21 March 2011

Mr. David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: Risk Management Requirements for Derivatives Clearing Organizations – Federal Register Vol. 76, No. 13 3698 (January 20, 2011) RIN 3038-AC98

Dear Mr Stawick,

The Financial Services Authority ("FSA") is submitting this letter in response to the request for comment in respect to the rule proposals by the Commodity Futures Trading Commission ("the Commission") regarding risk management requirements for derivatives clearing organisations ("DCOs").

The FSA supports the September 2009 G20 commitment to improving the over-the-counter ("OTC") derivatives markets and the clearing through central counterparties ("CCPs") of standardised OTC derivative contracts. Regulatory authorities need to consider how existing market infrastructures can best play a role in meeting these commitments in an environment where CCPs are becoming increasingly systemically important. There is a clear need for stronger international standards for CCPs and the FSA is contributing to the work currently underway in developing such standards through, for example, the CPSS-IOSCO[1] work on principles for financial market infrastructure[2].

Risk management standards for CCPs must be anchored in the characteristics of the products being cleared, and the FSA recognises that different product types may require different clearing models. This can extend to participant eligibility in models where the clearing members are required to perform specific actions to assist in a member default, for example Interest Rate Swap clearing models that include an obligation to bid for, or be allocated, portfolios from the defaulting clearing member.

The Commission has requested comment on whether establishing a capital threshold on participants is an effective approach to promoting fair and open access to DCOs[3]. The FSA supports transparent and non discriminatory rules, based on objective criteria, governing access to CCPs. We note the CPSS-IOSCO proposed principle that CCPs should allow "fair

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[1] Committee on Payment and Settlement Systems (CPSS), International Organization of Securities Commissions (IOSCO)

[2] CPSS IOSCO Principles for financial market infrastructures – consultative report 2011

[3] Fed Register Vol. 76, No. 13 page 3701.

and open access to its services….based on reasonable risk-related participation requirements".[1] However whilst capital thresholds or other participation eligibility threshold[2] limitations may be a potential tool to help ensure fair and open access to CCPs, to impose them on clearing arrangements for products that have complex or unique characteristics could lead to increased risk to the system in the short to medium term.

Participation requirements sometimes need to be tailored to take into account the types of products being cleared by a CCP. For example the less liquid derivative markets typically require more complex default management processes that impose more onerous obligations on the participants than the exchange traded futures market. The ability of the surviving clearing members to meet their obligations in relation to default management is important in mitigating systemic risk in the event of a clearing member default.

As noted by CPSS-IOSCO in its consultation, a CCP should ensure that its participants "have the requisite operational capacity, financial resources, legal powers, and risk-management expertise so that their activities do not generate unacceptable risk for the [CCP] and other participants"[3]. Capital requirements, the "swap dealer" criteria and portfolio size or volumes have previously served as proxies for establishing that a clearing member meets these criteria. If such criteria are to be excluded, then CCPs must develop alternative membership criteria that ensure the CCP's own safety. Consideration should be given to the time required to develop such criteria.

CCPs must therefore set appropriate risk based membership criteria that test a clearing member's financial and operational ability to

(i) manage the default of one of their own clients (i.e. to hedge and liquidate positions); and

(ii) participate in the CCPs default management process without introducing risk to the system (for example bid accurately in a default auction, hedge any portfolios acquired in a default auction, or manage any risks presented by the forced allocation of a portfolio in a default process).

Potential clearing members who lack the requisite operational capacity, financial resources, legal powers or risk-management expertise to participate in a default management process might consider that they could source these capabilities from a more experienced third party in the event of a default. Outsourcing the clearing member responsibility to partake in the

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[1] CPSS IOSCO Principles for financial market infrastructures – consultative report 2011, Principle 18, Key consideration 1.

[2] Such as the Commission's proposals 39.12 (a) (1) (iv) "A derivatives clearing organization shall not require that clearing members must be swap dealers" , *ibid* (v) "A derivatives clearing organization shall not require that clearing members maintain a swap portfolio of any particular size, or that clearing members meet a swap transaction volume threshold.", and *ibid* (2)(iii) "A derivatives clearing organization shall not set a minimum capital requirement of more than $50 million

[3] CPSS IOSCO Principles for financial market infrastructures – consultative report 2011, Principle 18, 3.18.1

default management process to a third party could present additional risk to the system[1] and increase the cost for the participant.

A CCP may seek to reduce the relative impact of the default process on participants with lesser financial and operational ability by providing that their role in a default be proportional to the risk they introduce. As this would only limit the relative and not the absolute size of the risk (for example the size of portfolio that could be allocated to a clearing member in a default) this approach does not reduce the CCP's need to set the appropriate membership criteria needed to gauge the ability of the clearing member to engage fully in the default management process (including loss allocation).

Increasing the amount of margin called or contributions to the default fund does not compensate for the risk that a participant cannot participate in the default management process. Margin and default funds increase the time available to a CCP to liquidate its positions, but they do not directly assist the actual liquidation.

We note that the Commission proposes that CCPs may exclude or limit certain types of market participant if the CCP can demonstrate that "the restriction is necessary to address credit risk or deficiencies in the participants' operational capabilities that would prevent them from fulfilling their obligations as clearing members"[2]. If capital requirements, the "swap dealer" criteria and portfolio size or volumes are to be subject to limitation as criteria then we believe the Commission's exclusion should specifically extend to address clearing members whose operational capabilities would prevent them from fulfilling their obligations to the CCP to participate in a default management process.

The FSA therefore requests that when the Commission finalises its rules it takes into account that access should be based on proportionate risk-related participation requirements and that risks may be introduced into the system by universally prohibiting certain participant eligibility criteria.

Yours sincerely

Alexander Justham
Director, Market Division
Financial Services Authority

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[1] As well as adding legal and operational complexity at a time market stress, there is the risk that third parties might act differently than clearing members acting for themselves, given their different incentives.

[2] Fed Register Vol. 76, No. 13 39.12 (a)(1)(iii)