEA. This clearing requirement is designed to standardize and reduce counterparty risk associated with swaps, and, in turn, mitigate the potential risk. This section states: "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 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."
systemic impact of such risks and reduce the likelihood for swaps to cause or exacerbate instability in the financial system. It reflects a fundamental premise of the Dodd-Frank Act: the use of properly functioning central clearing can reduce systemic risk.

Regulation 39.5 provides an outline for the Commission’s review of swaps for required clearing. Regulation 39.5 allows the Commission to review swaps submitted by DCOs or those swaps that the Commission opts to review on its own initiative. Under section 2(h)(2)(D) of the CEA, in reviewing swaps for required clearing, the Commission must take into account the following factors: (1) Significant outstanding notional exposures, trading liquidity and adequate pricing data, (2) the availability of rule framework, capacity, operational expertise and credit support infrastructure, (3) the effect on the mitigation of systemic risk, (4) the effect on competition and (5) the existence of reasonable legal certainty in the event of the insolvency of the DCO or one or more of its clearing members. Regulation 39.5 also directs DCOs to provide to the Commission other information, such as product specifications, participant eligibility standards, pricing sources, risk management procedures, a description of the manner in which the DCO has provided notice of the submission to its members and any additional information requested by the Commission. This information is designed to assist the Commission in identifying those swaps that are required to be cleared.

B. Overview of Swap Clearing

i. How Clearing Reduces Risk

When a bilateral swap is cleared, the clearinghouse becomes the counterparty to each of the original participants in the swap. This standardizes counterparty risk for the original swap participants in that they each bear the same risk—i.e., the risk attributable to facing the clearinghouse as counterparty. In addition, clearing mitigates counterparty risk to the extent that the clearinghouse is a more creditworthy counterparty relative to the original swap participants. Clearinghouses have demonstrated resilience in the face of past market stress. Most recently, they remained financially sound and effectively settled positions in the midst of turbulent events in 2007–2008 that threatened the financial health and stability of many other types of entities.

Given the variety of effective clearinghouse tools to monitor and manage counterparty risk, the Commission believes that DCOs will continue to be default the most creditworthy counterparties in the swap markets. These tools include the contractual right to: (1) Collect initial and variation margin associated with outstanding swap positions; (2) mark positions to market regularly (usually one or more times per day) and issue margin calls whenever the margin in a customer’s account has dropped below predetermined levels set by the DCO; (3) adjust the amount of margin that is required to be held against swap positions in light of changing market circumstances, such as increased volatility in the underlying product; and (4) close out the swap positions of a customer that does not meet margin calls within a specified period of time.

Moreover, in the event that a clearing member defaults on their obligations to the DCO, the latter has a number of remedies to manage associated risks, including transferring the swap positions of the defaulted member, and covering any losses that may have accrued with the defaulting member’s margin on deposit. In order to transfer the swap positions of a defaulting member and manage the risk of those positions while doing so, the DCO has the ability to: (1) Hedge the portfolio of positions of the defaulting member to limit future losses; (2) partition the portfolio into smaller pieces; (3) auction off the pieces of the portfolio, together with their corresponding hedges, to other members of the DCO; and (4) allocate any remaining positions to members of the DCO. In order to cover the losses associated with such a default, the DCO would typically draw from (in order): (1) The initial margin posted by the defaulting member; (2) the guaranty fund contribution of the defaulting member; (3) the DCO’s own capital contribution; (4) the guaranty fund contribution of non-defaulting members; and (5) an assessment on the non-defaulting members. These mutualized risk mitigation capabilities are largely unique to clearinghouses, and help to ensure that they remain solvent and creditworthy swap counterparties even when dealing with defaults by their members or other challenging market circumstances.

ii. Movement of Swaps Into Clearing

There is significant evidence that some parts of the OTC swap markets (the IRS and CDS markets in particular) have been migrating into clearing over the last few years in response to natural market incentives as well as in anticipation of the Dodd-Frank Act’s clearing requirement. LCH Clearnet data, for example, shows that the outstanding volume of interest rate swaps cleared by LCH has grown steadily since at least November 2007, as has the monthly registration of new trade sides. Data provided to the Commission shows that the notional amount of cleared IRS is approximately $72 trillion as of January 2007, and just over $236 trillion in September 2010, an increase of 228% in three and a half years. Together, those facts indicate increased demand for LCH clearing services related to interest rate swaps, a portion of which preceded the Dodd-Frank Act. Data available through CME and TriOptima indicate similar patterns of growing demand for interest rate swap clearing services, though their publicly available data does not provide a picture of demand prior to the passage of the Dodd-Frank Act.

In addition to IRS clearing, major CDS market participants are clearing their CDS indices and single names in significant volumes. As explained above, in 2008, the Federal Reserve Bank of New York (FRBNY) began encouraging market participants to establish a central counterparty to clear CDS. In the past four years, CDS clearing has grown significantly. In total, CFTC-registered DCOs are currently holding more than $20 billion in aggregate in initial margin to cover cleared CDS positions. Additionally, publicly available data shows that CME’s CDS guaranty fund has approximately $629 million; ICE Clear Credit has a guaranty fund equal to $4.4 billion; and ICE Clear Europe has a

164 Data provided to the Commission by LCH.
165 See http://www.lchclearnet.com/swaps/volumes/.
168 Based on Commission data for registered DCOs as of May 10, 2012.
guaranty fund €2.7 billion for its CDS business.169

Notably, the move toward central clearing has been particularly pronounced during times of crisis, as market participants have voluntarily used central clearing as a way of protecting against counterparty credit risk. The bankruptcy of Enron, in 2001, led to the emergence of clearing for OTC energy swaps in the United States. After Enron’s failure, many counterparties to energy swaps realized the benefits of substituting the creditworthiness of a clearing house for that of their bilateral counterparties. Much of the impetus for moving OTC energy swaps into clearing resulted from the credit crisis that developed following Enron’s collapse.170 According to CME, its ClearPort service “filled a major void in the aftermath of the Enron collapse, particularly in the OTC market for natural gas, which was left without a central OTC marketplace.” 171

iii. The Clearing Requirement and Role of the Commission

In the Dodd-Frank Act, Congress directed that clearing shift from a voluntary practice to a mandatory practice for certain swaps and gave the Commission responsibility for determining which swaps would be required to be cleared. Therefore, the costs and benefits of required clearing are attributable, in part, to the Act itself, and, in part, to Commission action, taking the form of an exercise of discretion to determine which swaps are required to be cleared. Because the requirements of the Dodd-Frank Act and the discretion of the Commission operate in concert in this way, it is impossible to distinguish precisely between those costs and benefits that result from the Dodd-Frank Act’s clearing requirement, considered in the abstract, and those that result from the Commission’s determinations that particular types of swaps will be required to be cleared. Also, because voluntary clearing of swaps has increased over past years (may be due in part to anticipation of the clearing requirement to be imposed under the Dodd-Frank Act, but may also be due in part to a realization of the benefits of clearing after the financial crisis), it is impossible to determine precisely the extent to which any increased use of clearing would result from statutory or regulatory requirements, as compared to OTC market participants’ desires to use clearing to obtain its risk-reducing benefits.172

The Commission also recognizes that there might not be a linear relationship between the quantity of swaps that are cleared (whether measured by number of swaps, the notional value of swaps or some other measure of swap quantity, such as the exposure resulting from the swaps) and the costs and benefits resulting from clearing. For example, if the Commission were to assume that the proposed rule would result in a doubling of the quantity of a certain type of swap that is cleared, it would not necessarily be the case that the costs and benefits of clearing that type of swap would double. Rather, the relationship could be non-linear for a variety of reasons (such as variations among the users of that type of swap). In fact, it may be reasonable to assume that where the costs of clearing are relatively low and the benefits are relatively high, market participants already voluntarily clear swaps even in the absence of a clearing requirement. The Commission requests comment on the relationship between the requirement that the swaps identified in this proposal are cleared and the costs and benefits of that requirement, including on whether that relationship is linear or non-linear.

For all these reasons, the Commission has determined that the costs and benefits related to the required clearing of the classes of IRS and CDS subject to this proposal are attributable, in part to (1) Congress’s stated goal of reducing systemic risk by, among other things, requiring central clearing for certain swaps and (2) the Commission’s discretion in selecting swaps or classes of swaps in order to achieve those ends. The Commission will discuss the costs and benefits of the overall move from voluntary clearing to required clearing for the swaps subject to this proposal.

