KANSAS CITY
BOARD OF TRADE
CLEARING CORPORATION

VIA ELECTRONIC SUBMISSION

Mr. David A. Stawick, Secretary
U.S. Commodity Futures Trading Commission
1155 21st Street, NW
Washington, D.C. 20581

March 21, 2011

Re: RIN 3038-AC98 - Risk Management Requirements for DCOs

Dear Mr. Stawick:

On January 11, 2011, the Commodity Futures Trading Commission ("Commission") published a Notice of Proposed Rulemaking regarding Risk Management Requirements for Derivatives Clearing Organizations ("Proposed Rule")[1] pursuant to Section 725(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[2] The Kansas City Board of Trade ("KCBT") and the Kansas City Board of Trade Clearing Corporation ("KCC") appreciate the opportunity to submit these comments on the Proposed Rule.[3]

KCBT is a designated contract market ("DCM") registered under Section 5a of the Commodity Exchange Act ("CEA"). KCBT was founded in 1856 by a group of Kansas City merchants, serving a function similar to a chamber of commerce, and was formally chartered in 1876. The exchange is located in Kansas City, one of the most productive wheat-growing regions in the world. Today, trading at KCBT is conducted by open outcry and electronic trading. Commercially-oriented cash grain trading is still the core business of many KCBT members.

Trading at KCBT primarily consists of hard red winter wheat futures and options.[4] The bulk of U.S. wheat production consists of hard red winter wheat and it is the primary ingredient in bread. Market participants look to the contract traded on KCBT as the international benchmark for global bread wheat prices. In 2010, KCBT traded nearly 5.7 million wheat futures contracts, equivalent to more than 28.5 billion bushels. KCBT wheat futures have a record of consistent growth, and volume as of 2010 had grown nearly 11 times over volume 20 years earlier.

KCC is a derivatives clearing organization ("DCO") registered with the Commission under Section 5b(a) of the CEA. KCC was established in 1913 and is wholly owned by the

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1 *Risk Management Requirements for Derivatives Clearing Organizations*, 76 Fed. Reg. 3698 (Jan. 11, 2011) (Notice of Proposed Rulemaking).

2 Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010).

3 References herein to KCC will generally refer to KCC and KCBT collectively.

4 *See* Products Traded at the KCBT, http://www.kcbt.com/kcbt_products.html.

KCBT. KCC clears KCBT derivatives on hard red winter wheat and certain other derivatives.[5] No customer of KCC has ever suffered a loss as a result of a clearing member ("CM") default. In fact, in the nearly 100 year history of KCC, no CM has ever defaulted on its obligations to KCC.

Sections I and II below outline our general comments on the shortcomings of the Proposed Rule, and Sections III through VIII provide more specific comments on the Proposed Rule.

I. The Commission has not Performed an Adequate Cost-Benefit Analysis

The Commission has not adequately considered the substantial costs that DCOs will incur in implementing the requirements of the Proposed Rule. In evaluating the costs, the Commission merely made the following statement:

> Section 15(a) of the CEA requires the Commission to consider the costs and benefits of its actions before issuing a rulemaking under the CEA. By its terms, section 15(a) does not require the Commission to quantify the costs and benefits of a rule or to determine whether the benefits of the rulemaking outweigh its costs; rather, it requires that the Commission "consider" the costs and benefits of its actions.[6]

CEA Section 15(a) may not specifically require the Commission to quantify costs associated with a rulemaking,[7] but it does require the Commission to carefully evaluate whether the costs associated with a proposal are accompanied by specific benefits. A cost-benefit analysis should address whether the specific requirements of the Proposed Rule enhance the risk management capacity of DCOs in comparison to presently existing risk management requirements based on the core principles for DCOs ("Core Principles"), which the Commission has reviewed and approved in the case of each registered DCO.[8]

