

J.P.Morgan

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Securities and Exchange
Commission
100 F Street, N.E.
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February 11, 2011

Re: 17 CFR Part 39 Risk Management Requirements for Derivatives Clearing Organizations 76 Fed. Reg. 3698.

RIN 3038-AC98

We welcome the opportunity to provide comments to the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") (each "the Commission" and together the "Commissions") with respect to Risk Management Requirements for Derivatives Clearing Organizations.

J.P. Morgan is committed to clearing OTC transactions and in fact we have been clearing dealer to dealer OTC transactions for a decade. We have made significant investments in our client clearing franchise and we employ several hundred people in support of our client clearing service.

We support the implementation of the core principles with respect to the requirements regarding clearing, trade execution and transparency set out by Congress in the Wall Street Reform and Consumer Protection Act (the "Act"). Whilst we understand that for efficiency reasons it may be necessary to issue separate proposed regulations implementing various aspects of the framework introduced by the Act, in our view the only way to increase systemic stability in preparation for the next downward cycle, is to look at the systemic changes introduced by the Act and related regulations as the interlinked components of a coherent whole, which must be viewed in their entirety before any one regulation goes live on its effective date.

To this effect, our comment letters taken together form part of a comprehensive commentary, aimed at supporting the implementation of the Act by indicating the elements which in our view will increase systemic stability as well as those which we believe may go against the stated principles of the Act and result in an increase in systemic risk, a decrease in liquidity or both. We refer to our comment letters dated November 17, 2010 regarding proposed financial resources requirements of derivatives clearing organizations and proposed limits on the ownership of clearing houses, SEFs and exchanges¹. We also refer to our letter dated January

¹ Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest -75 Fed. Reg. 63732 (October 18, 2010); Financial Resources Requirements for Derivatives Clearing Organizations - 75 Fed. Reg. 63113 (October 14, 2010); and Ownership Limitations and Governance Requirements for

12, 2011 regarding proposed post trade transparency regulations². We are in the process of writing additional comment letters, which we intend to be part of a comprehensive commentary on proposed regulation.

J.P.Morgan supports open access to clearing houses with a risk based framework that allows clearing members to clear client and house activity in proportion to their capital. By linking the amount of required capital to a clearing member's activity, the clearing house can ensure that it has sufficient financial resources and liquidity to absorb losses caused by the failure of a clearing member or one of its clients and, at the same time, provide access to a wider range of clearing members.

This is the approach adopted by the CFTC in the U.S. futures markets. It is also the approach with respect to cleared swaps, which is set out in the proposed Risk Management Requirements for Derivatives Clearing Organizations (DCOs) announced by the CFTC on December 16, 2010. The rules proposed by the CFTC prohibit DCOs from establishing minimum capital requirements on clearing members that exceed \$50MM. However, the rules permit a DCO to scale its risk tolerance to clearing members in proportion to their respective capital levels.

We support the CFTC proposed approach so long as clearing houses are required, rather than simply being permitted, to scale their risk tolerance to clearing members in proportion to their respective capital levels. We believe that a cap on a member's minimum capital requirement does not impact the systemic stability of a clearing house as long as: (1) clearing members clear house and client business in proportion to their available capital; (2) clearing houses employ real-time risk management processes to ensure compliance with this principle; (3) clearing houses hold a sufficient amount of margin and funded default guarantee fund; and (4) regulators monitor the ability of clearing members to meet their financial obligations with respect to all clearing houses of which they are members. It would be appropriate for regulators to perform this monitoring function by adopting a risk based assessment of the member's ability to pay guarantee fund and margin when required by the clearing houses of which it is a member.

In considering the clearing house membership requirements, it is important to keep in mind the nature of a clearing house. A clearing house is structured to provide for mutual sharing of counterparty risk among members. Each clearing member is exposed to the counterparty credit risk of all other members and, by extension, all clients clearing trades via such other members. Clearing houses themselves provide a very small portion of the capital which backs the performance of the clearing house, and the vast majority of the financial resources of a clearing house is provided by the members through their contributions to the guaranty fund as well as collateral posted by the clearing members. To the extent of their liability, each member is abdicating risk management of its capital to the clearing house. In addition, the risk management framework of a clearing house is heavily reliant not only on the capital and liquidity of its members but also on each member's risk management and operational capabilities. A clearing house that is prudently managed must have adequate margin and guarantee fund resources and must refresh its calculations daily and intraday to adjust its resources to changing market conditions.

Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps Under Regulation MC -75 Fed. Reg. 65882 (October 26, 2010).

² CFTC Proposed Rule On Real Time Public Reporting Of Swap Transaction Data – 75 Fed. Reg. 76140 (December 7, 2010) and SEC Proposed Regulation SBSR - Reporting And Dissemination Of Security Based Swap Information – 75 Fed. Reg. 75008 (December 2, 2010). Our letters are available on the comments sections of the website of each Commission. We can provide additional copies upon request.