The Commission requests comment on this assumption, and in particular on the extent to which swap market participants’ use of clearing results from a regulatory requirement that specific swaps be cleared (i.e., the rules proposed here), the Dodd-Frank Act’s general clearing requirement, or other motivations for the use of clearing, including, among other things, independent business reasons and incentives from other regulators, such as prudential authorities.

C. Consideration of the Costs and Benefits of the Commission’s Action

i. CEA Section 15(a)

Section 15(a) of the CEA requires the Commission to consider the costs and benefits of its actions before promulgating a regulation under the CEA or issuing certain orders. Section 15(a) further specifies that the costs and benefits shall be evaluated in light of the following five broad areas of market and public concern: (1) Protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations.

Accordingly, the Commission considers the costs and benefits resulting from its own discretionary determinations with respect to the section 15(a) factors.

In the sections that follow the Commission considers: (1) Costs and benefits of required clearing for the classes of swaps identified in this proposal; (2) alternatives contemplated by the commission and their costs and benefits relative to the approach proposed herein; (3) the impact of required clearing for the proposed classes of swaps on the 15(a) factors.

ii. Costs and Benefits of Required Clearing Under the Proposal

In order to clear swaps in the classes identified in this proposal, certain market participants are likely to face certain startup and ongoing costs relating to technology and infrastructure, new or updated legal agreements, ongoing fees from service providers, and costs related to collateralization of their positions. The per-entity costs related to changes in technology, infrastructure, and legal agreements are likely to vary widely, depending on each market participant’s existing technology infrastructure, legal agreements, operations, and anticipated needs in each of these areas. For market participants that already use clearing, some of these costs may be expected to be lower, while the opposite would
likely be true for market participants that begin to use clearing only because of the requirement. The costs of collateralization, on the other hand, are likely to vary depending on whether an entity is subject to capital requirements or not, and the differential between the cost of capital for the assets they use as collateral, and the returns they realize on those assets. Commenters are requested to address the extent to which factors such as these will affect the costs of clearing for various market participants.

There are also significant benefits associated with increased clearing, including reducing and standardizing counterparty risk, increased transparency, and easier access to the swap markets. These effects together will contribute significantly to the stability and efficiency of the financial system. It is impossible, at this point, to quantify these benefits with any degree of precision. The Commission notes, however, that the extraordinary financial system turbulence of 2008 has had profound and long-lasting adverse effects on the real economy, and therefore reducing systemic risk provides significant, if unquantifiable, benefits.173 Also, as is the case for the costs related to clearing, these benefits would be relatively less to the extent that market participants are already using clearing in the absence of a requirement. Commenters are requested to address this aspect of the analysis as well.

a. Technology, Infrastructure, and Legal Costs

With respect to technology, for market participants that already use swap clearing or transact in futures, many of the backend requirements for technology that supports cleared swaps are likely to be quite similar, and therefore necessary changes to those systems are likely to require a relatively lower costs. Market participants that are not currently using clearing for swaps or transacting in futures, however, may need to implement appropriate middleware to connect with an FCM that will clear their transactions. Similarly for legal fees, the costs related to clearing the swaps that are subject to the proposed clearing requirement are likely to vary widely depending on whether market participants already use clearing or transact in futures. For those market participants that have not already engaged an FCM, it has been estimated that smaller financial institutions will spend between $2,500 and $25,000 reviewing and negotiating legal agreements when establishing a new business relationship with an FCM.174 The Commission does not have information necessary to confirm these estimates or determine to what degree these estimates would apply to larger entities establishing a business relationship with an FCM. In addition, the Commission does not have information to determine costs associated with entities that already have established relationships with one or more FCMs but need to revise those agreements. In all cases such costs are likely to depend significantly on the specific business needs of each entity and therefore are expected to vary widely among market participants.

In addition, the Commission is exercising the anti-evasion rulemaking authority granted to it by the Dodd-Frank Act. Generally, proposed rule § 50.10 states that it is unlawful for any person to knowingly or recklessly evade or participate in or facilitate an evasion of the requirements of section 2(h) of the CEA, to abuse the exception to the clearing requirement as provided under section 2(h)(7) of the CEA and Commission rule § 39.6, or to abuse any exemption or exception to the requirements of section 2(h) of the CEA, including any exemption or exception as the Commission may provide by rule, regulation, or order.

Although proposed rule § 50.10 does not set forth a bright line test to define evasion or abuse, the proposed rule is expected to help ensure that would-be evaders cannot engage in conduct or activities that constitute an evasion of the requirements of section 2(h) or an abuse of any exemption or exception to such requirements. The Commission also proposes guidance as to how it would determine if such evasion or abuse has occurred, while at the same time preserving the Commission’s ability to determine, on a case-by-case basis, with consideration given to all the facts and circumstances, that other types of transactions or activities constitute an evasion or abuse under proposed § 50.10.

The Commission proposes that participants in the markets should already have policies and procedures in place to ensure that their employees, affiliates, and agents will refrain from engaging in activities, including devising transactions, for the purpose of evading, or in reckless disregard of, the requirements of section 2(h) of the CEA and Commission rules and regulations promulgated thereunder or to abuse any exemption or exception to such requirements. Given that the proposed rule imposes no affirmative duties (i.e., reporting or recordkeeping), it is unlikely that it will impose any additional ongoing costs beyond the pre-existing costs associated with ensuring that the firm is not engaging in unlawful conduct. In that regard, the Commission believes that it will not be necessary for firms that currently have adequate compliance programs to hire additional staff or significantly upgrade their systems to comply with the proposed rule. Firms may, however, incur some one-time costs such as costs associated with training traders and staff on the proposed rule. In addition, market participants may incur some ongoing costs when deciding whether particular conduct or activity could be construed as being an evasion of the requirements of section 2(h) or an abuse of any exemption or exception to such requirements. However, the proposed rules and proposed guidance explain what constitutes evasive or abusive conduct, which should serve to mitigate such costs.

The Commission requests comment, including any quantifiable data and analysis, on the changes that market participants will have to make to their technological and legal infrastructures in order to clear the swaps that are subject to the proposed clearing requirement. How many market participants may have to establish new relationships with FCMs, or significantly upgrade those relationships? What updates to legal documentation are necessary, if any, for entities that already have an existing FCM relationship? If commenting on this subject, please clarify whether the comment relates to market participants that currently transact in: (1) Unclarified

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173 For example, the Pew Economic Policy Group estimates total costs of the acute stage of the crisis for U.S. interests were approximately $12.04 trillion, including lost GDP, wages, real estate wealth, equity wealth, and fiscal costs. Their estimates include $7.4 trillion in losses in the equity markets between June 2008 and March 2009, but do not include subsequent gains in equity markets that restored markets to their mid-2008 levels by the end of 2009. In addition, their calculations do not include continued declines in real estate markets subsequent to March 2009. See Pew Economic Policy Group, “The Cost of the Financial Crisis: The Impact of the September 2008 Economic Collapse,” March 2010. The IMF estimated that the cost to the banking sector of the financial crisis through 2010 was approximately $2.2 trillion, or a range of estimates for total cost to the taxpayer of GSE bailouts that ranged from $160 billion (Office of Management and Budget, February 2010) to $500 billion (Barclays Capital, December 2009). See IMF, “Global Financial Stability Report: Responding to the Financial Crisis and Measuring Systemic Risks,” October 2010. Both studies acknowledge that the estimates are subject to uncertainties.

swaps without margin agreements; (2) uncleared swaps with margin agreements; (3) cleared swaps; and/or (4) futures. If possible, please quantify costs and the specific platforms being implemented, or changes being made to existing platforms.

b. Ongoing Costs Related to FCMs and Other Service Providers

In addition to costs associated with technological and legal infrastructure, market participants transacting in swaps subject to the proposed clearing requirement will bear ongoing costs associated with fees charged by FCMs. Regarding fees, DCOs typically charge FCMs an initial transaction fee for each of the FCM’s customers’ IRS that are cleared, as well as an annual maintenance fee for each of their customers’ open positions. Not including customer-specific and volume discounts, the transaction fees for IRS at the CME range from $1 to $24 per million notional amount for IRS and the maintenance fees range from $5 to $20 per swap per month, depending on the number of outstanding swap positions that an entity has with the clearinghouse. For CDS, ICE Clear Credit charges an initial transaction fee of $6 per million notional amount. There is no maintenance fee charged by ICE for maintaining open CDS positions. FCMs will also bear additional fees with respect to their house accounts at the DCO to the extent that they clear more swaps due to the clearing requirement. For example, for IRS that they clear through CMÉ, clearing members are charged a transaction fee that ranges from $0.75 to $18.00 per million notional, depending on the transaction maturity. Members, however, are not charged annual maintenance fees for their open house positions. For CDS, clearing members at ICE Clear Credit are charged $5 per transaction per million notional and there is no maintenance fee.

