ISDA Safe, Efficient Markets

September 6, 2012

Mr. David Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: Notice of Proposed Rulemaking – Clearing Requirement Determination under Section 2(h) of the CEA (RIN 3038-AD86)

The International Swaps and Derivatives Association, Inc. ("**ISDA**") appreciates the opportunity to provide the Commodity Futures Trading Commission (the "**Commission**") with comments and recommendations regarding the proposed rulemaking (the "**Proposed Clearing Determinations**")[1] described above.

ISDA's mission is to foster safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products. ISDA has more than 800 members from 58 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers.

ISDA and its members are longtime proponents of swap clearing done in a manner that promotes safety and market integrity. ISDA appreciates the careful consideration the Commission is according its first mandatory clearing determination proposal, and welcomes the opportunity to contribute to this process. Specifically, we make the following substantive recommendations:

- The Commission's mandatory clearing determinations should not take effect until there has been a further determination that a product has an adequate clearing history to support a finding of operational readiness to clear.

[1] 77 Fed. Reg. 47170 (August 7, 2012).

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- The delegation of subsequent determinations under proposed Rule 50.6, to the extent the Commission declines to follow our other recommendations and decides to retain this provision, should be supplemented with certain required criteria, a public comment period and a compliance phase-in period.

- The Commission should abandon its novel "fundamental to economic result test" (developed in its explanation of its proposed clearing determinations for interest rate swaps) and ground its analysis in the five statutory factors under Section 2(h)(2)(D)(ii) of the Commodity Exchange Act ("CEA").

- Mandatory clearing of iTraxx® Indices should not take effect until certain conditions relating to regulatory approvals and an operational history of voluntary client clearing have been met.

- Various technical changes relating to swaptions and extendible swaps, ownership change events, paired trades and other matters should be made.

- The Commission should undertake a study of DCO insolvency, with a goal of documenting uncertainties and proposing solutions.

- The anti-evasion provision should be modified to clarify the scienter requirement and avoid chilling business conduct that is free of fraud, deceit or unlawful activity.

I. Clearing Determination Process Errors

A. Deficient Swap Class Specifications Upset Statutory Requirements

The Commission's proposed swap class specifications are broadly drawn and do not differentiate between swaps that derivatives clearing organizations ("**DCOs**") currently clear and those that no DCO currently accepts for clearing or for which there is not sufficient cleared volume. The proposed classes group together swaps with widely differing characteristics when viewed in light of the five statutory factors of CEA section 2(h)(2)(D)(ii). Subsequent DCO submissions for swaps within these broad classes would be subject to review only under delegated authority by the Director of the Division of Clearing and Risk, in consultation with the General Counsel, and only on the question of whether they fall within the previously defined classes. The consequence of this overbreadth and the proposed process for subsequent reviews is that the Commission would effectively delegate the clearing determination for DCO product expansions (for which the proposed classes provide wide latitude) to the DCOs themselves, without any mechanism for review based on the statutory factors and in apparent contradiction of the statutory mandate of CEA section 2(h)(2)(B)(iii)(II) that the "Commission shall … review" each DCO submission.

B. Need for Continuing Review Process for Consistency with DCO Core Principles

Section 2(h)(2)(D)(i) of the CEA directs the Commission to review whether a DCO swap submission is consistent with DCO core principles. The Commission explains that its review

under that section is based on past examinations and surveillance of DCOs.[2] Although this may be a rational method for swaps that were cleared by a DCO and had a prior clearing history at the time of the examinations, it is difficult to see how it can be effective for swaps not yet cleared. By creating broad classes of swaps based on a narrow selection of characteristics taken from cleared swaps, many never-before-cleared swaps that share those characteristics are required to be cleared – in the absence of apt DCO history. As an illustration, Annex A lists examples of interest rate swaps within the proposed clearing-required class that are not currently accepted by any DCO for clearing.

C. Unsupervised DCO Product Expansion

The Commission proposes that new DCO product offerings, if they are identified by the DCO as falling within the clearing-required class, would not be reviewed by the Commission in light of the five statutory factors. Rather, the Commission would delegate authority pursuant to proposed Rule 50.6 to the Director of the Division of Clearing and Risk, who is directed only to confirm in consultation with the General Counsel whether the new product falls within the previously defined class of clearing-required interest rate swaps.[3] This process is not designed to identify the material differences (in terms of the five statutory factors, cost-benefit considerations or effects on DCO and FCM operations and risk management) that may exist among the different types of swaps, for example, within the proposed class of clearing-required interest rate swaps.