The Commission's cost-benefit analysis should also consider the impact the Proposed Rule will have generally on the market for cleared derivatives in the United States. Significantly, the market for cleared derivatives is global, and the Proposed Rule may have competitiveness impacts on U.S. DCOs in relation to their non-U.S. counterparts. The Commission should consider the extent to which the Proposed Rule will push the market for

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[5] KCC has been granted permission to provide clearing-only services for calendar wheat swaps. *See Order Pursuant to Section 4(c) of the Commodity Exchange Act, Permitting the Kansas City Board of Trade Clearing Corporation To Clear Over-the-Counter Wheat Calendar Swaps*, 75 Fed Reg. 34983 (June 21, 2010). Margin associated with the swap is commingled with customer futures and options positions at KCBT, pursuant to Commission exemptive order.

[6] 76 Fed. Reg. at 3717.

[7] Whether the Commission has performed an adequate cost-benefit analysis is a larger question relevant to many of the rules the Commission has proposed under the Dodd-Frank Act. *See* Letter from Representative Frank D. Lucas, et. al to Commission Inspector General A. Roy Lavik, March 11, 2011, *available at* http://agriculture.house.gov/pdf/letters/cftc_inspectorgeneral110311.pdf. KCC has thus not endeavored a thorough critique of the cost-benefit analysis in this letter, but may offer the Commission further comments on the requirements of Section 15(a) with respect to cost-benefit analyses in the future.

[8] 7 U.S.C. § 7a-1(c)(2); 76 Fed. Reg. at 3699-70.

clearance of derivatives overseas.[9] A reduced pool of clearing members and cleared products will shrink the benefits that market participants receive from participation in a clearinghouse, increasing the cost of clearing and resulting in fewer cleared trades and more systemic risk to participants and clearinghouses.[10]

One of the primary goals of the Dodd-Frank Act was to move a greater proportion of derivatives activities into a cleared environment.[11] By imposing on DCOs high risk management costs that have no reciprocal risk reducing benefits, the Proposed Rule will increase the cost of clearing trades and, consequently, discourage market participants from clearing their trades. KCC therefore believes that certain aspects of the Proposed Rule are at odds with the priorities Congress outlined in the Dodd-Frank Act.

II. The Dodd-Frank Act Mandates Further Distinction in Regulatory Treatment of DCOs, Not a One-Size-Fits-All Approach

The Dodd-Frank Act generally mandates that, in imposing regulatory requirements on various institutions, the Commission should distinguish among those institutions with respect to the risk the institution poses to financial stability.[12] This theme is present throughout the Dodd-Frank Act. The Proposed Rule is inconsistent with this mandate in two respects: first, the Dodd-Frank Act does not specifically require the Commission to adopt rules implementing the Core Principles and, second, where the Dodd-Frank Act does require the Commission to adopt rules regarding DCOs, the Commission is required to distinguish among DCOs like KCC and DCOs that present heightened risks to U.S. financial stability.

A. The IOSCO One-Size-Fits-All Approach Is Inappropriate

Section 725(c) of the Dodd-Frank Act amends and replaces Section 5b(c)(2) of the CEA, regarding the Core Principles.[13] Generally, the Dodd-Frank Act amended the DCO Core Principles requirements by: (i) adding greater specificity to the requirements of certain existing Core Principles; (ii) adding four new Core Principles;[14] and (iii) clarifying that the Commission *may* by rule impose further requirements related to the Core Principles under the Commission's

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9 *See generally* Address by Commission Chairman James E. Newsome, at the Winter Meeting of the American Bar Association, Key West, Florida (Feb.13, 2004), *available at* http://www.cftc.gov/opa/speeches04/opanewsm-49.htm (discussing Eurex's plans for establishing a transatlantic clearing link for transactions entered into on a U.S. DCM).

10 Further, in light of the Commission's transparency policy, KCC requests that the Commission publically disclose its cost-benefit analysis. The Commission should consider retaining external consultants to analyze and calculate the costs and benefits that will flow from the Proposed Rule. The public deserves to understand how regulation will impact businesses that create jobs and provide valuable services to the U.S. economy.

