



January 18, 2011

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

Re: Designation of a Chief Compliance Officer; Required Compliance Policies; and Annual Report of a Futures Commission Merchant, Swap Dealer, or Major Swap Participant (CFTC RIN 3038-AC96)

Dear Mr. Stawick:

Better Markets, Inc.<sup>1</sup> appreciates the opportunity to comment on the above-captioned proposed rules (the "Proposed Rules") of the Commodity Futures Trading Commission ("CFTC"), the purpose of which are to require each futures commission merchant ("FCM"), swap dealer ("SD") and major swap participant ("MSP") to designate a chief compliance officer ("CCO"), prescribe the qualifications and duties of each CCO and require that each CCO prepare, certify and furnish to the CFTC an annual report relating to compliance activities, all as required by provisions of the Dodd-Frank Financial Services Reform Act (the "Dodd-Frank Act").

## **Introduction**

We propose that the role of boards of directors relating to CCOs as set forth in the Proposed Rules be expanded, clarified and made more specific.

The Dodd-Frank Act changes the fundamental regulatory approach to derivatives market participants. For many years, market participants operated in an environment in which regulation was viewed as an obstacle to doing business. Changing this corporate culture requires attention from the highest levels of the corporate entity, and that means the Board

---

<sup>1</sup> Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

of Directors generally, and the independent members of the Board in particular. If there is any hope of effective CCOs, then the independent members of boards of directors will be crucial to addressing embedded anti-regulatory corporate cultures. Exclusive or primary reliance on executives to guide compliance policies would be inappropriate and almost certainly ineffective, as the history of market participants has repeatedly demonstrated.

We fully support the extension of duties specified in the Dodd-Frank Act for CCOs of SDs and MSPs to CCOs of FCMs. The FCMs occupy a critical role in the market, which will be expanded dramatically by the increased use of clearing as required by the Dodd-Frank Act. The role of CCO at an FCM parallels the role of CCO at SDs and MSPs and their duties must be parallel as well.

In addition, we propose specific additions to the Proposed Rules that will promote and protect the independence of CCOs. The pressures that can be brought to bear in the high-speed and immensely profitable and risky world of derivatives trading must be recognized. Moreover, the compensation practices, largely based on bonuses measured by individual profit and loss, that generate pressure to avoid compliance to generate profits must be expressly addressed in these rules as they relate to the CCO.

A CCO can be effective only if he or she is free from direct and indirect influences of individuals who are judged based on the profits and losses of the operations.

### **Regulatory Authority and Proposed Approach**

The Dodd-Frank Act requires the designation of a CCO by each SD and MSP<sup>2</sup> and by each FCM.<sup>3</sup> The duties and responsibilities of CCOs designated by SDs and MSPs are specified in detail in the Dodd-Frank Act.<sup>4</sup> With regard to CCOs designated by FCMs, the Dodd-Frank Act provides for “such duties and responsibilities as shall be set forth in regulations to be adopted by the Commission....”<sup>5</sup>

The Proposed Rules implement these provisions. The duties and responsibilities of CCOs designated by SDs and MSPs are parallel and implement those specified by the Dodd-Frank Act. The Proposed Rules appropriately adopt the same requirements relating to duties and responsibilities for CCOs designated by FCMs.

---

<sup>2</sup> Dodd-Frank Act, Section 731.

<sup>3</sup> Dodd-Frank Act, Section 732.

<sup>4</sup> Dodd-Frank Act, Section 731.

<sup>5</sup> Dodd-Frank Act, Section 732.

## **Discussion of Proposed Rules**

### *Qualifications and Independence*

The Proposed Rules provide that a CCO constitutes a “principal” under CFTC regulations.<sup>6</sup> They require that a CCO “shall have the background and skills appropriate for fulfilling the responsibilities of the position.”<sup>7</sup>

As suggested in the discussion of the Proposed Rules, we propose a limitation on a CCO’s qualifications to increase the likelihood of independence, in fact: a CCO must not also be an attorney (such as in-house general counsel), which represents the SD, MSP or FCM, or its board of directors. The potential conflict between the duties of a CCO and such an attorney disqualifies such an attorney from this position. An attorney in this position is an advocate for the SD, MSP or FCM or its board of directors regarding any controversy that may relate to regulatory compliance. The roles are simply incompatible.