D. ISDA Recommendation

For the foregoing reasons, ISDA recommends that the Commission's mandatory clearing determinations not take effect until there has been a further determination that a product has an adequate clearing history to support a finding of operational readiness to clear by DCOs and market participants. At a minimum, each product type should have been actually cleared by a DCO and exhibited non-zero open interest (for both inter-dealer and client clearing) on each day during a six month period prior to the effective date of the mandatory clearing determination. Procedurally, the Commission's clearing determinations could still be stated in terms of classes that are consonant with the five-factor analysis (rather than, for example, a listing of product codes for each unique DCO product). The limitation of the mandate to products with sufficient clearing history could be implemented by directing DCOs to distinguish, in their notices under Rule 50.3, the unique products that have met the history requirement.

E. Delegated Determinations Under Proposed Rule 50.6

In the event that the Commission declines to follow our recommendation in I.D. above, ISDA urges that the proposed form of the Rule 50.6 delegation be supplemented with (i) a requirement for a determination that new DCO product offerings are not merely within the previously defined class, but also that they do not raise materially different considerations regarding the five statutory factors or the Commission's cost-benefit analysis for its clearing determination, (ii) a public comment period and (iii) a compliance phase-in period of at least 90 days (commencing on the later of (a) the official publication date of the Director's proposed determination and (b) the first date as of which a DCO has commenced clearing the swap) to

[2] 77 Fed. Reg. 47192-3.
[3] 77 Fed. Reg. 47190.

allow time for implementing and testing changes to FCMs' and other clearing members' systems and procedures. FCMs in particular will need to ensure they are able to manage the risks of client clearing of the new products and include them in operational workflows and reports prepared for clients. Margining methodology must be made clear. The phase-in period is especially important in light of year-end systems freezes that many institutions observe in connection with preparing annual financial statements.

F. Relationship to Trade Execution Requirement

Should the Commission decline to follow our recommendation in D. above, it should be aware that its proposed broad designation of the clearing-required classes of swaps raises the possibility that many swaps could become subject to a trade execution requirement even if they are not actually accepted for clearing by a DCO. The application of trade execution requirements to products that are not accepted for clearing by a DCO is problematic because, without clearing, transaction pricing becomes dependent on individual counterparty credit quality and collateralization terms. SEF/DCM trading is ill-suited to allowing execution pricing to be calibrated to individual counterparty characteristics. Consequently, allowing a DCM or SEF to make an available to trade determination with respect to an uncleared product risks compromising swap dealers' ability to manage credit risk effectively as well as diminished liquidity and less efficient pricing. These considerations underscore the arguments presented in ISDA's comment letter dated February 13, 2012[4] that the Commission, rather than SEFs/DCMs, should make "available to trade" determinations and further argue that acceptance for clearing should be a prerequisite for an "available to trade" determination. Broad required-to-clear classes that do not incorporate an adequate set of limitations based on real transaction characteristics will open the door to "available to trade" decisions that may not be supported by market realities.

II. Interest Rate Swaps

A. The Commission's novel standard for interest rate swaps - "fundamental to economic result"

The Commission's explanation of its choice of only four clearing-determinative specifications for interest rate swaps employs a newly articulated standard that examines which elements of a swap are "fundamental to determining the economic result that parties are trying to achieve".[5] Difficulties with this standard are:

- It is not grounded in the five statutory factors of CEA section 2(h)(2)(D)(ii) and will fail to discriminate between swaps that may differ markedly in terms of the five factors, particularly factors I - liquidity and adequate pricing data, II - capacity and infrastructure to clear the contract on terms that are consistent with the material terms on which the contract is currently traded and III – effect on the mitigation of systemic risk, taking into account the size of the market for a contract and the resources of the DCO available to clear the contract.

[4] Available at www2.isda.org/dodd-frank
[5] 77 Fed. Reg. 47191.

- Even on its own terms, the standard is not workable because what is fundamental to the economic result depends on facts and circumstances of each transaction and the parties.

