

March 23, 2009

Chairman Mary Schapiro  
U.S. Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549

Re: *Temporary Exemptions for Eligible Credit Default Swaps to Facilitate Operation of Central Counterparties to Clear and Settle Credit Default Swaps* (File No. S7-02-09)

Dear Chairman Schapiro:

The Yale Law School Capital Markets and Financial Instruments Clinic appreciates the opportunity to comment on the *Temporary Exemptions for Eligible Credit Default Swaps to Facilitate Operation of Central Counterparties to Clear and Settle Credit Default Swaps* (“the Order”), dated January 22, 2009, and the related Securities and Exchange Commission exemptive orders authorizing the operation of one or more central counterparties for credit default swaps. We encourage the Commission to consider the comments that follow when instituting any future regulations. We would welcome the opportunity to discuss any of these issues further at your convenience.

#### **Exempt CCPs from the Securities Act, Exchange Act, and Trust Indenture Act**

Central counterparties for credit default swaps should be temporarily exempted from the registration requirements of the Securities Act, Exchange Act, and Trust Indenture Act. These exemptions are necessary to enable the operation of a CCP or CCPs in the CDS market, because requiring registration of CDS would likely present prohibitive administrative and financial burdens for a CCP. Moreover, parties are less likely to participate in a CCP if they are subject to registration requirements and other burdens. To encourage broad participation in CCPs, regulation of the CDS they handle should closely track regulation of OTC CDS. Provided that CCPs meet the stringent eligibility requirements detailed below, the exemptions are appropriate.

#### **Limit the scope of the Securities Act exemption to Sections 5 and 12**

Exempting CCPs from Sections 5 and 12 will eliminate registration requirements while preserving antifraud, enforcement, and liability provisions. Section 5 requires registration of securities; Section 12 imposes liability for misstatements in unregistered security offerings. Most other Securities Act sections provide procedures and requirements for registration. Preserving antifraud and oversight provisions will ensure that the exemptions for CCP-traded CDS track those for “swap agreements.” Keeping those provisions is imperative given that CCPs are not self-regulatory organizations and, as a result, cannot mandate or monitor member practices other than transactions involving the CCP itself. CCPs are authorized only to stipulate capitalization requirements, and their sole recourse for violations of their rules is revoking membership. This means that the

Commission must still play an important role in prohibiting and preventing fraud and misrepresentation between members and non-members, members and CCPs, and broker-dealers and their customers. Stripping the Commission of all oversight authority would leave a legal vacuum.

Additionally, expanding the scope of the Securities Act exemption might invite serious legal and jurisdictional problems — for example, exempting CCPs from the application of Section 18 could eviscerate federal preemptions over state registration laws. The exemption should also preserve the listed restrictions on broker-dealers with respect to customer fraud. To avoid the aforesaid complications, CCPs should be exempted only from the necessary provisions.

### **Require all CCPs to comply with the CPSS/TCIOSC Recommendations for Central Counterparties**

In addition to the requirements set forth in the Order, all CCPs should be required to comply with the 15 recommendations set forth below, which were proposed by the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions (“the Recommendations”).

*Recommendation 1: Legal risk.* A CCP should have a well-founded, transparent, and enforceable legal framework for each aspect of its activities in all jurisdictions.

*Recommendation 2: Participation requirements.* A CCP should require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the CCP. A CCP should have procedures in place to monitor that participation requirements are met on an ongoing basis. A CCP’s participation requirements should be objective, publicly disclosed, and permit fair and open access.

*Recommendation 3: Measurement and management of credit exposures.* A CCP should measure its credit exposures to its participants at least once a day. Through margin requirements, other risk control mechanisms, or a combination of both, a CCP should limit its exposures to potential losses from defaults by its participants in normal market conditions so that the operations of the CCP would not be disrupted and non-defaulting participants would not be exposed to losses that they cannot anticipate or control.

*Recommendation 4: Margin requirements.* If a CCP relies on margin requirements to limit its credit exposures to participants, those requirements should be sufficient to cover potential exposures in normal market conditions. The models and parameters used in setting margin requirements should be risk-based and reviewed regularly.

*Recommendation 5: Financial resources.* A CCP should maintain sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions.

*Recommendation 6: Default procedures.* A CCP’s default procedures should be clearly stated, and they should ensure that the CCP can take timely action to contain losses and liquidity pressures and to continue meeting its obligations. Key aspects of the default procedures should be publicly available.

*Recommendation 7: Custody and investment risks.* A CCP should hold assets in a manner whereby risk of loss or of delay in its access to them is minimized. Assets invested by a CCP should be held in instruments with minimal credit, market, and liquidity risks.

*Recommendation 8: Operational risk.* A CCP should identify sources of operational risk and minimize them through the development of appropriate systems, controls, and procedures. Systems should be reliable and secure, and have adequate, scalable capacity. Business continuity plans should allow for timely recovery of operations and fulfillment of a CCP's obligations.

*Recommendation 9: Money settlements.* A CCP should employ money settlement arrangements that eliminate or strictly limit its settlement bank risks, that is, its credit and liquidity risks from the use of banks to effect money settlements with its participants. Funds transfers to a CCP should be final when effected.

*Recommendation 10: Physical deliveries.* A CCP should clearly state its obligations with respect to physical deliveries. The risks from these obligations should be identified and managed.

*Recommendation 11: Risks in links between CCPs.* CCPs that establish links either cross-border or domestically to clear trades should evaluate the potential sources of risks that can arise, and ensure that the risks are managed prudently on an ongoing basis. There should be a framework for cooperation and coordination between the relevant regulators and overseers.

*Recommendation 12: Efficiency.* While maintaining safe and secure operations, CCPs should be cost-effective in meeting the requirements of participants.

