February 11, 2011

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

Re: General Regulations and Derivatives Clearing Organizations (CFTC RIN 3038-AC98)

Dear Mr. Stawick:

Better Markets, Inc.[1] 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 (a) to establish regulatory standards for compliance with certain derivatives clearing organization ("DCO") core principles and chief compliance officer ("CCO") requirements, (b) to revise procedures for DCO registration, (c) to add requirements for approval of DCO rules establishing a portfolio margining program for certain customer accounts, and (d) to update certain definitions and add other definitions of certain terms, all as required by or pursuant to provisions of the Dodd-Frank Financial Services Reform Act (the "Dodd-Frank Act").

Introduction

The Proposed Rules cover several topics. Our comments address CCO issues and certain definitions.

Chief Compliance Officers

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.

[1] 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.

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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 of Directors generally, and the independent members of the Board in particular. If there is any hope of having 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.

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 immensely profitable world of derivatives trading must be recognized. The financial performance of a DCO (and its executives) is measured by the volumes provided by members. DCO members (who constitute the customers of the DCO) are uniquely involved in operations. Structural independence of the CCO from the pressures of this system is critical.

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.

Definitions

Two of the definitions, those relating to "initial margin" and "spread margin," must be made more specific to avoid inappropriately restrictive interpretations.

Two other definitions, those relating to "back testing" and "stress testing," must be amended so that they both work better when read together and reflect the practical realities of DCO practices and operations.

Discussion of Proposed Rules Related to CCOs

The Dodd-Frank Act requires the designation of a CCO by each DCO.[2] The duties and responsibilities of CCOs designated by DCOs are specified in detail in the Dodd-Frank Act

> The chief compliance officer shall—
>
> (A) report directly to the board or to the senior officer of the derivatives clearing organization;

[2] Dodd-Frank Act, Section 725(b).

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> (B) review the compliance of the derivatives clearing organization with respect to the core principles described in subsection (c)(2);
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> (C) in consultation with the board of the derivatives clearing organization, a body performing a function similar to the board of the derivatives clearing organization, or the senior officer of the derivatives clearing organization, resolve any conflicts of interest that may arise;
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> (D) be responsible for administering each policy and procedure that is required to be established pursuant to this section;
>
> (E) ensure compliance with this Act (including regulations) relating to agreements, contracts, or transactions, including each rule prescribed by the Commission under this section;
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> (F) establish procedures for the remediation of noncompliance issues identified by the compliance officer through any—
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> (i) compliance office review;
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> (ii) look-back;
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> (iii) internal or external audit finding;
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> (iv) self-reported error; or
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> (v) validated complaint; and
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> (G) establish and follow appropriate procedures for the handling, management response, remediation, retesting, and closing of noncompliance issues.[3]

In addition, the Dodd-Frank Act requires that each CCO annually prepare, sign and file with the CFTC a report relating to compliance.[4]

The Proposed Rules implement these provisions.

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[3] Id.

[4] Id.

The Role of Boards of Directors and Conflicts of Interest

The business realities of DCOs are unique. Clearing members are both the customers of the DCO and the sources for capital infusion if required as a result of inadequacy of resources on default. As a result, members are responsible for the financial results of a DCO and, at the same time, can exert great influence over its activities because of the unusual allocation of risks.

The duties of a CCO will often come into conflict with the perceived interests of clearing members and, as a consequence, management whose compensation may well depend on revenues derived from volumes of transactions cleared. One duty specified in the Proposed Rules is resolution of conflicts of interest, which will be particularly contentious.[5] In these businesses, the explicit and implicit barriers to independent judgment related to compliance (which often is a perceived obstacle to profitability) 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.

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)[6] 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.

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.[7] The "or" must be changed to "and." As suggested above, a meeting once a year will be insufficient for the

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5 Proposed Rules, Section 39.10(b)(2)(ii).

6 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.

7 Proposed Rules Section 39.10(c)((1)(ii)..

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 arising from clearing members.

The importance of these changes to the Proposed Rules simply cannot be overstated, as highlighted by a telling observation relating to bank risk managers (who are subject to influences similar to those that will be experienced by CCOs) 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 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.[8]

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 DCO 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.[9]

Also, the Proposed Rules specify that resolving conflicts of interest must be undertaken in consultation with the board of directors *or* the senior officer.[10] 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.[11] 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.[12]

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8 Page 141 (emphasis added).