### *Affiliates*

The Proposed Rules must address the issue of affiliates and controlled groups. Compliance should be addressed based on the entire group. An affiliated organization should not provide a vehicle for avoidance of compliance with rules. A single senior CCO should have overall responsibility of each affiliated and controlled entity, even if individual entities within the group have CCOs. The annual report on compliance should likewise address both group and individual entity compliance.

### *The Role of Boards of Directors and Conflicts of Interest*

The business realities of SDs, MSPs and FCMs are unique. Inherently, they involve rapid decision-making with consequences to profits and losses that can be large. Furthermore, individual compensation is often based on bonuses that are mathematically related to trading profits and losses. This compensation arrangement greatly enhances the intensity of the pressures to generate profits by taking on risk.

The duties of a CCO will often come into conflict with the perceived interests of traders and managers in an intense and pressurized environment and one in which the trading and decision-making is lightning fast. One duty specified in the Proposed Rules is resolution of conflicts of interest, which will be particularly contentious.<sup>8</sup> In these businesses, the explicit and implicit barriers to independent judgment related to compliance (which often is a perceived obstacle to profitable trading) are unusually large.

The independent members of the boards of directors are, by design, independent from senior management. Compliance is less likely to be viewed by them as an obstacle and more likely to be viewed as an independently significant goal.

---

<sup>6</sup> Proposed Rules, Section 3.1(a).

<sup>7</sup> Proposed Rules, Section 3.3(b).

<sup>8</sup> Proposed Rules, Section 3.3(d)(2).

We propose the following provisions be added to the Proposed Rules to address the need for independence of a CCO from traders and managers:

1. The decisions to designate or terminate a CCO (or to materially change the CCO's position or responsibilities) should be the sole responsibility of the independent members of the board of directors (or Audit Committee)<sup>9</sup> acting by majority vote, and not the responsibility of any executive officer.
2. While day-to-day reporting responsibility of a CCO will inevitably be to an executive officer, the CCO must also have a direct reporting line to the independent directors and the CCO should meet with and report to the independent directors no less than once a quarter.
3. Compensation of a CCO should be the sole responsibility of the independent members of the board of directors, and not the responsibility of a senior officer.
4. A CCO's office should be located remotely from a trading floor.
5. Discussions between a CCO and traders or executives with oversight responsibility over traders involving trading practices and strategies and compliance should be recorded by the CCO and retained in his or her records.

The Proposed Rules require that the CCO meet with the board of directors *or* senior officer to discuss the effectiveness of compliance policies at least once each year.<sup>10</sup> The "or" must be changed to "and." As suggested above, a meeting once a year will be insufficient for the independent members of the board of directors to become adequately familiar with the compliance issues faced by the CCO and the entity. Thus, the CCO should meet at least quarterly with the independent directors. This will provide the foundation for the independent members of the board of directors to become truly effective partners with the CCO in promoting compliance and it will make it much less likely that the CCO will succumb to the inevitable intense pressure to permit highly lucrative, but highly risky and inappropriate practices.

The importance of these changes to the proposed rules simply cannot be overstated, as highlighted by a telling observation in Raghuram Rajan's award-winning book Fault Lines: How Hidden Fractures Still Threaten the World Economy:

"I remember a meeting between risk managers of the major banks and academics in the spring of 2007 at which we academics were surprised that the managers were not more worried about the risks stemming from the plunging housing market. After our questions elicited few satisfactory replies, one astute veteran risk manager

---

<sup>9</sup> Given their responsibilities and expertise, we believe that it would be best for the CCO to report to the audit committee of the board of directors, unless the entity does not have an audit committee, in which case the CCO should report to the independent members of the board of directors. Therefore, whenever we refer to "independent directors" in this letter, it means the audit committee for any entity having an audit committee.

