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

Dear Mr. Stanwick,

I am Ken Monahan, and I am writing to comment on the proposed CFTC Rule "Customer Clearing Documentation and Timing of Acceptance for Clearing" RIN 3038-AD51. I have previously written a more general comment letter on the rulemaking process which to which I will occasionally refer in this letter. My original letter was published in the Federal Register via the SEC website and was subsequently published on the CFTC Comment Site on February 14th 2011. For your reference I include the URL here:

http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27694&SearchText=

For a full listing of my qualifications please see my letter above. In brief, I have been involved in the exchange traded and OTC derivatives businesses in a wide range of capacities since 1989. During that time I had several opportunities to work on the formation of exchanges, clearinghouses and the regulatory environments which supported or, in some cases, retarded them. With this background I welcome the opportunity to comment on the rule-making process under the aegis of Dodd-Frank and hope that I can put my experience in the service of the objectives of the Act.

My Original Letter

The specific issue my original letter addressed was CDS CCP governance though I used that as a framework to describe the strategic landscape against which the rule-making process is unfolding. This landscape is characterized by the dominance of a dozen or so dealers. tThose dozen dealers are themselves dominated by the top three. I argued that the dominance of these dealers is rooted in the nature of the CDS product itself, dealer control over certain elements of CDS market infrastructure, their possession of the infrastructure to support both OTC and CCP clearing and therefore their ability to alter the relative economics between them, their latent power over exchanges and other CCPs through their control of order flow in unrelated securities and through their successful capture of the ICE Trust. From this I concluded that the extent and origin of dealer dominance was so great that no amount of statutory empowerment of the end user community would erode that power.

I then made the argument that the only way to successfully bring about the objectives of the Dodd-Frank Act was to seek out seek to exploit differences between the dealers by arming the mid and bottom tier dealers with infrastructural tools necessary for them to launch an assault on the market share dominance of the top three. I made a theoretical argument and supported it with the historical analogy to how in the early 1970s the CBOE radically altered the market structure in favor of new

entrants against the pervious dominance of the OTC brokers massively crushing the spreads and broadening the appeal in the US equity options markets.

The thrust of this argument was that the CBOE, in combination with the OCC possessed certain features which were essential for enabling true price competition between the various market participants. These features were straight through processing, standardized fungible contracts, margin rules which were competitive with bi-lateral clearing, and a default cascade that was clear and which would have the effect of aggregating the balance sheets of the smaller players so as to make credit risk a non-issue. These elements combined to enable a market structure characterized by anonymity which itself enabled competitive quoting which was the primary engine behind the tightening of the bid-offer spreads.

Given the power of the strong dealers to punish the weak by denying them access to the liquidity necessary for them to hedge their risks at reasonable cost, anonymity is the sine qua non of enabling defections from the dealer alliance. Anonymity and competitive quoting would enable these defections from and, combined with an effective CCP to level the field between market makers of various capitalizations, would attract new market entrants for whom bi-lateral trading is not a realistic possibility. Attracting new entrants is the key element in reducing systemic risk, the grand strategic objective of the Dodd-Frank Act. Thus I argued that the authorities should do everything in their power to encourage new entrants to the CCP space as the dealers had already captured the ICE Trust which was therefore unlikely to configure itself in such a way as to facilitate this anonymity.

The Issue At Hand

Needless to say the intervening nine months have not produced new entrants into the CDS CCP field but there have been some other interesting developments. The least surprising is the continuous conflict between the dealer community and the end users over the legal and technical infrastructure supporting and governed by the Act. The first section of this rule regarding Customer Clearing Documentation is evidence of that. I am not going to opine on that specific section of the rule but I think it is telling that the CFTC deems it necessary to seek to prevent two parties from freely entering into agreements between one another. Such a rule contains an implicit acknowledgement that the market power of the dealers is so great that they can compel market participants to enter into agreements which are so deleterious as to require statutory prohibition.

That said though the market power of the dealer alliance remains preponderant and there have been no new entrants to the CCP space to challenge the dealer capture of the ICE Trust the authorities have had some measurable success. In my original letter I contended that the dealer control of the ICE Trust enabled them to use it and its very stringent entrance requirements to use is to deter potential competitors. An example of this was the requirement that applicants possess $5 billion in tangible common equity, a standard which virtually only the original dealers themselves could meet and which vastly exceeds the standards at other clearinghouses, even those who clear products with similar jump to default characteristics to CDS. Some firms who did possess the requisite TCE found that the required capital contributions to the guarantee fund were so onerous as make application impossible. This was the type of barrier that I had hoped new entrants into the CCP space would help to lower. As mentioned this did not happen, however the barrier has been lowered by other means.