9 Id. At 144.

10 Proposed Rules Section 39.10(c)(2)(ii).

11 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.")

12 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.

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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.[13]

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 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.

Qualifications and Independence

The Proposed Rules require that a CCO "shall have the background and skills appropriate for fulfilling the responsibilities of the position."[14]

As suggested in the discussion of the Proposed Rules, we propose a limitation on a CCO's qualifications to increase the likelihood of independence: a CCO must not also be an attorney (such as in-house general counsel), which represents the DCO 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 DCO 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.

Discussion of Proposed Rules Related to Definitions

The Proposed Rules add certain definitions to the CFTC's regulations.

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[13] Proposed Rules Section 39.10(c)(4)(i).
[14] Proposed Rules, Section 39.10(c)(ii).

"Initial margin" is defined in Part 1 of the CFTC's Regulations as:

> money, securities, or property posted by a party to a futures, option, or swap as performance bond to cover *potential future exposures arising from changes in the market value of the position*. [Emphasis added][15]

Initial margin is, in this formulation, largely defined by a purpose – covering *future exposures arising from changes in a position's market value.* The emphasis of a time period – here, the future – introduces unnecessary ambiguity. At any given point in time, the market price change which could result in losses covered by initial margin might actually be in the past. The actual time period embedded in the concept starts at the most recent moment that the maintenance margin was set based on a mark-to-market or mark-to-index. But, more importantly, if the most recent mark did not in fact reflect a market price, this off-market mark could result in a loss on default. The risk of this happening is particularly high for contracts that are marked in order to set maintenance margin using index algorithms. If maintenance margin is inaccurately measured, initial margin is available and would be used to cover resulting losses. Therefore, a definition based exclusively on future price changes is conceptually inadequate.

Thus, the emphasized language in the block quote above should be replaced with "exposure to losses in excess of amounts held as maintenance margin," so that it reads as follows:

> money, securities, or property posted by a party to a futures, option, or swap as performance bond to cover exposure to losses in excess of amounts held as maintenance margin

If needed, methods of calculation can be dealt with elsewhere.

"Spread margin" is defined as:

> reduced initial margin that takes into account correlations between certain related positions held in a single account.[16]

This definition omits certain key characteristics of netting initial margin which are needed to precisely define spread margin. The quoted language should be replaced by the following:

> initial margin relating to two positions in a single account that has been reduced from the aggregate initial margin otherwise applicable to the two positions by application of an algorithm that measures statistical correlations between the historic price movements of the two positions.

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[15] Proposed Rules, Section 1.3(lll).
[16] Proposed Rules, Section1.3(nnn).

The Proposed Rules also add definitions for the term "back test" and "stress test" to Part 39 of the CFTC's Regulations:

> *Back test* means a test that compares a derivatives clearing organization's initial margin requirements with historical price changes to determine the extent of actual margin coverage.
>
> ***
>
> *Stress test* means a test that compares the impact of a potential price move, change in option volatility, or change in other inputs that affect the value of a position, to the financial resources of a derivatives clearing organization, clearing member, or large trader, to determine the adequacy of such financial resources.[17]

These two definitions are connected because they are tests related to price movements. They also share a less obvious issue related to the fact that, uniformly, a DCO's margin level is based on statistical analysis of historic price moves. As a result, back testing, as defined, could yield a result that is little more than a confirmation that the statistical analysis was properly applied. And the stress test, if based on historic precedent, could inevitably result in a finding that resources are adequate.

It is difficult to comment with specificity on these definitions without clarity on each place in the regulations in which they are used. However, in general, a back test is only useful with respect to the accuracy of the algorithms used by the clearinghouse to calculate initial margin. A stress test, on the other hand, can be extremely useful, *but only if it tests unprecedented circumstances of illiquidity, volatility and other factors.* It **cannot** be based on historic price data, which would make the stress tests virtually meaningless.

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 clearing business require that the issues of independence and conflicts of interest relating to CCOs be addressed carefully.

In addition, the definitions added by the Proposed Rules must be closely aligned with the real world functions of DCOs.

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[17] Proposed Rules, Section 39.1(b).

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

Sincerely,

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