As discussed above, it is difficult to predict precisely how the proposed requirement to clear the classes of swaps covered by this proposed rule will increase the use of swap clearing, as compared to the use of clearing that would occur in the absence of the requirement. However, the Commission expects that application of the clearing requirement to the swaps covered by the proposed rule will generally increase the use of clearing, leading to the ongoing transaction costs noted above. In addition, the Commission understands that FCM customers that only transact in swaps occasionally are typically required to pay a monthly or annual fee to each FCM that ranges from $75,000 to $125,000 per year. Again, although it is impossible to predict precisely how many FCM customers would be subject to such fees based on the proposed clearing requirement for CDS and IRS, the Commission expects that some market participants that previously did not use clearing would be subject to the requirements of the proposed rule.

The Commission requests comment on whether the cited fee information is accurate and typical, as well as, the extent to which such fees are expected to result from the requirement to clear the classes of swaps subject to the proposed rule. Comment is also requested on whether the increased use of clearing that may result is expected to change such fees, and if so, how. The Commission also requests additional comment, data, and analysis regarding the fee structures of FCMs in general, and in particular as they relate to the clearing of the types of swaps covered by the proposed rule. Specifically, the Commission requests comment on the following:

- Do the fees described above typically include fees charged by the DCO to the FCM for the FCM customer’s swap positions?
- Do FCMs typically charge a similar fee to customers that are more active in trading swaps, and are such fees are generally greater, lesser, or similar to the fees charged to less active institutions?
- Do such maintenance fees exist for larger customers, and if so, approximately how much charged?

The Commission also expects that application of the clearing requirement to the swaps covered by the proposed rule will be required to post collateral at the DCO. Of course, the incremental cost of collateral resulting from the application of the proposed clearing requirement depends on the extent to which such swaps are already being cleared (even in the absence of the requirement) or otherwise collateralized. The incremental cost also depends on whether such swaps are, if not collateralized, priced to include implicit contingent liabilities and counterparty risk born by the counterparty to the swap.

A conservative approach would be to assume that the swaps that would be covered by the proposed clearing requirement currently are uncleared, completely uncollateralized, and not priced to include implicit contingent liabilities and counterparty risk born by the counterparty. In this case, imposition of the clearing requirement for those types of swaps would create additional costs due to: (1) The spread between cost of capital and returns on that capital for assets posted to meet initial margin for the entire term of the swap; and (2) the spread between cost of capital and returns on that capital for assets posted to meet the variation margin to the extent a party is “out of the money” on each swap. Under the assumptions mentioned above, if every IRS and CDS that is not currently cleared were moved into clearing, the maximum additional initial margin that would need to be posted is approximately $19.2 billion for IRS and $53 billion for CDS. However, for the reasons described below, these numbers likely overestimate the amount of additional initial margin that would need to be posted.

The Commission calculated its estimated additional initial margin amounts based on the following assumptions. According to representations made to the Commission by LCH, they clear approximately 51% of the IRS market. The total amount of initial margin on deposit at LCH for IRS is approximately $20 billion. Therefore, if all remaining IRS were moved into


176 See LCH pricing for clearing services related to OTC IRS at: http://www.lchclearnet.com/swaps/swapclear_for_cleared_members/fees.asp.

177 See ICE Clear Credit fees for CDS at: https://www.theice.com/publicdocs/clear_credit/circulars/ICEClearCredit%20Fee%20Schedule%20Notice_FINAL.pdf.

178 See CME Pricing Charts.

179 See id.

180 See LCH pricing for clearing services related to OTC IRS at: http://www.lchclearnet.com/swaps/swapclear_for_cleared_members/fees.asp.

181 See CME clearing letters from Chatham and Webster Bank.

182 There also is a possibility that the numbers calculated above underestimate the amount of additional initial margin that will need to be posted under a required clearing regime for IRS and CDS. For instance, there may be numerous market participants with directional portfolios that will be unable to benefit from margin offsets. However, the Commission continues to believe that its estimates are more likely to overstate the required additional margin.

183 The total amount of initial margin on deposit at CME for IRS is $5 billion, but for purposes of this estimate, the Commission is not including that amount.
cleared, approximately $19.2 billion ($20B/0.51 $20B = 19.2B) would have to be posted in initial margin.

Similarly, the initial margin related to CDS currently on deposit at CME, ICE Clear Credit, and ICE Clear Europe is approximately $21.4 billion. This amount includes initial margin based on both index-based CDS and single-name CDS positions. BIS data indicates that approximately 36.6% of the CDS market comprises index-based CDS. If we assume that approximately 36.6% of the overall portfolio-based CDS margin (i.e., CDS indices and single-name CDS margined together) currently held by DCOs for CDS positions is related to index-based CDS, and then add any margin held by DCOs attributable solely to index-based CDS, we can estimate that approximately $9.0 billion in margin currently held by those DCOs is related to index-based CDS. ISDA data indicates that 14.5% of the index-based CDS market is currently cleared. Therefore, if the entire index-based CDS market moved into clearing, $53 billion ($9.0 / 0.145 $9.0/$53) in initial margin would have to be posted at DCOs.

Again, it is highly probable that these estimates significantly overstate the amount of additional capital that would have to be posted for a number of reasons described below.

First, this analysis assumes that every IRS and index-based CDS not currently cleared is brought into clearing under the proposed rule. However, in this rule the Commission has proposed required clearing only for certain classes of IRS and CDS, and not for all IRS and CDS. Therefore, there will still be certain types of IRS, such as those related to the thirteen additional currencies cleared by LCH, that are not required to be cleared. Moreover, the clearing requirement will apply only to new swap transactions whereas market estimates include legacy transactions.

In addition, non-financial entities entering into swaps for the purpose of hedging or mitigating commercial risk are not required to use clearing under section 2(h)(7) of the CEA. As a consequence, many entities will not be required to clear, even when entering into IRS or CDS that are otherwise required to be cleared. Third, some IRS and CDS involve cross-border transactions to which the Commission’s clearing requirement will not apply.

Fourth, collateral is already posted with respect to many non-clearing IRS and CDS. ISDA conducted a recent survey which reported that 93.4% of all trades involving credit derivatives, and 78.1% of all trades involving fixed income derivatives are subject to collateral agreements. Moreover, ISDA estimated that the aggregate amount of collateral in circulation in the non-cleared OTC derivatives market at the end of 2011 was approximately $3.6 trillion.

In any case, it is reasonable to assume that the requirement to clear the swaps for the swaps that are currently cleared and those that are not. While the Commission recognizes that these factors are not likely to be identical among both groups of products, adequate information to quantify the impact of each of these possible differences between the two groups of swaps on the amount of additional collateral that would have to be posted is not available. However, the Commission also requests comment from the public regarding the accuracy of ISDA and BIS estimates for index-based CDS markets, and requests from the public any additional data for purposes of determining with greater certainty how much of the index-based CDS market is currently being cleared.

Both estimates assume that additional IRS brought into clearing would have similar margin requirements per unit of notional to those IRS that are already in clearing, and assumes that additional CDS brought into clearing would have similar margin requirements per unit of notional to those CDS that are already being cleared. These assumptions, in turn, imply similar levels of liquidity, compression, netting, and similar tenors covered by the proposed rule will result in increased use of clearing and increased posting of collateral with respect to such swaps. To calculate the additional collateral cost to market participants, we must estimate the difference between the cost of capital for the additional collateral and the returns on that capital. In comments regarding other Commission rules, commenters have often taken the view that the difference between the cost and returns on capital for funds that are used as collateral is substantial.

In a study commissioned by the Working Group of Commercial Energy Firms, for example, NERA used an estimate of 13.08% for the pre-tax weighted average cost of capital for the firm, and an estimate of 3.49% for the pre-tax yield on collateral, for a difference as 9.59% which NERA used as the net pre-tax cost of collateral. However, these estimates use the borrowing costs for the entire firm, but only consider the returns on capital for one part of the firm, when determining the spread between the two. The result is an over-stated difference, and therefore a higher cost associated with collateral than would result if the costs of capital and returns of capital were compared on a consistent basis.