*Recommendation 13: Governance.* Governance arrangements for a CCP should be clear and transparent to fulfill public interest requirements and to support the objectives of owners and participants. In particular, they should promote the effectiveness of a CCP's risk management procedures.

*Recommendation 14: Transparency.* A CCP should provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with using its services.

*Recommendation 15: Regulation and oversight.* A CCP should be subject to transparent and effective regulation and oversight. In both a domestic and an international context, central banks and securities regulators should cooperate with each other and with other relevant authorities.

Requiring rigorous compliance with these recommendations will ensure that CCPs minimize the risks they inevitably face — counterparty credit risk, liquidity risk, investment risk, operational risk, and legal risk – and thus safeguard their financial health. This, in turn, will protect CCP participants and the CDS industry.

The SEC should require compliance with the Recommendations as a precondition for serving as a CCP for CDS transactions. The FSA certified that LCH.Clearnet complied

with the Recommendations, and that certification appears to have been material to the SEC when it approved LCH.Clearnet as a CCP. See Release No. 34-59164. Mandating FSA compliance review or an equivalent procedure would be more effective than a piecemeal approach through individual exemptive orders. Any delay that might be caused by requiring a thorough examination of a CCP's practices will be mitigated by the fact that there is already an active compliant CCP.

**Mandate measures to enhance the quality of information available to CCPs about balance sheet risks, their incentive and ability to collect and analyze it, and their capacity to price premiums accordingly**

CCPs do not specialize in valuing complex derivatives contracts and may lack strong incentives to monitor and manage counterparty risks because they do not completely internalize default losses. Dealers in these product markets are likely to have more precise risk information than CCPs when setting premiums. This information asymmetry, coupled with the voluntary character of CCPs, creates a danger of adverse selection that should be addressed in the following ways.

*Require use of reliable models and capital experts to incorporate information about complex derivative products from other financial intermediation activities*

The public good character of third-party CCPs leaves a centralized CDS approach vulnerable to deficient information about product-specific risks and balance sheet risks. To discourage trading activity by less creditworthy firms, the SEC should require CCPs to incorporate best-practice models and capital experts. CCPs should be required to develop data to calibrate and test models to better quantify, characterize, and manage price risks and default risks.

*Require CCPs to adjust collateral levels to reflect balance sheet risks specific to each firm*

Centralized risk evaluation and risk pricing mechanisms avoid duplicative monitoring by setting collateral prices according to financial statement information about the risk of cleared products held in each member's portfolio. Centralized monitoring, however, fails to calibrate collateral requirements to product-specific default risks. CCPs should therefore be required to appraise counterparty risk and underwrite credit derivatives by reference to balance sheet risks specific to each firm. If daily balance sheet risk appraisal proves prohibitively costly, CCPs should be required to impose simple product-specific risk standards with respect to minimum capital, total assets, credit ratings, or credit policy, and should review such standards regularly. Similar review requirements for operational capability and risk management are common for CCPs such as LCH.Clearnet. See, e.g., [www.lchclearnet.com/Images/LCH.Clearnet%20-%20Risk%20Mitigation\\_tcm6-44531.pdf](http://www.lchclearnet.com/Images/LCH.Clearnet%20-%20Risk%20Mitigation_tcm6-44531.pdf).

## **Define the classes of eligible instruments and eligible participants broadly**

A CCP reduces systemic risk by increasing liquidity, netting trades, and providing an insurer of last resort for all CDS. As many instruments and participants as possible should be brought within its purview.

### *Require Eligible CDS to be marked to market*

The Order's definition of Eligible CDS is generally appropriate and sufficiently broad. However, because increasing transparency in the CDS market is a critical goal of the new regulatory regime, "Eligible CDS" should be explicitly limited to instruments that are marked to market on a daily basis. Marking to market should be an ordinary part of the margining process for any CCP operating in compliance with the Recommendations; however, it should also be made an explicit prerequisite to participating in the market.

### *Consider eliminating the requirement that Eligible CDS be sold to an Eligible Contract Participant*

The definition of Eligible Contract Participant comes from the Commodity Exchange Act, which was aimed at providing a system of self-regulation for sophisticated market participants. The SEC's attempt to constrain participation in the CDS market may be unnecessary in a market so thoroughly dominated by professional traders. A CCP is likely in a better position than the SEC to determine which parties should participate in the market, because the CCP is motivated to protect its financial integrity by excluding inappropriate counterparties. The SEC should thus consider eliminating the requirement that Eligible CDS be sold to Eligible Contract Participants.

## **Import the information conditions in the exemptive orders into the Order**

The importance of accurate real-time price information renders the information conditions contained in subsection (a) of Release No. 34-59164 sufficiently important that they should be incorporated into the Order itself. The conditions should be incorporated (1) to ensure that no future exempted CCP operates without fulfilling the information conditions and (2) to ensure that CCPs that do not require a Section 17A exemption to operate – i.e. those already registered under the Act – are required to comply with the information conditions as well.

## **Treat Eligible Contract Participants sold Eligible CDS in reliance on the Order as Qualified Purchasers for the purposes of Section 18 of the Securities Act**

Section 18 exempts Qualified Purchasers from state securities laws, including registration requirements. Because the Order is intended to reduce regulatory burdens and encourage CCP novation, it makes sense to prevent states from imposing registration requirements that would frustrate the efficiency gains from federal exemption. States remain free to apply and enforce their own antifraud laws. Limiting the scope of "Qualified Purchasers" to Eligible Contract Participants sold Eligible CDS by a CCP will allow states to retain protections for unsophisticated consumers and to regulate non-CCP CDS transactions.

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We appreciate the opportunity to provide comments regarding the Order and respectfully request that the Commission consider these comments. Should the Commission have any questions about our suggestions, please do not hesitate to contact us.

Respectfully submitted,



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