The Commission should abandon this standard and instead return to the statute and base its designation of the clearing-required class on an analysis of the five statutory factors and costs/benefits relative to other possible class specifications. In other words, a swap class should be defined so as to avoid grouping within it transaction types that are materially less conducive to clearing, when viewed in light of the five factors and a cost/benefit analysis.

B. Dismissal of "Mechanical" Specifications[6]

The Commission explains its decision to exclude other specifications from the definition of the clearing-required IRS class by grouping a series of examples of additional specifications under the heading of "mechanical issues" and asserting that, while such terms "may affect the value of a swap in a mechanical way", it believes that parties may account for their effects with adjustments to the price or to other specifications.[7] Although the discussion was presumably intended to illustrate the basis for the choice of four factors under the "fundamental to economic result" test by distinguishing other enumerated product terms, it may be read as a directive to abandon these many so-called mechanical terms and simply conform such terms to DCO offerings. ISDA believes, and seeks confirmation that (in the event the Commission preserves its "fundamental to economic results" test), footnote 97 establishes that if a DCO does not accept a certain mechanical specification that the parties desire as a term of their swap, then entering into the swap as an uncleared transaction is permissible. The Commission should further state that choice of a mechanical specification (or a fortiori an "idiosyncratic" specification (as described in the proposed rulemaking – i.e., one that is unique to the circumstances of the parties entering into a swap)) not offered by a DCO does not by itself raise any presumption of evasion. In other words, the choice of adjusting a "mechanical" or "idiosyncratic" term and otherwise compensating so as to clear, or not adjusting and trading uncleared, belongs solely to the parties.

C. Recommended Approach to Defining the Clearing-required Classes of Interest Rate Swaps

The Commission requests comment[8] on whether a product-by-product determination would impose a greater burden on market participants than the proposed class-based approach. Although it is true that an overly intricate set of specifications by product would impose burdens on the market, the diametrically opposite approach of using broad, class-based definitions imposes greater burdens and uncertainties of its own – namely the search efforts needed to filter out from among the broad class those specific products that a DCO will accept for clearing. The statements in footnote 97 -- that it is "likely" that DCOs and vendors will develop screening tools to assist in determining whether a particular swap is accepted by a DCO -- acknowledge the difficulty of the task, but provide no present-tense resolution.

[6] 77 Fed. Reg. 47191.
[7] See 77 Fed. Reg. 47192.
[8] 77 Fed. Reg. 47190.

ISDA believes that its recommended approach of limiting mandatory clearing to products with prior clearing history, see I.D. above, supplemented by a robust DCO notice process under proposed Rule 50.3 (as we recommend below), strikes a reasonable balance between these competing considerations.

III. Credit Default Swaps

A. Concerns with respect to European Untranched CDS iTraxx® Indices

European Untranched CDS iTraxx® Indices present novel issues and make additional demands on market participants. Although these issues may be acceptable to market participants who are now clearing such transactions on a voluntary basis, ISDA believes that although a preliminary mandatory clearing determination with respect to these indices might be made now, that determination's effectiveness should be subject to a determination by the Commission that the additional conditions we describe below have been satisfied.[9]

1. Restructuring Credit Event

Potential splitting off of single-name CDS

A significant difference between the CDX and iTraxx® indices is that the latter includes Restructuring as a credit event. Standardized iTraxx® documentation requires that upon a Restructuring credit event with respect to a reference entity, a new single-name CDS transaction on the reference entity is effectively spun out of the index CDS. This creates a number of complexities. First, no clearing venue currently supports clearing of single-name CDS in all 100 of the reference entities that underlie any of the iTraxx® indices that the Commission is proposing to subject to mandatory clearing. Should a Restructuring credit event occur in respect of an uncleared member of a mandatorily cleared index, the rules of the Securities and Exchange Commission (a single-name CDS is a security-based swap), a foreign regulator or the DCO itself may preclude clearing of the single-name credit default swaps that potentially could spin out of an iTraxx® index, either generally or for particular classes of market participant. In this regard, we note that further action from the SEC and CFTC is needed to establish how clearing members and DCOs may satisfy statutory requirements for the protection of customer collateral for single-name CDS. Even *if* the single-name CDS were or could expeditiously be made available for clearing, a party to a cleared index swap could face logistical difficulties such as not being approved to clear security-based swaps (or their foreign equivalents) at a given DCO, via a given FCM or under a given regulatory regime.