However, the Commission notes that this cost is not only likely overstated, for the reasons mentioned above, but that it also may not be a new cost. Rather, it is a displacement of a cost that is embedded in uncleared, uncollateralized swaps. Entering into a swap is costly for any market participant because of the default risk posed by its counterparty, whether the counterparty is a DCO, swap dealer, or other market participant. When a market participant faces the DCO, the DCO accounts for that counterparty risk by requiring collateral to be posted, and the cost of capital for the collateral is part of the cost that is necessary in order to maintain the swap position. When a market participant faces a dealer or other counterparty in an uncleared swap, however, the uncleared swap contains an implicit line of credit upon which the market participant effectively draws when its swap position is out of

184 The total amount of initial margin on deposit only includes those amounts reported to the Commission by registered DCOs. Other clearinghouses such as LCH.Clearnet SA, clear the indices included in the proposed determination, however, the relative size of the open interest in the relevant CDS indices is substantially smaller than each of the DCOs included in this calculation.

185 BIS estimates that the gross notional value of outstanding CDS contracts is $28.6 trillion, and that $10.5 trillion of that is index related CDS. See BIS data, available at http://www.bis.org/statistics/otcder/dt21.pdf.

186 ISDA has estimated that 14.5% of the index-based CDS market is currently being cleared, whereas the total outstanding notional at CME, ICE Clear Europe, and ICE Clear Credit represents approximately 7.5% of the global index-based CDS market estimated by BIS. Such a discrepancy would be expected if one or more of the following occurred: (1) If ISDA overestimated the percentage of the index-based CDS that is currently being cleared; (2) if BIS overestimated the size of the global index-based swap market; (3) if a significant amount of compression occurs as index-based CDS are moved into clearing; and/or (4) if a significant portion of the cleared index-based CDS market is held at clearinghouses other than CME, ICE Clear Europe, and ICE Clear Credit. The Commission believes that the compression of CDS positions moving into clearing is the most likely explanation, and has used the ISDA estimate. However, the Commission also requests comment from the public regarding the accuracy of ISDA and BIS estimates regarding index-based CDS markets, and requests from the public any additional data for purposes of determining with greater certainty how much of the index-based CDS market is currently being cleared.


188 See ISDA Margin Survey 2012, at 15, available at: http://www2.isda.org//functional-areas/research/surveys/margin-surveys/. Although it is unclear exactly how many of the derivatives covered by this survey are swaps, it is reasonable to assume that a large part of them are.

189 This estimate, however, does not adjust for double counting of collateral assets. The same survey reports that as much as 91.1% of cash used as collateral and 43.8% of securities used as collateral are being reused, and therefore are counted two or more times in the ISDA survey. See ISDA Margin Survey 2012, at 20 and 11, respectively.

190 This estimate, however, does not adjust for double counting of collateral assets. The same survey reports that as much as 91.1% of cash used as collateral and 43.8% of securities used as collateral are being reused, and therefore are counted two or more times in the ISDA survey. See ISDA Margin Survey 2012, at 20 and 11, respectively.

191 The NERA study is available at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=50037 and their comments defending their cost of capital methodology are available in their letter at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=57015.

192 This aspect of the NERA study has been described in greater detail by MIT professors John Parsons and Antonio Mello, available at: http://bettingthebusiness.com/2012/01/22/phantom-costs-to-the-swap-dealer-designation-and-otc-reform/ and http://bettingthebusiness.com/2012/03/19/nera-doubles-down/.
the money. Counterparties charge for this implicit line of credit in the spread they offer on uncleared, uncollateralized swaps. It can be shown that the cash flows of an uncleared and uncollateralized swap are, over time, substantially equivalent to the cash flows of a collateralized swap with an explicit line of credit. And because the counterparty risk created by the implicit line of credit is the same as the counterparty risk that would result from an explicit line of credit provided to the same market participant, to a first order approximation, the charge for each should be the same as well. This means that the cost of capital for additional collateral posted as a consequence of requiring uncollateralized swaps to be cleared does not introduce an additional cost, but rather takes a cost that is implicit in an uncleared, uncollateralized swap and makes it explicit. This observation applies to capital costs associated with both initial margin and variation margin.

The Commission invites further comment regarding the total amount of additional collateral that would be posted due to required clearing of the classes of swaps designated in this proposal. Furthermore, the Commission invites comment regarding the cost of capital and returns on capital for that collateral, as well as on the cost of the implicit line of credit embedded in uncleared, uncollateralized swaps. The Commission, in particular, welcomes any quantifiable data and analysis that commenters are willing to share regarding these subjects.

Another impact of the proposed rule may be that financial institutions are required to hold additional capital with respect to their swap positions pursuant to prudential regulatory capital requirements. Basel III standards are designed to incentivize central clearing of derivatives by applying a lower capital weighting to them than for similar uncleared derivatives positions.

Therefore, the Commission expects that the capital that financial institutions are required to hold is likely to be reduced as a consequence of their increased use of swap clearing. The Commission invites comment on the effects of required clearing on the capital requirements for financial institutions. To the extent possible, please quantify the relevant costs and benefits and explain the effect of the relevant capital standards.

In addition, operational costs may result from the collateral requirements that apply to the proposed clearing requirement. With uncleared swaps, counterparties may agree not to collect variation margin until certain thresholds of exposure are reached, thus reducing or perhaps entirely eliminating the need to exchange variation margin as exposure changes. DCOs, on the other hand, collect and pay variation margin on a daily basis and sometimes more frequently. As a consequence, increased required clearing may increase certain operational costs associated with moving to required clearing from the DCO. On the other hand, increased clearing is also likely to lead to benefits from reduced operational costs related to valuation disputes, as parties to cleared swaps agree to abide by the DCO’s valuation procedures. To the extent that the requirement to clear the types of swaps covered by the proposed rule leads to increased use of clearing, these costs and benefits are likely to result. The Commission invites further comment regarding the costs and benefits associated with operational differences related to the collateralization of uncleared versus cleared swaps.

Increases in clearing as a result of the proposed clearing requirement also may result in additional costs for clearing members in the form of guaranty fund contributions. However, it also may be that increased clearing of swaps would decrease guaranty fund contributions for certain clearing members. Market participants that currently transact swaps bilaterally and do not clear such swaps must either become members of an appropriate DCO or submit such swaps for clearing through an existing clearing member, once the clearing requirement applies to such swaps. A party that chooses to become a clearing member of a DCO must make a guaranty fund contribution. A party that chooses to clear swaps through an existing clearing member may have a share of the clearing member’s guaranty fund contribution passed along to it in the form of fees. While the addition of new clearing members and new customers for existing clearing members may result in existing clearing members experiencing an increase in their guaranty fund requirements, it should be noted that if 1) new clearing members are not among the two clearing members used to calculate the guaranty fund and 2) any new customers trading through a clearing member do not increase the size of uncollateralized risks at either of the two clearing members used to calculate the guaranty fund, all else held constant, existing clearing members may experience a decrease in their guaranty fund requirement.195

d. Benefits of Clearing

As noted above, the benefits of swap clearing, in general, are significant. Thus, to the extent that the proposed clearing requirement for certain classes of IRS and CDS leads to increased use of clearing, these benefits are likely to result. As is the case for the costs noted above, it is impossible to predict the precise extent to which the use of clearing will increase as a result of the proposed rule, and therefore the benefits of the proposed rule cannot be precisely quantified. But the Commission believes that the benefits of increased clearing resulting from the proposed rule will be significant, because the classes of swaps required to be cleared by the proposed rule represent a substantial portion of the total swap markets. Currently outstanding IRS and CDS indices have notional amounts of about $504 trillion and $10.4 trillion, respectively, which is a substantial part of the $648 trillion notional global swap markets. As noted above, the proposed rule requires that only certain classes of IRS and CDS indices be cleared, but such classes likely represent the largest common swaps within those overall asset classes, and therefore are likely to constitute a relatively large portion of those asset classes. By requiring these particular swaps to be cleared, the benefits of clearing are expected to be realized across a relatively large portion of the

195 In order to calculate the size of their guaranty funds, clearinghouses for swaps generally stress their clearing members’ portfolios under a number of extreme, but plausible, scenarios in order to identify the two clearing members with the largest losses. The resulting loss calculation of those two clearing members is used to size the guaranty fund. Once that amount is established, the clearinghouse will require contributions of all clearing members based on their relative “losses” under the stress scenarios. Assuming that the portfolios of new clearing members and new customers do not alter the overall sizing of the guaranty fund, but that the new clearing members are making contributions to the guaranty fund based on their relative potential losses, the overall guaranty fund contribution for existing clearing members may decrease.

market. The Commission requests comment on whether such benefits will result from the proposed rule and, if so, the expected magnitude of such benefits.

