



February 14, 2011

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

Re: Information Management Requirements for 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 to establish standards for compliance by derivatives clearing organizations (“DCOs”) with certain Core Principles, make certain technical amendments to CFTC Regulations and delegate certain authority to the Director of the Division of Clearing and Intermediary Oversight, all as required by or pursuant to provisions of the Dodd-Frank Financial Services Reform Act (the “Dodd-Frank Act”).

Introduction

The Proposed Rules establish a much-needed and comprehensive structure for information flows from DCOs to the CFTC to enhance the ability of the CFTC to discharge its obligations under the Dodd-Frank Act. DCOs are entrusted with an expanded and crucially important role in the derivatives marketplace that is still emerging from the effects of the financial crisis. The CFTC must develop a thorough and timely understanding of the activities of DCOs to guard against the systemic risks which arose from the explosive growth of derivatives trading over the last 20 years.

While the structure of the Proposed Rules establishes a strong reporting regime, several specific reporting requirements must be refined to be truly effective, as described below.

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.

In addition, the information required to be made available to market participants and the public must specifically include several matters which must be reported to the CFTC.

Discussion of Proposed Rules

The Dodd-Frank Act amended the Commodity Exchange Act provisions establishing Core Principles relating to reporting and recordkeeping by DCOs.² The Proposed Rules implement these amendments.

Credit Facility Funding Change

Although appearing near the end of the list of reporting obligations in the Proposed Rules, changes to facility funding arrangements are critically important notifications to the CFTC. Reporting is required as follows:

No later than one business day after a derivatives clearing organization changes a credit facility funding arrangement it may have in place, is notified that such arrangement has changed, or knows or reasonably should have known that the arrangement will change, including but not limited to a change in lender, change in the size of the facility, change in expiration date, or any other material changes or conditions.³

For any entity holding positions in the derivatives markets, including a DCO, the activities of the financial institutions that provide liquid funding are important indications of potential threats to such entity. These activities are like a canary in a mineshaft.

Liquid funding is central to the continued viability of any entity which is subject to market price risk and severe disruption. Loss of the source of such funding can be lethal. Because of this, the Proposed Rule quoted above is both too narrow and too loose.

First, the Proposed Rule must explicitly ***cover access to commercial paper and repurchase agreement markets***. While changes to credit facilities are unquestionably important, they are not the exclusive means for liquid funding. Material changes in access to these alternative sources of liquidity are just as important.

Second, ***the timing should be immediate, not within a business day***. While certain matters covered may not require immediate notice, those that do are likely to be very significant and require immediate attention.

² Dodd-Frank Act, Section 725(c).

³ Proposed Rules, Section 31.19(c)(4)(xii).

Third, the proposed knowledge standard is “knows or reasonably should have known that the arrangement will change.” The standard must be expanded to include knowledge that ***“there is reasonable likelihood that the arrangement may change.”***

Decrease in Financial Resources

One of the reporting requirements covers decreases in financial resources of a DCO:

If there is a decrease of 10 percent in the total value of the financial resources required to be maintained by the derivatives clearing organization ... either from the last quarterly report submitted... or from the value as of the close of the previous business day, the derivatives clearing organization shall report such decrease to the Commission no later than one business day following the day the 10 percent threshold was reached. The report shall include:

(A) The total value of the financial resources:

(1) as of the close of business the day the 10 percent threshold was reached, and

(2) if reporting a decrease in value from the previous business day, the total value of the financial resources immediately prior to the 10 percent decline;

(B) A breakdown of the value of each financial resource reported in each of paragraph... (1) and (2)... including the value of each individual clearing member’s guaranty fund deposit if the derivatives clearing organization reports guaranty fund deposits as a financial resource; and

(C) A detailed explanation for the decrease.⁴

The foregoing rule must better reflect the very different characteristics of the various components of “financial resources.” Maintenance margin can fluctuate substantially based on changes in open interest and in market prices. Initial margin is often adjusted to reflect market conditions. Changes for these reasons are of interest, but not of concern.

However, reduction in other financial resources, such as the DCO’s own capital, guaranty funds, default insurance and assessments, and facilities are of much greater concern. That

⁴ Proposed Rules, Section 31.19(c)(4)(i).

concern is just as important if such a reduction is offset by *coincidental increases* in margin-based resources, which are hydraulically related to risk exposures. ***The Proposed Rules should set a threshold for reporting decreases in non-margin based financial resources at a level of 5 percent of those resources.***

In addition the focus of the Proposed Rules should be expanded. As proposed, it is designed to capture decreases in financial resources. ***The focus should also be on the adequacy of financial resources.*** Resources can become inadequate if available financial resources are reduced, but they can also become inadequate if the *required level* of financial resources increases substantially. These requirements are addressed in a prior proposed rule of the CFTC.⁵ There is little doubt that DCOs continuously monitor the relationship between financial resources and CFTC regulatory requirements; it would, in fact, be a troubling omission by management if a DCO did not monitor this relationship.

In addition to reporting on decreases in financial resources, the Proposed Rules must require reporting if the ***ratio of financial resources to minimal required levels decreases to 1 to 1.*** This will alert the CFTC that the level of financial resources, as required by CFTC regulation, may no longer be sustained.

Decrease in Ownership Equity

The Proposed Rules require reporting of certain decreases in ownership equity amounts:

No later than two business days prior to an event which the derivatives clearing organization knows or should reasonably know will cause a decrease of 20 percent or more in ownership equity from the last reported ownership equity balance as reported on quarterly or audited financial statements... but in any event no later than two business days after such decrease in ownership equity for events that caused the decrease for which the derivatives clearing organization does not know and reasonably should not have known about prior to the event. The report shall include:

- (A) Pro forma financial statements reflecting the DCO's estimated future financial condition following the anticipated decrease for reports submitted prior to the anticipated decrease and current financial statements for reports submitted after such a decrease; and

⁵ CFTC Release, October 14, 2010, Financial Resource Requirements for Derivatives Clearing Organizations, 75 FR 63113.