2. Operational Readiness

Although the Commission has identified that CDS transactions referencing certain iTraxx® indices are being cleared by ICE Clear Europe, only transactions between dealers are currently being cleared. We understand that not only are no buyside clients clearing iTraxx®

[9] See 17 CFR 39.5(b)(6).

currently, but that none of the submitting DCOs have an approved buyside clearing platform for iTraxx®. Even if regulatory approval were to be granted between the finalization of this clearing requirement proposal and the first anticipated compliance date, there would be insufficient time to test the requisite systems and procedures to ensure safe and sound clearing of client trades.

3. Jurisdictional Choice

Many U.S.-based buyside counterparties desire to clear only at U.S.-based DCOs. No U.S.-based DCO currently clears any iTraxx® index. In the event a non-U.S. based DCO offers client clearing of iTraxx® before a U.S.-based DCO, the Commission's proposal would effectively mandate the use of a non-U.S. DCO by U.S. counterparties that do not desire to clear outside of the United States.

4. Recommended Conditions Upon an iTraxx® Clearing Requirement

For the reasons explained above, ISDA believes that mandatory clearing of iTraxx® indices should not take effect until the Commission makes a formal determination that each of the following conditions has been satisfied:

- Regulatory actions and approvals have been obtained to permit client clearing of the index CDS in at least one DCO;

- the Commission, the SEC and other competent authorities have taken the actions necessary to permit client clearing of single-name CDS that could result from a restructuring credit event; and

- voluntary client clearing has been operational for a period of at least 90 days and the relevant DCOs, FCMs, executing brokers and buyside counterparties have completed all requisite testing and instituted all appropriate processes for clearing both the iTraxx® index and its constituents.

B. On- and Off-the-run

The Commission asks whether certain sub-classes of index CDS should be excluded from the clearing mandate. ISDA agrees with the Commission's proposed determination not to distinguish between on-the-run and off-the-run index series in its clearing determination. A clearing mandate that ceases to apply during the lifecycle of a swap would have the undesirable effect of fracturing liquidity between cleared and uncleared segments of the market. This is not to say that the significant liquidity differences between on-the-run and off-the-run index series should not be taken into account for purposes of other rulemakings, such as block size and "available to trade" determinations.

IV. Technical Comments

A. Swaptions and Extendible Swaps

In general, options are not within the classes subject to mandatory clearing. ISDA requests that the Commission clarify that swaptions, as well as swaps ("extendible swaps") the terms of which include an option exercisable by one of the parties to extend the stated termination date of the swap, are included within the class of options. ISDA suggests that swaps that resulting from the exercise of swaptions or extension options be treated as follows:

- If the underlying swap and counterparty were subject to a clearing requirement at the time the swaption or extendible swap was executed, then the underlying or newly extended swap should be cleared on exercise of the swaption or extension option. No trading requirement, however, should apply to the exercise of option rights as these rights were previously bargained for and form part of the terms of an outstanding transaction between the two parties.

- If the swaption or extendible swap was executed before the underlying swap was subject to a clearing requirement, then the underlying swap would not be subject to a clearing requirement. This result is necessary because the original transaction between the parties could not have taken into account the cost of clearing.[10]

B. Ownership Change Events

The Commission asks[11] if it should "clarify" 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." ISDA believes that if a swap was not subject to a clearing requirement when it was executed, it should not become subject to a clearing requirement upon an ownership change event, (a) unless circumstances allow agreement by the parties (including the remaining party in the case of novation) on the pricing and other terms necessary to reflect costs and other consequences of clearing and (b) until relevant systems allow the transition of uncleared to cleared with accuracy.

We note that the remaining party may be economically sensitive to the choice of DCO (due, for example to differing exposure limits and effects on portfolio margin). As a result, it would seem that the remaining party's consent must include an agreement with the transferee on the choice of DCO. Further, because current novation conventions result in a deemed trade between the transferor and transferee if the remaining party's consent is not received, those two parties would also need to agree on a DCO. The process is operationally complex. Consequently, ISDA is concerned that mandatory clearing would deter novations, with the result that an effective means for parties to reduce risk would be hindered.