<sup>10</sup> Proposed Rules Section 3.3(a)(1).

took me aside during the break and said: 'You must understand, **anyone who was worried was fired long ago** and is not in this room.' Top management had removed all those who could have restrained the risk taking precisely at the point of maximum danger."<sup>11</sup>

This isn't to suggest that a strong reporting and working relationship between independent directors and the CCO are all that are needed. The most senior executives of a firm must also fully support the CCO. For example, the CEO of one major bank that survived the crisis relatively well was personally involved in increasing the pay of risk managers and ensuring that they had stature and authority.<sup>12</sup>

Also, the Proposed Rules specify several activities that are to be undertaken in consultation with the board of directors *or* the senior officer: development and enforcement of policies and procedures;<sup>13</sup> establishing compliance policies;<sup>14</sup> resolving conflicts of interest;<sup>15</sup> establishing procedures for the remediation of noncompliance issues;<sup>16</sup> and establishing procedures for responses to noncompliance issues.<sup>17</sup> In each of these cases, the consultation should be with *both* the independent members of the board of directors *and* the senior officer.

It is also important that the CCO meet with the entire Board of Directors, which should also be done on a regularly scheduled basis. The executive officers on the Board bring knowledge and a perspective that is valuable and necessary to compliance, but it is not sufficient.<sup>18</sup> Ideally, the independent members of the board and the executive officers, working with the CCO, will together usher in an optimal compliance regime that is both robust and effective while being appropriately tailored to the particular business.<sup>19</sup>

Finally, the duty of the CCO to prepare an annual report as to compliance, certify the report and furnish the report to the CFTC is central to the efficacy of the Proposed Rules. Under the Proposed Rules, the report must be furnished to the board of directors or the senior officer.<sup>20</sup>

We propose that the CCO present his or her finalized report to the board of directors and executive management prior to its submission to the CFTC. In addition, we propose that the independent directors as well as the entire Board be required to review and approve

---

<sup>11</sup> Page 141 (emphasis added).

<sup>12</sup> *Id.* At 144.

<sup>13</sup> Proposed Rules Section 3.3(a).

<sup>14</sup> Proposed Rules Section 3.3(d)(1).

<sup>15</sup> Proposed Rules Section 3.3(d)(2).

<sup>16</sup> Proposed Rules Section 3.3(d)(4).

<sup>17</sup> Proposed Rules Section 3.3(d)(5).

<sup>18</sup> *See*, Rajan, *Id.* At 165. ("[A] board can obtain better information if the risk managers in the firm are required to report directly to it on a regular basis.")

<sup>19</sup> This structure should avoid a common complaint about board members: "Board members are generally poorly informed when they are truly independent, and excessively cozy with management when they are not." *Id.*

<sup>20</sup> Proposed Rules Section 3.3(d) [the Proposed Rule includes two such subparagraph (d)'s and this refers to the second one].

Mr. David A. Stawick

Page 6

the report in its entirety or to detail where and why it disagrees with any provision. The CCO should be required to then file the report with the CFTC, either as approved or with statements of disagreement.

### **Conclusion**

The role of CCO and the required annual compliance report as set forth in the Proposed Rules is critical to the requirements of the Dodd-Frank Act. The unique characteristics of the derivatives trading business require that the issues of independence and conflicts of interest relating to CCOs be addressed carefully.

We hope these comments are helpful in your consideration of the Proposed Rules.

Sincerely,



Dennis M. Kelleher  
President & CEO

Wallace C. Turbeville  
Derivatives Specialist

Better Markets, Inc.  
Suite 307  
1225 Eye Street, N.W.  
Washington, D.C. 20005  
(202) 481-8224  
[dkelleher@bettermarkets.com](mailto:dkelleher@bettermarkets.com)  
[wturbeville@bettermarkets.com](mailto:wturbeville@bettermarkets.com)

[www.bettermarkets.com](http://www.bettermarkets.com)