On January 20th the CFTC published RIN 3038-AC98 in the Federal Register which in 39.12 a(2)iii

prohibits derivatives clearing organizations from requiring more than $50 million in capital. The ICE Trust subsequently lowered its capital requirement in anticipation of these rules coming into force. At this point the dealers could have halted central clearing of CDS in protest of the new rules and dug in their heels that the high capital requirements were absolutely necessary for the safety of the markets essentially going on strike against the rule. In the event, they did no such thing. Despite the lower capital requirements, the ICE Trust continues to clear trillions of CDS notional indicating that the market participants are content with capital requirements several orders of magnitude lower than those originally implemented. This is important because it seems both to indicate that the dealer alliance does indeed intend to use its control of the ICE Trust to forestall potential entrants and that regulatory fiat can produce outcomes which I had hoped would have been produced by effective competition among the CCPs.

This brings us to the current rule. As mentioned, I do not intend to comment on the documentation issue. I understand the concerns of both the dealer community and the end users which have been documented in the letters and documents to which the rule itself refers. Aside from drawing certain conclusions about the relative power of the dealers earlier in this letter I do not plan to address myself to it. Instead I will opine on the aspects of the rule which seek to define the time horizon over which contracts can be accepted for clearing. This aspect of the rule "is intended to be a performance standard, not the prescription of a particular method of trade processing" and defines that standard as "quickly as would be practicable if fully automated systems were used." This is elaborated on as "a matter of milliseconds or seconds or, at most, a few minutes, not hours or days." If the CFTC, carrying out its responsibilities under the Dodd-Frank Act, is to prod the CDS market structure in the direction of open competition this or a similar rule is essential.

As I mentioned in my original letter the key element to leveling the playing field, promoting defection from the dealer alliance, and bringing in new sources of liquidity and ultimately eliminating systemic risk is anonymous quoting. Anonymous quoting enables the dealers to compete for market share through aggressive pricing without fear of retribution and enables qualified market makers who do not have elaborate marketing operations to compete solely on price. Anonymous quoting is really only possible in a straight through processing(STP) environment. This is because if there is a chance that trades will not in fact be instantly novated to the CCP then market participants are exposed to the credit of their original counter-party on a bilateral basis. This exposure, even if temporary, makes the identity of the original counter-party essential. This confers an advantage on the relatively well capitalized dealers and renders anonymous trading an impossibility.

The Rule, by establishing a standard which would force acceptance for clearing onto a time horizon over which a rejection followed by a break of the trade would have minimal market impact on the counter-parties. While not identical this is very close to the effect of STP It is also important to point out that this rule does not merely stand on its own but rather is supported by RIN 3038-AD51 which requires that client credit limits be predetermined and automated systems be implemented which would prevent trades which are likely candidates for rejection from being executed in the first place. These two rules in combination should have the effect of rendering the current CDS CCPs effectively STP marketplaces despite their retention of the rights to reject trades for clearing. On this basis I strongly encourage the CFTC to enact them or rules similar to them.

This is not to say that the rule is perfect. Regulatory fiat is, desirable though it may be, remains a blunt instrument. While STP clearing is optimal for standardized fungible products and essential for developing transparent markets in them, it is not necessarily the case for certain bespoke products which may also be submitted for clearing. By applying the standard to products with both mandatory

and non-mandatory cleared products, the CFTC may open itself to justifiable criticism that it is being unreasonable. This justifiable criticism could then be used to undermine the original intent of the rule. On the other hand if the CFTC exempts non-mandatory swaps from the timeframe the temptation to attach trivial specifics to certain trades so as to avoid the requirements may be too great for the dealers to resist also undermining the rule. Thus though I am supportive of the rule, and believe that the intention behind it is essential for bringing about the objectives of the Dodd-Frank Act I believe there is some room for improvements which would make the argument for virtual STP timing incontrovertible with regard to standardized products which make up the vast majority of trading but which would not empower arguments against it by catching products which are less suitable up in the net.

In conclusion, absent effective competition at the CCP level government fiat is the only way to compel market participants to conform to optimal market practice, and therefore I strongly suggest that the CFTC implement the proposed rule or a similar rule with the same intent. In so doing the CFTC compel the CDS market structure to take a major step forward toward greater transparency and less systemic risk thereby achieving the objectives of the Dodd Frank Act.

Thank you for your time and consideration,

Kenneth A. Monahan