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[10] This rationale does not apply in cases where, after a clearing mandate is in effect, the parties to a swaption mutually agree to amend its terms to add physical settlement or, independent from their obligations under a cash-settled swaption, mutually agree to enter into a new swap on equivalent terms to the swap underlying the swaption, and we are not suggesting that such cases should be excluded from the clearing requirement by reason of the parties having previously entered into the swaption.

[11] 77 Fed. Reg. 47208.

C. Non-linear Trade Hedges and Other Common Pairings

Exclusions from the clearing requirements should be available to take account of common trade pairings that will no longer be functional if one-half of the pairing would be cleared and the other half not. For example, in the case of IRS, a fixed-for-floating swap may be entered into as a hedge for a swaption. In the case of CDS, non-linear instruments are commonly hedged with index swaps. If the hedges become subject to a clearing requirement, costs (especially margin costs) will no longer match up, risks will increase, and the intended economic result of the pairing may be lost.

D. Technical Clarifications to Rule 50.2

Proposed Rule 50.2 requires, among other matters, that parties submit clearing-required swaps to a DCO no later than the end of the day of execution. ISDA recommends a number of technical clarifications to proposed Rule 50.2. First, the rule text "shall submit such swap to a derivatives clearing organization" should be aligned with the preamble discussion[12], which recognizes that persons that are not clearing members are deemed to have satisfied this requirement upon submission of the swap to their FCMs. Second, the preamble reference[13] to the transacting party's FCM should be broadened to recognize that in cross-border transactions a party's clearing member will not necessarily be an FCM. Third, an exception to the timing requirement is needed for system outages and other force majeure events. Finally, the description of the exceptions to the clearing mandate under "section 2(h)(7) of the Act and [Rule] 39.6" should also refer to the interpretive exclusion for foreign governments and governmental entities set out in the adopting release for the end-user exception.

E. DCO Notices - Rule 50.3

DCO notices should contain, in a readily accessible format, reasonable detail regarding the "mechanical" specifications that a DCO will accept for clearing. Given the enormous number of permutations that fall within the clearing-required class of IRS, ease of access and use is crucial to parties' ability to comply with the submission deadlines. Distilling this information from DCO rules that contain product specifications could be unduly time consuming. In addition, DCO uptake needs to be preceded by an adequate notice period for the market to clear the newly accepted products – i.e., at least one month advance notice. DCO notices should include cross-references to a description of their margining methodology for a new product. Because DCO margining methodology will affect the pricing of cleared swaps, it is important that the methodology be publicly disclosed sufficiently in advance of the compliance date for a new clearing requirement in order to allow market participants to form views on the price impact. Otherwise, pricing uncertainty could adversely affect liquidity in the product.

F. Stated Termination Date Range

The Commission should clarify in the text of proposed Rule 50.4 that the Stated Termination Date Ranges are applied only at trade inception for purposes of determining whether a swap is in a clearing-required class. The application of mandatory clearing at some

[12] 77 Fed. Reg. 47205-47206.
[13] 77 Fed. Reg. 47206.

future date (as remaining tenor decreases over time) would be highly problematic as the economics of the trade could have changed significantly and pricing for the cost of future clearing on the trade date would be pure guesswork.

G. Loss of Broad-based Index Status

In certain circumstances changes in the relative notional weightings of the reference entities in an index (such as might occur following a credit event) and/or in the information made publicly available by a reference entity could cause a CDS index to become a "narrow-based security index" within the meaning of Commission Rule 1.3(aaaa) and therefore a security-based swap. The proposal contains no analysis of how such an eventuality would be monitored and dealt with.

H. Inter-affiliate Transactions

Unless the timing of the final clearing determination is aligned with finalization of the proposed exemption from clearing of interaffiliate swaps, an interim interaffiliate exemption should be included in the final determination.

V. Additional Issues

A. Insolvency Certainty

Section 2(h)(2)(D)(ii)(V) of the CEA requires the CFTC "to take into account" the "existence of reasonable legal certainty in the event of the insolvency of the DCO or its clearing members "with regard to the treatment of customer and swap counterparty positions, funds and property." The CFTC recognizes this obligation but bases the conclusion required by statute, that such reasonable legal certainty exists, on largely theoretical support.