The proposed rule’s requirement that certain classes of swaps be cleared is expected to increase the number of swaps in which market participants will face a DCO, and therefore, will face a highly creditworthy counterparty. DCOs are some of the most creditworthy counterparties in the swap market because they have at their disposal a number of risk management tools that enable them to manage counterparty risk effectively. Those tools include contractual rights that enable them to use margin to manage current and potential future exposure, to close out and transfer defaulting positions while minimizing losses that result from such defaults, and to protect solvency during the default of one or more members through a waterfall of financial contributions from which they can draw, as outlined above. Also, clearing protects swaps from the risk of having to share in loss mutualization among FCMs if one DCO member defaults and such measures are necessary.

This proposed rule requires that classes of swaps that are required to be cleared must be submitted to clearing “as soon as technologically practicable after execution, but in any event by the end of the day of execution.” 197 This conforms to the requirements established in the recently finalized rule regarding acceptance for clearing, which is designed to promote rapid submission of these swaps for clearing and reduce the unnecessary counterparty risk that can develop between the time of execution and submission to clearing.198

The Commission expects that the requirement for rapid submission, processing, and acceptance or rejection of swaps for clearing will be beneficial in several respects. It is important to note that when two parties enter into a bilateral swap with the intention of clearing it, each party bears counterparty risk until the swap is cleared. Once the swap is cleared, the clearinghouse becomes the counterparty to each of the original parties, which minimizes and standardizes counterparty risk.

Where swaps of the type covered by the proposed rule are not executed on an exchange, the proposed rule should significantly reduce the amount of time needed to process them. Although costs associated with latency-period counterparty credit risk cannot be completely eliminated in this context, the rules will reduce the need to discriminate among potential counterparties in off-exchange swaps, as well as the potential costs associated with rejected swaps. By reducing the counterparty risk that could otherwise develop during the latency period, these rules promote a market in which all eligible market participants have access to counterparties willing to trade on terms that approximate the best available terms in the market. This may improve price discovery and promote market integrity.

In addition, absent proposed § 50.10 and related interpretations, certain risks could increase in a manner that the Commission would not be able to measure accurately. Proposed § 50.10 and related interpretations are expected to bring the appropriate scope of swaps within the requirements of section 2(h), which will facilitate the achievement of the benefits of swap clearing and trade execution, among others. Activity conducted solely for a legitimate business purpose, absent other indicia of evasion or abuse, would not constitute a violation of proposed § 50.10 as described in the Commission’s proposed interpretation.

D. Costs and Benefits of the Proposed Rule as Compared to Alternatives

The Commission’s proposal to apply the clearing requirement initially to certain CDS and IRS is a function of both the market importance of these products and the fact that they already are widely cleared. In order to move the largest number of swaps to required clearing in its initial determination, the Commission believes that it is prudent to focus on swaps that are widely used and for which there is already a blueprint for clearing and appropriate risk management. CDS and IRS that match these factors are therefore well suited for required clearing.

As noted above, IRS with a notional amount of $504 trillion are currently outstanding.201 While CDS indices do not have as prominent a share of the entire swaps market as IRS, uncleared CDS is capable of having a sizeable market impact, as it did during the 2008 financial crisis. In addition, many of the swaps within each of the classes proposed for required clearing are already cleared by one or more clearinghouses. LCH claims to clear IRS with a notional amount of about $284 trillion—meaning that, in notional terms, LCH clears 51% of the interest rate swap market.202 The swap market has made a smooth transition into clearing CDS on its own initiative. As a result, DCOs, FCMs, and many market participants already have experience clearing the types of swaps that have been proposed for required clearing. The Commission expects, therefore, that DCOs and FCMs are equipped to handle the increases in volume and outstanding notional amount in these swaps that is likely to be cleared as the result of the proposed rule. Because of the wide use of these swaps and their importance to the market, and because these swaps are already cleared safely, the Commission is proposing to subject certain types of IRS and CDS to the initial clearing requirement.

The Commission is proposing certain key specifications for CDS and IRS that will inform whether a particular swaps falls within one of the classes of swaps that are required to be cleared. The two classes of CDS that are required to be cleared are (1) U.S. dollar-denominated CDS covering North American corporate credits and (2) euro-denominated CDS referencing European obligations. The four classes of IRS required to be cleared are (1) fixed-to-floating swaps, (2) basis swaps, (3) OIS, and (4) FRAs.

Regarding CDS, the Commission has outlined three key specifications comprising (1) region and nature of reference entity, (2) the nature of the CDS itself, and (3) tenor. Each of these specifications will assist market participants in determining whether a swap falls within the CDS classes of swaps required to be cleared. For the first, a distinguishing characteristic is whether the reference entity is in North American or European and whether it is one of Markit’s CDX.NA.IG, CDX.NA.HY, iTraxx Europe, iTraxx Europe Crossover and iTraxx Europe High Volatility indices. The second key specification relates to whether the CDS is tranched or untranced. The classes that are required to be cleared include only untranced CDS where the contract covers the entire index loss

197 See proposed § 50.2(a).
199 The Commission notes that if a market participant executed a swap that is required to be cleared on a SEP or DCM, then that market participant will be deemed to have met their obligation to submit the swap to a DCO because of the straight-through processing rules previously adopted by the Commission.
201 See id.
202 See id.
distribution of the index and settlement is not linked to a specified number of defaults. Tranched swaps, first- or "Nth" to-default, options, or any other product variations on these indices are excluded from these classes. Finally, the third key specification entails whether a swap falls within a tenor, specific to an index, that is required to be cleared. The Commission has determined that each of the 3-, 5-, 7-, and 10-year tenors be included within the class of swaps subject to the clearing requirement determination for CDX.NA.IG; the 5-year tenor be included for CDX.NA.HY; each of the 5- and 10-year for iTraxx Europe; the 5-year for iTraxx Europe Crossover; and, the 5-year for iTraxx Europe High Volatility. In addition, it should be noted that only certain series will be viewed as required to be cleared.

The Commission had a number of alternatives to that proposed. First, the Commission could have used a narrower or broader group of reference entities. For example, the Commission has not included the CDX.NA.IG.HVOL within the North American swap class. While doing so would have increased the number of swaps required to be cleared, the Commission questions whether there is sufficient liquidity to justify required clearing at this time given that the recent series of CDX.NA.IG.HVOL have not been cleared by ICE (and are not offered at all by CME).

The Commission could also have endeavored to include tranched CDS. The Commission recognizes that there is a signal for tranching within the indices. In these transactions, parties to the CDS contract agree to address only a certain range of losses along the entire loss distribution curve. Other swaps such as first or “Nth” to default baskets, and options, also exist on the indices. However, these swaps are not being cleared currently and were not submitted by a DCO for consideration under § 39.5.

Regarding tenor, the Commission could have included more of those offered within the classes of swaps required to be cleared. For example, the CDX.NA.IG has 1- and 2-year tenors and the CDX.NA.HY, has 3-, 7-, and 10-year tenors that have not been included among the specified tenors. The iTraxx Europe has 3- and 7-year tenors and the Crossover and High Volatility each have 3-, 7-, and 10-year tenors that have not been included. In addition, the Commission could have included all series of active indices. The concern, regarding both tenors and series, is that certain series have lower liquidity and may be difficult for a DCO to adequately risk manage. While including more tenors and series would have increased the volume of swaps required to be cleared to some degree, the Commission proposes that doing so may have raised costs for DCOs and other market participants and been less desirable relative to the factors established in § 39.5.

With regard to IRS, as mentioned above, the Commission is proposing a clearing requirement for four classes of interest rate swaps: fixed-to-floating swaps, basis swaps, OIS, and FRAs. Within those four classes, the Commission is proposing three affirmative specifications for each class: (i) Currency used for in which the notional and payment amounts are specified, (ii) rates referenced for each leg of the swap, and (iii) stated termination date of the swap and three “negative” specifications for each class: (i) No optionality (as specified by the DCOs); (ii) no dual currencies; and (iii) no conditional notional amounts.

The Commission considered whether to establish affirmative requirements on a product-by-product basis. Such a determination would need to identify the multitude of legal specifications of each product that would be subject to the clearing requirement. Although the industry uses standardized definitions and conventions, the product descriptions would be lengthy and require counterparties to compare all of the legal terms of their particular swap against the terms of the many different swaps that would be included in a clearing requirement. The Commission believes that for interest rate swaps, a product-by-product determination could be unnecessarily burdensome for market participants in trying to assess whether each swap transaction is subject to the requirement. A class-based approach would allow market participants to determine quickly whether they need to submit their swap to a DCO for clearing by checking initially whether the swap has the basic specifications that define each class subject to the clearing requirement. As an alternative to the classes selected, LCH recommended that the Commission use the following specifications to classify interest rate swaps for purposes of making a clearing determination: (i) Swap class (i.e., what the two legs of the swap are (fixed-to-floating, basis, OIS, etc.), (ii) floating rate definitions used, (iii) the currency designated for swap calculations and payments, (iv) stated final term of the swap (also known as maturity), (v) notional structure over the life of the swap (e.g., amortizing, roller coaster, etc.), (vi) floating rate frequency, (vii) whether optionality is included, and (viii) whether a single currency or more than one currency is used for denominating payments and notional amount. CME recommended a clearing determination for all non-option interest rate swaps denominated in a currency cleared by any qualified DCO.