11 *See generally* Brief Summary Of The Dodd-Frank Wall Street Reform And Consumer Protection Act *available at* http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf

12 *See id.*

13 7 U.S.C. § 7a-1(c)(2).

14 The four new Core Principles added by the Dodd-Frank Act are: governance fitness standards, conflicts of interest, composition of governing boards, and legal risk.

general rulemaking authority under Section 8a(5) of the CEA.[15] Generally, it is unclear why the Commission finds it necessary to further define each of the DCO Core Principles at this time, as the Dodd-Frank Act does not specifically mandate the Commission to do so. Neither the DCO Core Principles requirements of the CEA nor the changes thereto made by the Dodd-Frank Act specifically require the Commission to implement the statutory requirements by rule.

The overall complexion and structure of the Proposed Rule reflects the Recommendations for Central Counterparties issued jointly by the International Organization of Securities Commissions and the Bank for International Settlements ("IOSCO/BIS Recommendations").[16] The Commission should note that IOSCO and BIS prerogatives may differ greatly from the Commission's own regulatory mandates, both under the Dodd-Frank Act and under the CEA generally. For instance, former IOSCO Co-Chairman Andrew Sheng, signatory to the IOSCO/BIS Recommendations, advocated for the merger of the Commission with the Securities & Exchange Commission and recently suggested that state controlled capitalist systems and the U.S. open market system are converging as a result of the financial crisis.[17] Further, the non-governmental signatories to the IOSCO/BIS Recommendations are large global banks, which generally reflects the absence of input on the recommendations from small clearing organizations such as KCC, and the fact that the recommendations are a general set of norms which must be tailored to the risk management needs of specific clearing institutions.[18] IOSCO and BIS have acknowledged this shortcoming.[19]

The Commission should revisit the Proposed Rule with the experience and concerns of smaller clearing organizations like KCC and others in mind. Competition among DCOs generally results in each DCO adapting its risk management requirements to the needs of different types of CMs that specialize in different types of cleared products. The inflexible, one-size-fits-all approach embodied in the Proposed Rule will result in less diversity among DCOs, and consequently less competition and higher cost of cleared products. Such a result would discourage clearing of certain products, which is directly at odds with the goals of the Dodd-Frank Act.

B. The Commission Should Not Treat *All* DCOs as Beneficiaries of the Federal Safety Net

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15 7 U.S.C. § 12a(5).

16 Recommendations for Central Counterparties (March 2004), *available at* http://www.bis.org/publ/cpss61.pdf. The IOSCO/BIS Recommendations were published originally in 1999 and revised approximately six years ago by the BIS Committee on Payment and Settlement Systems and IOSCO's Technical Committee, comprised of domestic and foreign regulatory authorities and international banks.

17 *See* Foreword to Y. V. Reddy, GLOBAL CRISIS, RECESSION AND UNEVEN RECOVERY (2011).

18 Note that IOSCO and BIS are currently reviewing the recommendations for potential revisions thereto. *See* 76 Fed. Reg. at 3701, Fn. 21.

19 Guidance on the application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties to OTC derivatives CCPs, at iii (May 2010), *available at* http://www.bis.org/publ/cpss89.pdf ("[a]pplying the [recommendations] to newly established OTC derivatives CCPs in practice has involved a considerable degree of interpretation and judgment.").

KCC agrees that DCOs must monitor and manage the default and other risks it faces at all times. The Proposed Rule, however, appears to impose on *all* DCOs the heightened risk management standards that apply to institutions that receive federal assistance, such as banks insured under the Federal Deposit Insurance Act ("FDIA"). DCOs are generally not beneficiaries of the federal "safety net," as the Dodd-Frank Act makes clear in its distinction between ordinary DCOs and "systemically significant" DCOs ("SIDCOs").[20] Non-systemically significant DCOs do not receive direct or indirect financial assistance from the federal government, and few DCOs are likely to be designated as SIDCOs under the Dodd-Frank Act.[21] KCC certainly will not be so designated, and there is no need to impose on it or other similar, small and medium-sized DCOs a regulatory framework that guards against the risk that the failure of the institution would require a federal government bailout.

