UNIVERSITY OF MARYLAND
SCHOOL OF LAW

December 13, 2010

David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

Re: Financial Resources Requirements for Derivatives Clearing Organizations

Dear Mr. Stawick:

These comments are submitted in response to the Commodity Futures Trading Commission's ("CFTC" or "Commission") Notice of Proposed Rulemaking on Financial Resources Requirements for Derivatives Clearing Organizations[1] under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act[2] (the "Dodd-Frank Act").

I. General Comments

One of the main principals shaping derivatives regulation under the Dodd-Frank Act is to provide *free and open access* to clearing and exchange trading (including alternate swaps

[1] Proposed Rules, 75 Fed. Reg. 63113 (October 14, 2010), *available at* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2010-25322a.pdf.

[2] Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

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execution facilities).[3] Specifically, Section 723(a)(3) of the Dodd-Frank Act amends the Commodity Exchange Act[4] ("CEA") to provide that "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 [("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."[5] Congress acknowledges the importance of the central clearing requirement in Section 745(b) of the Dodd-Frank Act by directing the Commission to prescribe criteria, conditions, or rules under which the Commission will determine the initial eligibility or the continuing qualification of a DCO to clear swaps.[6] In light of this, the Commission proposed a set of rules, Regulation 33.11,[7] for DCOs that would further the goal of avoiding market disruptions and financial losses to market participants and the general public. The Commission is correct that these proposed rules should promote financial strength and stability, thereby fostering efficiency and a greater ability to compete in the broader financial markets.

II. Amount of Financial Resources Required

Under proposed Regulation 39.11(a)(1), a DCO must maintain sufficient financial resources to meet its financial obligations to its clearing members notwithstanding a default by the clearing member creating *the largest financial exposure* for the DCO *in extreme but plausible market conditions*.[8]

At the very minimum, the largest financial exposure for the DCO in extreme but plausible market conditions should reflect market conditions during 2008 and 2009. At that time, major swaps dealers, who were also clearing members of many DCOs, would have been unable to operate their business, were it not for the multi trillion dollar bailouts from the Treasury and the Fed based on the backing of U.S. taxpayers. During this financial crisis, the Nation's most

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[3] *See*, e.g., S. REP. 111-176, at 32–35 (2010) (noting that draft provisions concerning OTC derivatives were designed to minimize non-cleared, off-exchange trades); [3] *See* Letter from Stephen F. Lynch, U.S. House of Representatives, to the Commodity Futures Trading Commission (October 18, 2010), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26291&SearchText ("clearing is at the heart of reform"); Transcript of Public Roundtable on Governance and Conflicts of Interest in the Clearing and Listing of Swap, August 20, 2010, at 33, *available at* http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/derivative9sub082010.pdf (statement of Randy Kroszner, University of Chicago, Booth School of Business, "And the law is clear: Open access is the fundamental principle.").

[4] 7 U.S.C. 1 *et seq.*

[5] *See* Section 2(h) of the CEA, 7 U.S.C. 2(h).

[6] *See* Section 5c(c)(5)(C)(iii) of the CEA, 7 U.S.C. 7a-2(c)(5)(C)(iii).

[7] *See* Proposed Rules, *supra* note 1.

[8] *Id*. (emphasis added).

prominent financial firms were forced to sell themselves off to avoid almost certain liquidation. For example, Merrill Lynch was purchased by Bank of America under highly expedited circumstances.[9] In hindsight, we see that these market conditions were extreme but plausible. In light of this, historical market data that led up to the passage of the Dodd-Frank Act should be taken into account in determining market conditions that could be defined as extreme but plausible.

The Commission should keep in mind that under the Dodd-Frank Act, for the most part, standardized swaps between financial entities must be brought to clearing houses. As such, Chairman Gensler recently stated that the number of clearinghouses is expected to increase to approximately 20 from currently 14 clearing houses.[10] Because there will be more clearinghouses, it is absolutely critical that the Commission promulgate rules that would determine a clearing member's risk of default and its availability of financial resources *across all clearinghouses*. As stated in JP Morgan's comment letter to the Commission, "it should be noted that a clearing member may have committed to additional assessments at more than one clearing house."[11] Even J.P. Morgan, one of the largest market participants, asks the Commission to "adopt a risk based analysis to determine the likelihood that a clearing member will be able to meet its assessment obligations across all clearing houses."[12]

The Commission correctly proposes in Regulation 39.11(a)(2) that a DCO maintain sufficient financial resources to cover its operating costs for at least one year, calculated on a rolling basis.[13] Proposed Regulation 39.11(b)(1) correctly lists the types of financial resources,

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[9] "Merrill Lynch's shotgun sale to Bank of America will create the nation's largest financial services company […]. The deal keeps Merrill from a Bear Stearns-style fire sale or a complete meltdown like Lehman Brothers while removing a major player that some expected to be the next shoe to drop in the credit crisis." Joe Bel Bruno and Stephen Bernard, *Bank Of America Buys Merrill Lynch For $50 Billion*, HUFFINGTON POST (Sept. 15, 2008), *available at* http://www.huffingtonpost.com/2008/09/15/bank-of-america-buys-merr_n_126416.html (last visited on Dec. 12, 2010).

[10] *See* Statement of Gary Gensler, Chairman, Commodity Futures Trading Commission, *Statement on Support of Advanced Notice of Proposed Rulemaking on the Authority to Designate Financial Market Utilities as Systemically Important* (November 23, 2010), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/ChairmanGaryGensler/genslerstatement112310.html (last visited on Dec. 11, 2010).