These alternative specifications fall into two general categories: specifications that are commonly used to address mechanical issues for most swaps, and specifications that are less common and address idiosyncratic issues related to the particular needs of a counterparty. Examples of the latter are special representations added to address particular legal issues, unique termination events, special fees, and conditions tied to events specific to the parties. None of the DCOs clear interest rate swaps with terms in the second group. As for mechanical specifications, while the Commission recognizes that such specifications may affect the value of the swap, such specifications are not, generally speaking, fundamental to determining the economic result the parties are trying to achieve.

The Commission has proposed the three affirmative specifications described above because it believes that they are fundamental specifications used by counterparties to determine the economic result of a swap transaction for each party. The Commission also could have avoided the negative specifications for IRS, which would have had the effect of potentially including more IRS swaps within the universe of those required to be cleared. However, the Commission believes that swaps with optionality, multiple currency swaps, and swaps with conditional notional amounts raise concerns regarding adequate pricing measures and consistency across swap contracts. Such contingencies make them difficult for DCOs to effectively risk manage. Additionally, at this time, no DCO is offering them for clearing. Another alternative considered by the Commission, but not proposed, was that of stating the clearing requirement in terms of a particular type of swap, rather than using broad characteristics to describe the type of swaps for which clearing would be required. For example, rather than requiring that all IRS that meet the six specifications in proposed § 50.4(a) be cleared, the rule could have specified that only certain

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203 As noted in Section I.E above, mechanical specifications include characteristics such as floating rate reset tenors, reference city for business days, business day convention, and others that have some small impact on valuation but that do not fundamentally alter the economic consequence of the swap for the parties that enter into it.
sub-types of those IRS—such as all such IRS with a term of five years—are required to be cleared. Such an approach might permit the Commission to account for variation in liquidity and outstanding notional values among different sub-types of swap, and thereby focus the clearing requirement on very particular swaps to account for these differences within the same general class. Also, generally speaking, limiting the clearing requirement to fewer swaps could reduce some costs associated with clearing.

However, this advantage was weighed against an important disadvantage of this approach. A highly focused clearing requirement could increase the ability for market participants to replicate the economic results of a swap that is required to be cleared by substituting a swap not required to be cleared; this greater latitude for clearing avoidance, in turn, could increase systemic risk and dampen the beneficial effects of clearing noted above. Under the approach proposed by the Commission, all swaps that fall within identified classes are covered by the clearing requirement, which reduces the risk of such avoidance and the associated reduction of benefits. Moreover, stating the clearing requirement in more general terms reduces the costs associated with determining whether or not a particular swap is subject to the clearing requirement.

The Commission invites comment on the costs and benefits of identifying classes of swaps for clearing in a more focused or more general manner. If possible, please quantify costs and benefits that result either from the approach proposed by the Commission or from alternatives that you believe the Commission should consider.

The Commission also considered proposing required clearing for all seventeen currencies of IRS that are currently offered for clearing, but decided instead to propose required clearing at this time for IRS in four currencies (EUR, USD, GBP, and JPY). The Commission recognizes that requiring IRS in all seventeen currencies submitted by LCH Clearnet to be cleared would provide the benefit of some incremental reduction in overall counterparty, and thus systemic, risk attendant to clearing a greater portion of IRS. However, as noted above, the Commission proposes that initiating the clearing requirement in a measured manner with respect to IRS in the four specified currencies familiar to many market participants is the preferable approach at this time because it would give market participants an opportunity to identify and address any operational challenges related to required clearing. Moreover, the currencies included in the proposed classes constitute approximately 93% of cleared IRS, which suggests that significant reductions in counterparty risk and gains in systemic protection will be accomplished by limiting the clearing determination to them.

Similarly, the Commission considered requiring clearing of all CDS that are currently being cleared, but decided not to include, in the initial clearing requirement, certain types of CDS that have a less significant role in the current market. The Commission invites further comment on its decision-making with regard to the classes of IRS and CDS that would be required to be cleared.

Commenters are also invited to submit any data or other information that they may have quantifying or qualifying the costs and benefits of the proposal with their comment letters.

E. Section 15(a) Factors

As noted above, the requirement to clear the classes of swaps covered by the proposed rule is expected to result in increased use of clearing, although it is impossible to quantify with certainty the extent of that increase. Thus, this section discusses the expected results from an overall increase in the use of swap clearing in terms of the factors set forth in section 15(a) of the CEA.

i. Protection of Market Participants and the Public

As described above, required clearing of the classes of swaps identified in this proposed rule is expected to reduce counterparty risk for market participants that clear those swaps because they will face the DCO rather than another market participant that lacks the full array of risk management tools that the DCO has at its disposal. This also reduces uncertainty in times of market stress because market participants facing a DCO are less concerned with the impact of such stress on the solvency of their counterparty for cleared trades.

By proposing to require clearing of certain classes of swaps, all of which are already available for clearing, the Commission expects to encourage a smooth transition by creating an opportunity for market participants to work out challenges related to required clearing of swaps while operating in familiar terrain. More specifically, the DCOs will clear an increased volume of swaps that they already understand and have experience managing. Similarly, FCMs likely will realize increased customer and transaction volume as the result of the requirement, but will not have to simultaneously learn how to operationalize clearing for new types of swaps. And the experience of FCMs with these products is also likely to benefit customers that are new to clearing, as the FCM guides them through initial experiences with cleared swaps.

In addition, uncleared swaps subject to collateral agreements can be the subject of valuation disputes. These valuation disputes sometimes require several months, or longer, to resolve. Uncollateralized exposure can grow significantly during that time, leaving one of the two parties exposed to counterparty risk that was intended to be covered through a collateral agreement. DCOs reduce valuation disputes for cleared swaps as well as the risk that uncollateralized exposure can develop and accumulate during the time when such a dispute would have otherwise occurred, thus providing additional protection to market participants who transact in swaps that are required to be cleared.

As far as costs are concerned, market participants that do not currently have established clearing relationships with an FCM will have to set up and maintain such a relationship in order to clear swaps that are required to be cleared. As discussed above, market participants that conduct a limited number of swaps per year will likely be required to pay monthly or annual fees that FCM’s charge to maintain both the relationship and outstanding swap positions belonging to the customer. In addition, the FCM is likely to pass along fees charged by the DCO for establishing and maintaining open positions.

205 For instance, the Commission decided not to include CDX.NA.IG.HiVOL from the proposed determination given the lack of volume in the current on-the-run and recent off-the-run series. In addition, CME currently does not clear any HiVOL contracts, and ICE Clear Credit no longer clears the most recent series.

206 As discussed in Section II.C and II.E above, DCOs offering clearing for CDS and IRS have established extensive risk management practices, which focus on the protection of market participants. See also Sections II.D and II.F for a discussion of the effect on the mitigation of systemic risk in the CDS market and in the IRS market, as well as the protection of market participants during insolvency events at either the clearing member or DCO level.

207 See Sections II.D and II.F above for a further discussion of how DCOs obtain adequate pricing data for the CDS and IRS that they clear. Based on this pricing data, valuation disputes are minimized, if not eliminated for cleared swaps.
ii. Efficiency, Competitiveness, and Financial Integrity of Swap Markets

Swap clearing, in general, is expected to reduce uncertainty regarding counterparty risk in times of market stress and promote liquidity and efficiency during those times. Increased liquidity promotes the ability of market participants to limit losses by exiting positions effectively when necessary in order to manage risk during a time of market stress.

In addition, to the extent that positions move from facing multiple counterparties in the bilateral market to being run through a smaller number of clearinghouses, clearing facilitates increased netting. This reduces the amount of collateral that a party must post in margin accounts.

As discussed in Sections II.D and II.F above, in setting forth this proposal, the Commission took into account a number of specific factors that relate to the financial integrity of the swap markets. Specifically, the discussion above includes an assessment of whether the DCOs clearing CDS and IRS have the rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear CDS and IRS on terms that are consistent with the material terms and trading conventions on which the contract is then traded. The proposal also considered the resources of DCOs to handle additional clearing, as well as the existence of reasonable legal certainty in the event of a clearing member or DCO insolvency.