In the case of U.S. law, the Commission refers to the commodity broker liquidation provisions of the US Bankruptcy Code (the "Code") and its own 17 CFR Part 190 as providing the relevant legal framework (along with, potentially, the Securities Investor Protection Act and the Orderly Liquidation Authority mechanism under Title II of the Dodd-Frank Act). The Commission does not note, however, that the Code and Part 190 provisions cited have never been applied to a failed DCO.[14] The Orderly Liquidation Authority mechanism is entirely novel and has never been applied to any entity, let alone a DCO. As a result, a host of legal and practical uncertainties exist under U.S. law.

In the case of the one relevant clearing house located in the UK, the Commission appears to rely on one or more legal opinions referencing applicable insolvency laws. It is our understanding, however, that there is a lack of practical experience with DCO insolvency in the UK and there presently exist multiple proposals to improve upon various perceived uncertainties.

[14] See Report to the Supervisors of the Major OTC Derivatives Dealers on the Proposals of Centralized CDS Clearing Solutions for the Segregation and Portability of Customer CDS Positions and Related Margin, June 30, 2009. Available at www.newyorkfed.org/markets/Full_Report.pdf

ISDA advocates swap clearing. ISDA does not believe that a lack of actual DCO insolvency experience under current law is a reason to refrain from clearing mandates. The lack of experience and practical know-how, however, is important and should be noted and explored by the CFTC, in a proactive effort to perfect both law and practical mechanisms before the first DCO insolvency. We recommend that the CFTC commit itself as part of these first mandatory clearing determinations to a study of DCO insolvency, with a goal of documenting uncertainties and proposing solutions. We also recommend that the CFTC respond to the present lack of DCO insolvency experience by making its mandatory clearing determinations in a cautious and deliberate manner. A move to market-wide clearing that may be vulnerable to insolvency uncertainties will increase, not reduce, risk.

B. Anti-evasion

1. Scienter

The CFTC proposes several anti-evasion rules, 50.10(a), (b) and (c). Proposed Rule 50.10(a) states the unlawfulness of "knowing or reckless" evasion of the clearing and trading requirements of CEA section 2(h). Proposed 50.10(b) terms unlawful "abuse" of the exception to the clearing requirement; 50.10(c) does the same with respect to abuse of any exemption or exception to the requirements of CEA section 2(h). We believe that all three provisions should be described as being subject to a scienter standard.

According to the Commission, proposed Rule 50.10(a) takes its explicit knowing or reckless scienter standard from CEA sections 6(e)(4) and (5).[15] The Commission states that proposed 50.10(b) finds its linguistic roots in CEA section 9(a)(6) which, although without an explicit scienter standard, is a felony statute providing for fine and imprisonment. The Commission also states that proposed 50.10(c) shares some commonality with 50.10(b).

The Commission, expressly articulating the relationship between evasion and abuse violations, proposes a common purpose-focused approach to all of 50.10. Although we take issue with aspects of that approach, as described below, we agree that 50.10 should be governed by a single standard. A focus on purpose, of course, is a focus on intent.[16] Accordingly, we urge the Commission to make clear that the knowing standard of proposed 50.10(a) should be read into 50.10(b) and (c), regardless of whether that language is found in related provisions of statute. (This would be analogous to the linguistic structure of the Commission's new antifraud and manipulation rules: Rule 180.1 contains an express intentional or reckless standard, while Rule 180.2 contains no such express standard, but is explained by the Commission to require specific intent only.[17]

2. Overall Approach

The Commission proposes to adopt a "facts and circumstances" business purpose test to govern application of proposed 50.10. This test is drawn from that articulated by the Commission with respect to new Rule 1.6, the swap definition anti-evasion provision.

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[15] 77 Fed. Reg. 47207.
[16] The Commission recognizes this in describing its parallel rule1.6 test as scienter based. 77 F.R. 48302.
[17] See 76 F.R. 41407.

The Commission's final Rule 1.6 test was moderated from its original proposed form in several respects. We realize that Rule 1.6 is now in final form. Nonetheless, the Commission's preamble explanation of Rule 1.6 bears clarification, which we hope the Commission will achieve, both with respect to proposed Rule 50.10 and Rule 1.6.