(B) Details describing the reason for the decrease or anticipated decrease in the balance.⁶

The events that trigger reporting under the above provision are extraordinary and dramatic. However, a change in ownership at levels far lower than the 20 percent threshold set forth is an event that should, at least, be monitored. Moreover, any such change is very likely to be anticipated for an extended period of time.

The CFTC should look to the rules of the Securities Exchange Commission addressing reporting thresholds for acquisition of interests in reporting companies. Acquisition of beneficial ownership of **5 percent** of a class of shares triggers reporting obligations.⁷ Because of the unique position of DCOs in the derivatives marketplace, the reporting threshold must be no higher than 5 percent, and most certainly not as high as 20 percent.

In addition, the time period for notice prior to the event causing the decrease must be longer. A longer period permits reaction by the CFTC and is in no way a burden to the DCO. The period should be increased to not less than 5 business days.

Change in Working Capital

The Proposed Rules require notice to the Commission no later than two days after a DCO's working capital becomes negative.⁸ ***Given the potential gravity of such an event, anything less than a requirement for immediate notification is simply indefensible.***

Intraday Initial Margin Calls

The Proposed Rules require notice to the CFTC within one hour of any intra-day margin call to a clearing member.⁹ Intraday margin calls are critical early warning signals of rapidly increasing positions. ***The notice should be immediate; a DCO is clearly capable of constructing its systems so that an intraday margin call automatically triggers notice.***

⁶ Proposed Rules, Section 31.19(c)(4)(ii).
⁷ Securities Exchange Commission, Rule 13d-1.
⁸ Proposed Rules, Section 31.19(c)(4)(iv).
⁹ Proposed Rules, Section 31.19(c)(4)(v).

Change in Ownership or Corporate Organization Structure

The Proposed Rules require advance notice of certain changes in ownership or corporate organizational structure.

(A) Reporting Requirement. Any anticipated change in the ownership or corporate or organizational structure of the derivatives clearing organization or its parent company that would:

- (1) Result in at least a 10 percent change of ownership of the derivatives clearing organization,
- (2) create a new subsidiary or eliminate a current subsidiary of the derivatives clearing organization or its parent company, or
- (3) result in the transfer of all or substantially all of its assets, including its registration as a derivatives clearing organization to another legal entity.¹⁰

Similar to the above discussion in relation to decreases in ownership equity, these events are dramatic and anticipated well ahead of time. The 10 percent change of ownership threshold is simply too high, given the importance of the event and that it is a notification requirement. ***Based on other standards as cited above, the threshold should be 5 percent.***

Public Information

DCO Core Principle L¹¹ provides, in relevant part:

Each derivatives clearing organization shall provide to market participants sufficient information to enable the market participants to identify and evaluate accurately the risks and costs associated with using the services of the derivatives clearing organization.

Each derivatives clearing organization shall disclose publicly and to the Commission information concerning... the margin-setting methodology, and the size and composition, of the financial resource package of the derivatives clearing organization any other matter relevant to participation in the

¹⁰ Proposed Rules, Section 31.19(c)(4)(x).

¹¹ Dodd-Frank Act Section 725.

settlement and clearing activities of the derivatives clearing organization.

The Proposed Rules provide:

Each derivatives clearing organization shall provide to market participants sufficient information to enable the market participants to identify and evaluate accurately the risks and costs associated with using the services of the derivatives clearing organization.¹²

Each derivatives clearing organization shall disclose publicly and to the Commission information concerning... The size and composition of the financial resource package available in the event of a clearing member default; Any other matter that is relevant to participation in the clearing and settlement activities of the derivatives clearing organization.¹³

It is clear from the foregoing that the Dodd-Frank Act requires that market participants and the public be informed of the risks and other potential consequences of transacting with a DCO. Much of the information required to be transmitted to the CFTC under the Proposed Rules is directly relevant to these issues. For example, the level of financial resources can only be understood in the context of the *adequacy* of those resources. This is readily measured in relation to the level of resources established by regulations (which include important rules relating to valuation). Furthermore, decreases in ownership equity and changes in ownership or corporate structure can affect the very nature of the DCO as a venue for clearing.

The Proposed Rules must, at a minimum, specifically include the following required public disclosures under Section 39.21:

- The adequacy of its financial resources, measured by the required level of financial resources established under CFTC rules.
- Reduction in financial resources required to be reported to the CFTC.
- Decreases in ownership equity which must be reported to the CFTC.
- Changes in ownership or corporate structure which must be reported to the CFTC.

¹² Proposed Rules, Section 39.21(a).

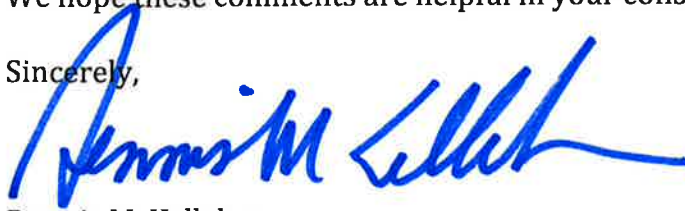
¹³ Proposed Rules, Section 39.21(c).

Conclusion

The continuing viability of DCOs is critical to the success of the market structure put in place by the Dodd-Frank Act. The CFTC can only fulfill its mission to monitor DCOs if it is promptly informed of important events. The Core Principles implemented by the Proposed Rule are fundamental to receipt of that information by the CFTC and its availability to market participants and the public.

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

Sincerely,



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