As discussed above, bilateral swaps create counterparty risk that may lead market participants to discriminate among potential counterparties based on their creditworthiness. Such discrimination is expensive and time consuming insofar as market participants must conduct due diligence in order to evaluate a potential counterparty’s creditworthiness.

Requiring certain types of swaps to be cleared reduces the number of transactions for which such due diligence is necessary, thereby contributing to the efficiency of the swap markets.

In proposing a clearing requirement for both CDS and IRS, the Commission must consider the effect on competition, including appropriate fees and charges applied to clearing. As discussed in more detail in Sections II.D and II.F above, there are a number of potential outcomes that may result from required clearing. Some of these outcomes may impose costs, such as if a DCO possessed market power and exercised that power in an anticompetitive manner, and some of the outcomes would be positive, such as if the clearing requirement facilitated a stronger entry-opportunity for competitors.

As far as costs are concerned, the markets for some swaps within the classes that are proposed to be required to be cleared may be less liquid than others. All other things being equal, swaps for which the markets are less liquid have the potential to develop larger current uncollateralized exposures after a default on a cleared position, and therefore will require posting of relatively greater amounts of initial margin.

iii. Price Discovery

Clearing, in general, encourages better price discovery because it eliminates the importance of counterparty creditworthiness in pricing swaps cleared through a given DCO. That is, by making the counterparty creditworthiness of all swaps of a certain type essentially the same, prices should reflect factors related to the terms of the swap, rather than the idiosyncratic risk posed by the entities trading it.

As discussed in sections II.D and II.F above, DCOs obtain adequate pricing data for the CDS and IRS that they clear. Each DCO establishes a rule framework for its pricing methodology and rigorously tests its pricing models to ensure that the cornerstone of its risk management regime is as sound as possible.

iv. Sound Risk Management Practices

If a firm enters into swaps to hedge certain positions and then the counterparty to those swaps defaults unexpectedly, the firm could be left with large outstanding exposures. As stated above, when a swap is cleared the DCO becomes the counterparty facing each of the two original participants in the swap. This standardizes and reduces counterparty risk for each of the two original participants. To the extent that a market participant’s hedges comprise swaps that are required to be cleared, the requirement enhances their risk management practices by reducing their counterparty risk.

In addition, from systemic perspective, required clearing reduces the complexity of unwinding/transfering swap positions from large entities that default. Procedures for transfer of swap positions and mutualization of losses among DCO members are already in place, and the Commission anticipates that they are much more likely to function in a manner that enables rapid transfer of defaulted positions than legal processes that would surround the enforcement of bilateral contracts for uncleared swaps.

v. Other Public Interest Considerations

In September 2009, the President and the other leaders of the “G20” nations met in Pittsburgh and committed to a program of action that includes, among other things, central clearing of all standardized swaps. Together, IRS and CDS represent more than 75% of the notional amount of outstanding swaps, and therefore, requiring the most active, standardized classes of swaps within those groups to be cleared represents a significant step toward the fulfillment of that commitment.

VI. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) requires that agencies consider whether the rules they propose will have a significant economic impact on a substantial number of small entities and, if so, provide a regulatory flexibility analysis respecting the impact. The clearing requirement determinations and rules proposed by the Commission will affect only eligible contract participants (ECPs) because all persons that are not ECPs are required to execute their swaps on a DCM, and all contracts executed on a DCM must be cleared by a DCO, as required by statute and regulation; not by operation of any clearing requirement.

As discussed in Sections II.C and II.E above, sound risk management practices are critical for all DCOs, especially those offering clearing for CDS and IRS. In the discussion above, the Commission considered whether each DCO submission under review was consistent with the core principles for DCOs. In particular, the Commission considered the DCO submissions in light of Core Principle D, which relates to risk management. See also Sections II.D and II.F for a discussion of the effect on the mitigation of systemic risk in the CDS market and in the IRS market, as well as the protection of market participants during insolvency events at either the clearing member or DCO level.

A list of the G20 commitments made in Pittsburgh can be found at: http://www.g20.utoronto.ca/analysis/commitments-09-pittsburgh.html.

214 To the extent that this rulemaking affects DCNs, DCOs, or FCMS, the Commission has previously determined that DCNs, DCOs, and FCMS are not small entities for purposes of the RFA. See, respectively and as indicated, 47 FR 18818, 18819.
The Commission has previously determined that ECPs are not small entities for purposes of the RFA.214 However, in its proposed rulemaking to establish a schedule to phase in compliance with certain provisions of the Dodd-Frank Act, including the clearing requirement under section 2(h)(1)(A) of the CEA, the Commission received a joint comment (Electric Associations Letter) from the Edison Electric Institute (EEI), the National Rural Electric Cooperative Association (NRECA) and the Electric Power Supply Association (EPSA) asserting that certain members of NRECA may both be ECPs under the CEA and small businesses under the RFA.215 These members of NRECA, as the Commission understands, have been determined to be small entities by the Small Business Administration (SBA) because they are “primarily engaged in the generation, transmission, and/or distribution of electric energy for sale and [their] total electric output for the preceding fiscal year did not exceed 4 million megawatt hours.”216 Although the Electric Associations Letter does not provide details on whether or how the NRECA members that have been determined to be small entities use the IRS and CDS that are the subject of this rulemaking, the Electric Associations Letter does state that the EEI, NRECA and EPSA members “engage in swaps to hedge commercial risk.”217 Because the NRECA members that have been determined to be small entities would be using swaps to hedge commercial risk, the Commission expects that they would be able to use the end-user exception from the clearing requirement and therefore would not be affected to any significant extent by this rulemaking.

Thus, because nearly all of the ECPs that may be subject to the proposed clearing requirement are not small entities, and because the few ECPs that have been determined by the SBA to be small entities are unlikely to be subject to the clearing requirement, the Chairman, on behalf of the CFTC,

herself certifies pursuant to 5 U.S.C. 605(b) that the rules herein will not have a significant economic impact on a substantial number of small entities. The Commission invites public comment on this determination.

B. Paperwork Reduction Act

The Paperwork Reduction Act (PRA)218 imposes certain requirements on federal agencies (including the Commission) in connection with conducting or sponsoring any collection of information as defined by the PRA. Proposed § 50.3(a), which would require each DCO to post on its Web site a list of all swaps that it will accept for clearing and clearly indicate which of those swaps the Commission has determined are required to be cleared, builds upon the requirements of § 39.21(c)(1), which requires each DCO to disclose publicly information concerning the terms and conditions of each contract, agreement, and transaction cleared and settled by the DCO. Thus, this rulemaking will not require a new collection of information from any persons or entities. The Commission invites public comment on whether this rulemaking will require a new collection of information.

List of Subjects in 17 CFR Part 50

Business and industry, Clearing, Swaps.

In consideration of the foregoing, and pursuant to the authority in the Commodity Exchange Act, as amended, and in particular section 2(h) of the Act, the Commission hereby adopts an amendment to Chapter I of Title 17 of the Code of Federal Regulation by proposing to amend part 50 as follows:

PART 50—CLEARING REQUIREMENT AND RELATED RULES

1. The authority citation for part 50 reads as follows:


2. Add new part 50 to read as follows:

PART 50—CLEARING REQUIREMENT AND RELATED RULES

Subpart A—Definitions and Clearing Requirement

Sec. § 50.1 Definitions.

50.2 Treatment of swaps subject to a clearing requirement.

50.3 Notice to the public.

50.4 Classes of swaps required to be cleared.

50.5 Swaps exempt from a clearing requirement.

218 44 U.S.C. 3507(d).

50.6 Delegation of Authority.

Subpart B—Compliance Schedule

50.25 Clearing Requirement Compliance Schedule.

Subpart C—Exceptions to Clearing Requirement

§ 50.50–100 [Reserved]

50.1 Definitions.

For the purposes of this part, Business day means any day other than a Saturday, Sunday, or (legal) holiday.

Day of execution means the calendar day of the party to the swap that ends latest, provided that if a swap is (A) entered into after 4:00 p.m. in the location of a party, or (B) entered into on a day that is not a business day in the location of a party, then such swap shall be deemed to have been entered into by that party on the immediately succeeding business day of that party, and the day of execution shall be determined with reference to such business day.

§ 50.2 Treatment of swaps subject to a clearing requirement.