The Commission should recall that no customer losses were experienced at any DCO operating under the Core Principles prior to the Dodd-Frank Act – despite the extensive financial market turmoil beginning in the summer of 2008, which is a testament to the strength of DCO risk management systems and robust self-regulation. By contrast, many of the banks that followed the risk management mandates of FDIA did not fare so well.

C. The Proposed Rules Do Not Adequately Distinguish Between Institutions that Present Varying Degrees of Risk to Financial Stability

The Commission has specifically acknowledged that DCOs should, consistent with the statutory mandate of the CEA, be accorded flexibility in implementing the Core Principles in light of the particular business model of each DCO.[22] KCC does not believe the Commission has struck the appropriate balance in the Proposed Rule. In particular, the absence in the Proposed Rule of a distinction between requirements applicable to SIDCOs and those applicable to non-SIDCO DCOs demonstrates that the Commission is not appropriately balancing the costs of heightened requirements with the benefits to market participants generally of the increased costs. The Dodd-Frank Act provides a clear distinction between SIDCOs, which are subjected to heightened regulatory requirements, and ordinary DCOs, which are not, and the Commission should re-evaluate the Proposed Rule in light of the distinction.

III. DCO Core Principle C: Participant and Product Eligibility

A. Fair and Open Access

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[20] Section 805(a) provides the Commission the authority to prescribe certain rules for DCOs that the Financial Services Oversight Council ("FSOC") has designated as systemically significant under Section 113 of the Dodd-Frank Act. *See Financial Resources Requirements for Derivatives Clearing Organizations*, 75 Fed. Reg. 63113 (Oct. 14, 2010).

[21] The FSOC may designate certain institutions as "systemically significant" and impose on that institution certain heightened capital and risk management requirements exceeding the capital and risk management requirements applicable to banks generally. *See generally*, Dodd-Frank Act §§ 113, 165, 804. The FSOC may designate such institutions as "systemically significant" only if the institution is "predominantly engaged" in activities that are "financial in nature" under § 4(k) of the Bank Holding Company Act and the failure of the institution would pose a risk "to the financial stability of the United States."

[22] *See* 75 Fed. Reg. at 63113.

Core Principle C requires DCOs to establish participation requirements that permit fair and open access.[23] Consistent with the Core Principle, KCC imposes objective CM eligibility standards and uses a risk-based approach to CM capital requirements.[24] Further, KCC requires that certain members maintain offices in the Kansas City metropolitan area in order to facilitate the operational needs of KCC and its related DCM. These requirements are tailored to manage the financial and operational risks that KCC faces in the markets in which its CMs operate – wheat futures and options.

KCC believes that certain aspects of the fair and open access requirements of proposed 39.12(a)(1)(i)-(iii) limit the ability of DCOs to deny eligibility to low credit quality CMs, and consequently to lower credit quality within the clearing organization as a whole. KCC would remind the Commission that the core function of a DCO is to evaluate and monitor the credit quality of CMs and provide a venue for distributing credit risk among high credit quality members. As described in more detail below, the Commission's detailed proposals as to fair and open access will limit the ability of DCOs to control the credit quality of CMs.

Proposed Rule 39.12(a)(1)(i) would impose further specific requirements as to fair and open access by prohibiting DCOs from adopting a standard "if less restrictive requirements that would not materially increase risk to the [DCO] or CMs *could* be adopted" (emphasis added). KCC opposes the "least restrictive alternative" test of Proposed Rule 39.12(a)(1)(i). A "least restrictive alternative" test is highly subjective and will be difficult to implement in practice. KCC reminds the Commission that the DCO Core Principles state that fair and open access standards of clearing organizations should not limit access on grounds "other than risks."[25] The Commission should clarify that participant eligibility requirements that are intended to limit risks to the clearing organization are permissible under Core Principle C.