[11] *See* Comment Letter by Barry L. Zubrow, EVP & Chief Risk Officer, J.P. Morgan Chase & Co. to David A. Stawick, Secretary, Commodity Futures Trading Commission, and Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, Nov. 7, 2010, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26481&SearchText= (last visited on December 11, 2010) [hereinafter "JP Morgan Comment Letter"].

[12] *Id*.

[13] *See* Proposed Rules, *supra* note 1.

including a DCO's own capital, that would be available to a DCO to satisfy the requirements of proposed Regulation 39.11(a)(1).[14]

Although the proposed Regulation 39.11(b) does not prescribe capital requirements for DCOs, the Commission should require DCOs to set aside a reasonable amount of capital, so that the DCO would have sufficient financial resources to absorb a default. This amount should be equal to an average size of one contract for that DCO. This amount would not impose an unnecessary burden on the DCO. In addition, the capital requirements for DCOs must require that the DCOs' capital be highly liquid so that the DCO can cure the default in a timely manner. A comment letter submitted by a market participant also notes that "it would be appropriate for the Commission's Regulations […] to require that if a clearing house enumerates its own capital as part of the waterfall, that clearing house must provide sufficient assurances that its […] capital will be available to meet those obligations and will not be reallocated to serve other purposes at the discretion of that clearing house."[15]

III. Computation of the Financial Resources Requirement

Proposed Regulation 39.11(c)(1) correctly requires a DCO to perform stress testing on a monthly basis in order to make a reasonable calculation of the financial resources it needs to meet the requirements of proposed Regulation 39.11(a)(1).[16] Specifically, as required by the proposed rules, a DCO must consider both historical data and hypothetical situations in performing stress testing. Proposed Regulation 39.11(c)(1) and (2) correctly requires the Commission to review the DCO's stress test methodology. If the Commission determines that the methodology is inappropriate, the Commission should require the DCO to change its methodology.

IV. Liquidity of Financial Resources

Having highly liquid financial resources is key to ensuring the stability of a clearing house. When there is a default by a clearing member, the clearinghouse has to guarantee the defaulting member's position and settle that position in a timely manner. If there are not liquid financial resources available to the non-defaulting members, and the clearing house will not have liquid financial resources to cover the position, the clearing house will be in danger of collapse. One market participant recently stated that "it is ultimately in the interest of the clearinghouses and *all* of their members to have a liquid, transparent market at the exchanges where *all* buy and

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[14] *E.g.* (1) the margin of the defaulting clearing member; (2) the DCO's own capital; (3) the guaranty fund deposits of the defaulting clearing member and non-defaulting clearing members; (4) default insurance; (5) if permitted by the DCO's rules, potential assessments for additional guaranty fund contributions on non-defaulting clearing members; and (6) any other financial resources deemed acceptable by the Commission. *See* Proposed Regulation, *supra* note 1.

[15] *See* JP Morgan Comment Letter, *supra* note 11.

[16] *See* Proposed Rules, *supra* note 1.

sell interests are expressed."[17] In light of this, proposed Regulation 39.11(e)(1) requires a DCO to have sufficient capital in the form of cash to cover the average daily settlement variation pay per clearing member over the last fiscal quarter.[18] In calculating the capital, the Commission permits the DCO to take into account a "committed line of credit" or similar facility for the purpose of meeting the liquidity requirement. Because there may be an incident where a clearing member would be unable to settle its position during the time span of an intra-day settlement cycle, the standards for "committed line of credit" or similar facility must be narrowly and strictly defined, so that the party can easily use such highly liquid line of credit or similar facility.

Specifically, the standards for what constitutes a committed line of credit should not be weakened to include a mere promise to lend a specified amount of money in the future. Rather the standards should require the party to specify the multiple sources of capital. This would ensure the availability of sufficient capital. In addition, the standards should specifically state that there must be same-day drawing rights to the committed line of credit. In the absence of such rights, the committed line of credit would be useless in an intra-day settlement cycle where the defaulting party would need to put up a capital within a few hours in the same day.

The purpose of the financial resources requirement is to provide a cushion in the event of a default by a member of a clearing house. Obviously, the defaulting clearing member either does not have means to honor the promissory note, or is not in its interest to honor the promissory note because it has already defaulted on its obligation. Therefore, there is a real danger of having a mere promise to lend money without diversified sources as well as same-day drawing rights. The Commission should note that greater participation by clearing members in a committed line of credit or a similar instrument at times of market distress would not provide necessary liquidity, rather it would increase the systemic risk.

The Commission is correct that DCOs should maintain unencumbered liquid financial assets in the form of cash or highly liquid securities, equal to six months' operating costs.[19] However, the rules allow a DCO to use a "committed line of credit or similar facility to satisfy this requirement." As stated above, the Commission must promulgate a strict set of standards about what constitutes a committed line of credit or similar facility so that a mere promise by a party would not satisfy the liquidity requirements.

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[17] *See* Comments of Thomas Peterffy, Chairman and CEO, Interactive Brokers Group, Before the 2010 General Assembly of the World Federation of Exchanges (Oct. 11, 2010), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26316&SearchText= (last visited on December 11, 2010).

[18] *See* Proposed Rules, *supra* note 1.

[19] *See* Proposed Regulation, *supra* note 1.

V. Systemically Important Derivatives Clearing Organizations ("SIDCOs")

The Commission is correct in stating that SIDCOs should be required to meet a higher standard than DCOs because the failure of a SIDCO to meet its obligations would have a greater impact on the financial system. As such, the Commission proposed that a SIDCO should maintain sufficient financial resources to meet its financial obligations to its clearing members notwithstanding a default by *two clearing members*.[20]

Sincerely,

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[20] *Id*.