First, in its exposition on Rule 1.6, the Commission does not clearly respond to the proposition that considering costs and burdens of regulation is a legitimate business purpose.[18] Squarely put, if a business has a choice, without fraud, deceit or unlawful activity, of entering into a hypothetical transaction that is not a swap (but will produce identical economic effect) in order to avoid the sole distinguishing feature of a swap, regulatory burden and cost, or of entering into an uncleared swap, rather than a cleared swap, simply because it is cheaper, or free of unwanted aspects of clearing or trading, then that choice should be clearly identified by the Commission as legitimate.

Second, as we hope the foregoing examples illustrate (and as the Commission itself recognizes is a hallmark of evasion in tax cases, see id.), fraud, deceit or unlawful activity are proper prerequisites to evasion or abuse violations.

Reliance on these prerequisites is needed more in the derivatives context than in tax cases. The "sham transaction doctrine" used in the tax cases has no application in the derivatives context, where transactions will necessarily have economic consequences. Without relying on identification of fraud, deceit or unlawful activity as hallmarks of evasion or abuse, derivatives market participants will be subject to constant uncertainty as they structure and transact in markets that offer legitimate alternatives, be they regulated or unregulated, cleared or uncleared.

C. Clearing and Systemic Risk

CEA Section 2(h)(z)(I)(ii)(III) requires the CFTC to "take into account" in a mandatory clearing determination the "effect on the mitigation of systemic risk." Although the CFTC discussion makes a number of flat assertions as to the risk mitigating aspects of clearing[19], the discussion does not deal[20] with the fact that clearing involves a greater centralization of risk than the over-the-counter markets ever did, see, e.g., Pirrong, The Economics of Central Clearing: Theory and Practice.[21] Nor does the discussion deal with the fact that the capital, collateral and disclosure requirements of Dodd-Frank make uncleared trades safer, individually and systemically, than they may have appeared before.[22]

As an advocate of clearing, ISDA believes these ambiguities should not stand in the way of careful and deliberate progress towards greater clearing. ISDA does believe, however, that mandatory clearing requirements should be well and carefully made; this requires prudent

[18] See 77 F.R. 48302.
[19] See 77 Fed. Reg. 47183.
[20] Other than to conclusorily imply that such risk concentration may be disregarded because "central clearing was developed and designed to handle such risk." 77 Fed. Reg. 47203).
[21] "The Economics of Central Clearing: Theory and Practice", by Dr. Craig Pirrong. Available at www2.isda.org/functional-areas/research/discussion-papers/
[22] The preamble discussion observes that the 2008 financial crisis "demonstrated the potential for systemic risk" in the derivatives market. It is by no means apparent that swap clearing would have diminished this perceived risk potential under the facts of 2008.

application of the clearing requirement and adherence to the five statutory factors. The best swap market will be the market that uses both cleared and uncleared swaps to best advantage.

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ISDA appreciates the opportunity to provide these comments. Should you require further information, please do not hesitate to contact me or ISDA staff.

Sincerely,

Robert Pickel
Chief Executive Officer

Annex A

Illustrative Clearing Ineligible Variations for Fixed-to-Floating Swap and Basis Swap Classes

- Variable notionals for currencies other than EUR, GBP and USD
- For Basis Swaps only, where the regular float leg fixing rate tenor is larger than the Reset Frequency of the float leg
- Trades with both a front stub and a back stub
- Stubs less than 2 days + currency settlement lag (2 days for CAD/EUR/GBP/USD - 3 days for others)
- Additional payments post-termination date
- Trades with Effective Date adjustments
- Different Business Day Conventions used for fixed or float period end dates and termination date (Fixed-to-Floating Swaps only)
- Different Business Day Conventions used for period end dates and termination dates on each leg of the contract
- Partial novation with a novation date greater than today + spot
- Fixed payment cycle does not follow the floating payment cycle – although some swaps with different payment cycles are now accepted
- Non-standard rounding
- Roller coaster swaps, where the notional and fixed rate varies

Illustrative Clearing Ineligible Variations for the Overnight Index Swap Class

- Trades with a spread
- Different Business Day Conventions used for fixed or float period end dates and termination date
- Different Business Day Conventions used for period end dates and termination date on each leg of the contract
- Non-standard fixing Lags
- Non-standard initial fixing rate
- End-of-Month roll dates
- IMM roll dates