(a) All persons executing a swap that (1) is not subject to an exception under section 2(b)(7) of the Act and § 39.6, and (2) is included in a class of swaps identified in § 50.4, shall submit such swap to a derivatives clearing organization for clearing as soon as technologically practicable after execution, but in any event by the end of the day of execution.

(b) Each person subject to the requirements of paragraph (a) shall undertake reasonable efforts to verify whether a swap is required to be cleared.

§ 50.3 Notice to the public.

(a) In addition to its obligations under § 39.21(c)(1), each derivatives clearing organization shall make publicly available on its Web site a list of all swaps that it will accept for clearing and identify which swaps on the list are required to be cleared under section 2(b)(1) of the Act and this part.

(b) The Commission shall maintain a current list of all swaps that are required to be cleared and all derivatives clearing organizations that are eligible to clear such swaps on its Web site.
§50.4 Classes of swaps required to be cleared.

(a) **Interest rate swaps.** Swaps that have the following specifications are required to be cleared under section 2(h)(1) of the Act, and shall be cleared pursuant to the rules of any derivatives clearing organization eligible to clear such swaps under §39.5(a) of this chapter.

<table>
<thead>
<tr>
<th>Fixed-to-Floating Swap Class</th>
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<tbody>
<tr>
<td>----------------</td>
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<tr>
<td>U.S. Dollar (USD)</td>
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<tr>
<td>Euro (EUR)</td>
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<tr>
<td>Sterling (GBP)</td>
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<td>Yen (JPY)</td>
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</table>

<table>
<thead>
<tr>
<th>Basis Swap Class</th>
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<tbody>
<tr>
<td>----------------</td>
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<tr>
<td>U.S. Dollar (USD)</td>
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<tr>
<td>Euro (EUR)</td>
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<tr>
<td>Sterling (GBP)</td>
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<tr>
<td>Yen (JPY)</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Forward Rate Agreement Class</th>
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</thead>
<tbody>
<tr>
<td>----------------</td>
</tr>
<tr>
<td>U.S. Dollar (USD)</td>
</tr>
<tr>
<td>Euro (EUR)</td>
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<tr>
<td>Sterling (GBP)</td>
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<tr>
<td>Yen (JPY)</td>
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</tbody>
</table>

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<thead>
<tr>
<th>Overnight Index Swap Class</th>
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<tbody>
<tr>
<td>----------------</td>
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<tr>
<td>U.S. Dollar (USD)</td>
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<td>Euro (EUR)</td>
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<tr>
<td>Sterling (GBP)</td>
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<tr>
<td>Yen (JPY)</td>
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</tbody>
</table>

(b) **Credit default swaps.** Swaps that have the following specifications are required to be cleared under section 2(h)(1) of the Act, and shall be cleared pursuant to the rules of any derivatives clearing organization eligible to clear such swaps under §39.5(a) of this chapter.

<table>
<thead>
<tr>
<th>North American Untranced CDS Indices Class</th>
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</thead>
<tbody>
<tr>
<td>----------------</td>
</tr>
<tr>
<td>Corporate</td>
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</tbody>
</table>
§ 50.5 Clearing Transition Rules.

(a) Swaps entered into before July 21, 2010 shall be exempt from the clearing requirement under § 50.2 if reported to a swap data repository pursuant to section 2(h)(5)(A) of the Act and § 44.02 of this chapter.

(b) Swaps entered into before the application of the clearing requirement for a particular class of swaps under § 50.2 and § 50.4 shall be exempt from the clearing requirement if reported to a swap data repository pursuant to section 2(h)(5)(B) of the Act and § 44.03 of this chapter.

§ 50.6 Delegation of Authority.

(a) The Commission hereby delegates to the Director of the Division of Clearing and Risk or such other employee or employees as the Director may designate from time to time, with the consultation of the General Counsel or such other employee or employees as the General Counsel may designate from time to time, the authority:

(1) To determine whether one or more swaps submitted by a derivatives clearing organization under § 39.5 falls within a class of swaps as described in § 50.4; and

(2) To notify all relevant derivatives clearing organizations of that determination.

(b) The Director of the Division of Clearing and Risk may submit to the Commission for its consideration any matter which has been delegated in this section. Nothing in this section prohibits the Commission, at its election, from exercising the authority delegated in this section.

§ 50.7–9 [Reserved].

§ 50.10 Prevention of Evasion of the Clearing Requirement and Abuse of an Exception or Exemption to the Clearing Requirement.

(a) It shall be unlawful for any person to knowingly or recklessly evade or participate in or facilitate an evasion of the requirements of section 2(h) of the Act or any Commission rule or regulation promulgated thereunder.

(b) It shall be unlawful for any person to abuse the exception to the clearing requirement as provided under section 2(h)(7) of the Act and § 39.6 of this chapter.

(c) It shall be unlawful for any person to abuse any exemption or exception to the requirements of section 2(h) of the Act, including any exemption or exception as the Commission may provide by rule, regulation, or order.

By the Commission.
Issued in Washington, DC, on July 24, 2012.
Sauntia S. Warfield.
Assistant Secretary of the Commission.

Appendices to Clearing Requirement Determination Under Section 2(h) of the CEA—Commission Voting Summary and Statements of Commissioners

Note: The following appendices will not appear in the Code of Federal Regulations.

Appendix 1—Commission Voting Summary
On this matter, Chairman Gensler and Commissioners Stumpf, Chilton, O’Malley and Wetjen voted in the affirmative; no Commissioner voted in the negative.

Appendix 2—Statement of Chairman Gary Gensler
I support the proposal to require certain interest rate swaps and credit default swap (CDS) indices to be cleared as provided by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).
For over a century, through good times and bad, central clearing in the futures market has lowered risk to the broader public. Dodd-Frank financial reform brings this effective model to the swaps market. One of the primary benefits of swaps market reform is that standard swaps between financial firms will move into central clearing, which will significantly lower the risks of the highly interconnected financial system.
The Dodd-Frank Act requires the Commission to determine whether a swap is required to be cleared. For purposes of this first set of determinations, the Commission has looked to swaps that are currently cleared based upon submissions from eight derivatives clearing organizations (DCOs). This first proposed clearing determination would require that swaps within identified classes be cleared by a DCO. This first determination includes interest rate swaps in four currencies, as well as five CDS indices. The proposal addresses swaps that five DCOs are already clearing, including standard interest rate swaps in U.S. dollars, euros, British pounds and Japanese yen, as well as a number of CDS indices, including North American and European corporate names. Subsequently, the Commission will consider other swaps, such as agricultural, energy and equity indices.
I believe that the Commission’s proposed determination for each class satisfies the five factors provided for by Congress in the Dodd-Frank Act, including the first factor that addresses outstanding exposures, liquidity and pricing data.
Under the proposal, a DCO would be required to post on its Web site a list of all swaps it will accept for clearing and must
indicate which swaps the Commission had determined are required to be cleared.

I look forward to receiving public input on this proposed rule.

Appendix 2—Statement of Commissioner Scott D. O’Malia

I respectfully concur with the Commodity Futures Trading Commission’s (“Commission”) proposal to establish a clearing requirement for certain classes of credit default swaps and interest rate swaps pursuant to the Commission’s authority under new section 2(h)(1)(A) of the Commodity Exchange Act (“CEA”).

Centralized clearing is a vital part of the Dodd-Frank Act reforms and is expected to reduce counterparty credit risks, improve transparency and fairness around the setting of margin requirements, increase market liquidity, and reduce overall systemic risks.

I am pleased that the Commission’s proposal thoughtfully incorporates comments received in response to my July 28, 2011 letter to the public seeking comment on the five substantive criteria that the Commission is required to consider in making mandatory clearing determinations. The comments help provide the necessary clarity and guidance that the markets have sought regarding how the Commission will consider and weigh these criteria.

Today’s proposal also (1) includes a more reasoned cost-benefit analysis that is based on an appropriate pre-Dodd-Frank baseline, (2) discusses a variety of alternatives based on public comments, and (3) asks a series of questions in the absence of available data. Once again, I am encouraged that Commission staff is working with technical experts from the Office of Management and Budget (“OMB”) to improve our cost-benefit analyses. It is my hope that the Commission’s final rule similarly benefits from our cooperative relationship with OMB.

Once this proposal is published in the Federal Register, the 90-day clock will start. The Commission will review all comments, and discuss its final determination for clearing the majority of swaps in due course. I implore commenters to provide feedback and to submit data as soon as possible so that the Commission can account for the actual impact that today’s rule will have on market liquidity, margining, and the reduction of risks.

[PR Doc. 2012–18382 Filed 8–6–12; 8:45 am]

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