Clearing House “Skin In The Game” Contribution To Its Own Financial Safeguards Package

In our view, the implementation of prudent risk management methodologies by clearing houses is a key step towards greater systemic stability. This can be achieved by establishing a direct link between the earnings that a clearing house derives from cleared activity and the contribution of that clearing house to its own financial safeguards package. We would support regulations that require a CCP to retain in a segregated deposit account, on a rolling basis, 50% of the earnings from the previous 4 years. We observe that this amount would represent approximately 10% of the clearing house enterprise value, therefore achieving a reasonable balance between risk and reward for clearing house shareholders. In addition, it would be appropriate for at least 50% of the retained earnings to have a first loss position in the financial waterfall. This solution would accomplish the goal of greater systemic stability, and would scale over time the contribution by the clearing house to its own financial safeguards package without large decreases or increases at any one resizing date. We recommend that the clearing house contribution be subject to a minimum floor of \$50MM, to provide adequate protection and provide increased confidence in the markets while market participants ramp up access to clearing services.

(1) Members Clearing In Proportion To Their Capital:

As a systemically important institution, a clearing house must ensure that each member has: (a) the financial means to withstand another member's default or multiple member defaults occurring within a short time period; and (b) risk management resources to assist the clearing house in its risk management processes. Linking the amount that can be cleared by a member to that clearing member's available capital is a key prerequisite to enabling clearing houses to provide open access to clearing services. This will establish a direct relationship between the amount of risk introduced by a clearing member and the ability of that clearing member to contribute to the financial resources needed to support losses that may result from that member's clearing activity.

As we noted in our comment letter dated November 17 addressed to the CFTC and SEC regarding financial resources requirements for derivatives clearing organizations and ownership limitations on clearing houses, a clearing member may have committed to additional unfunded assessments at more than one clearing house. We believe it would be appropriate for regulators to adopt a risk based analysis to assess and monitor the ongoing likelihood that a clearing member will be able to meet its contingent obligations across all clearing houses. This framework will require greater supervision by regulators and clearing houses to ensure that clearing members have sufficient liquid resources to support the business they clear in each of the clearing houses they face. Another key aspect of this framework is the implementation by clearing houses of capped liability for members so that members and their respective regulators can monitor funded and unfunded contributions, both actual and expected.

Regulatory oversight would require a system-wide monitoring of a risk-based cap on the exposure of a clearing member to the clearing houses it faces. Given the global nature of the markets, international cooperation between regulators would be essential. In our view some existing infrastructure could be leveraged for this purpose, such as the OTC Derivatives Regulators' Forum (ODRF)³—a group comprised of over 50 financial regulators from around the world; or the CPSS-IOSCO working group jointly established by the Committee on Payment and

³ For a list of members, see <http://www.otcdrf.org/about/members.htm>

Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO)²¹⁵⁴.

(2) Real Time Risk Management Systems And Processes: Credit Limits, Additional Margin, Additional Default Guarantee Fund Contributions:

We believe each clearing house should establish risk-based position limits for each of its members and monitor exposures against these limits on a real time basis. The purpose of these limits would be to contain any unsecured exposure or concentration from any one member firm. In setting the position limits applicable to any one member the clearing house should consider its overall exposure to members in the aggregate.

(3) Sufficient Amount Of Margin And Funded Default Guarantee Fund:

Adequate margin and guarantee funds are two of the most important measures in maintaining the safety and soundness of the clearing system. Intraday margin calls with greater frequency and higher margin multipliers for members who present a higher risk profile should be adopted as part of the overall risk management framework.

We believe that rather than generating a pro-cyclical effect, the implementation of these procedures would result in a significant reduction of systemic risk. A higher clearing member risk profile may result from excessive concentration of risk cleared, reduced creditworthiness or from other factors affecting that member. Additional margin and guarantee fund requirements, including permissible multipliers tied to credit quality should be documented in risk management policies applicable to all members. The additional collateral and guarantee fund contributions would protect the clearing house against the risk of near-term default by the clearing member as well as acting as an incentive for the clearing member to de-risk. Clearing members not wishing to commit additional liquidity into the clearing house would de-risk their positions resulting in greater systemic stability.

(4) Sufficient Liquidity:

In our view it is necessary for clearing houses to maintain sufficient liquidity. This could be achieved through requiring that members post a minimum amount of liquid (cash and qualifying government securities) margin and default guarantee fund contributions with the clearing house. Alternatively, all clearing members could be required to participate in a liquidity facility. The liquidity facility could also be open to solvent market participants who are not clearing members.

Conclusion

In our view the various components of the risk management framework of a clearing house are interconnected and as such, must be considered in their entirety. For this reason, a low minimum capital requirement may be applied to clearing house members only in conjunction with, at a minimum, the implementation of the following prudent risk management requirements: (1) a direct relationship between the amount of risk that can be cleared by a clearing member and that clearing member's capital; (2) the implementation by the clearing house of real time risk management systems and processes, as well as active supervision by regulators; (3) a sufficient amount of funded default guarantee fund held by the clearing house; and (4) sufficient liquid resources held by the clearing.

⁴ For a list of members, see <http://www.bis.org/publ/cpss89.pdf>

Thank you for the opportunity to comment publicly on these important matters. Please contact J.P. Morgan should you wish to discuss these matters in greater detail.

Sincerely,



Barry L. Zubrow
Chief Risk Officer
JP Morgan Chase

cc:

Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott O'Malia, Commissioner

Honorable Mary L. Schapiro, Chairman
Honorable Elisse B. Walter, Commissioner
Honorable Kathleen L. Casey, Commissioner
Honorable Luis A. Aguilar, Commissioner
Honorable Troy A. Paredes, Commissioner