The proposal also requires DCOs to admit *all* market participants that meet the DCO's participant requirements.[26] KCC does not believe this requirement is workable. The Commission's proposal does not acknowledge that, regardless of whether certain applicant CMs may *satisfy* the DCO's requirements, the DCO may not be capable of admitting the member due to various operational constraints – e.g., the DCO's electronic systems or the operational capacity of the DCO's related DCM. The Commission should clarify that DCOs may set limits on the number of market participants that may be admitted in light of the operational constraints of the DCO.

The proposal further prohibits exclusion of CMs or limitations on membership unless the DCO can prove 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 CMs" (emphasis added). KCC is of the view that a DCO's right to exclude or place limitations on certain CMs should not be subjected to ex-post determinations as to the "necessity" of such

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23 7 U.S.C. § 7a-1(c)(2)(C)(iii)(III).

24 *See* KCC Rulebook, Rule 8.01 (CM Requirements), *available at* http://www.kcbt.com/histdata/rule_book/KCCC_AVIII.pdf.

25 *See* 76 Fed. Reg. at 3701.

26 Proposed Rule 39.12(a)(1)(ii).

restrictions, as the DCO itself is in the best position to monitor the risks posed by the activities of its CMs. KCC views this requirement as a *limitation* on the risk management capabilities of the DCO, and as such it appears to be inconsistent with the purpose of Core Principle C in general. DCOs should be accorded flexibility in their assessments of the operational capabilities of applicant CMs.

B. Financial Resources of a CM

Core Principle C requires that a DCO's participant eligibility requirements include standards as to the CM's financial resources and operational capacity. Consistent with the Core Principle, KCC has adopted the Commission's minimum net capital requirements for futures commission merchants ("FCMs") as the financial resources requirement for CMs. KCC understands the Commission's desire to balance the requirement for fair and open access against the requirement for minimum financial resources. KCC does not, however, believe the $50 million figure the Commission has proposed as a ceiling on minimum financial resources requirements in relation to a swaps clearing membership is appropriate. The figure appears to be arbitrary and is not adequately flexible to permit variation among the types of clearing members that would be clearing the many different types of swaps that will come to be cleared at DCOs after the swaps clearing requirements of the Dodd-Frank Act come into effect.[27]

C. Monitoring, Reporting, and Enforcement

Core Principle C requires DCOs to have procedures to continuously verify CMs' compliance with the DCO's participation and membership requirements. Consistent with the Core Principle, KCC requires CMs to notify the DCO whenever the CM knows or should have known that its working capital or adjusted net capital has declined by 20% or more.[28] KCC also retains the authority to suspend or terminate clearing privileges to any CM who does not maintain CM eligibility requirements. The Proposed Rule would further require all CMs, including those not registered with the Commission as FCMs, to adequately inform the DCO about their financial status.[29] KCC believes the Commission should carefully reevaluate whether it has the authority to require unregistered entities to make the periodic financial reports that they file with the DCO available to the Commission upon the Commission's request.

IV. DCO Core Principle D: Risk Management

Core Principle D requires DCOs to establish an appropriate risk management framework. Proposed Rule 39.13(b) would further specify that the DCO's policies and procedures must clearly identify and document the broad range of risks to which the DCO is exposed. KCC generally supports the requirement, but certain aspects of the Proposed Rule implementing Core

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27 Proposed Rule 39.12(a)(2)(iii). The Commission also requested specific comment on market participants' views of the adequacy of guarantees and credit facilities for financial resources purposes. *See* 76 Fed. Reg. at 3701. KCC does not believe a guarantee or credit facility provided by the parent of a CM would provide adequate liquidity in "extreme but plausible market conditions."

28 KCC Rulebook, Rule 8.01(c).

29 Proposed Rule 39.12(a)(5).

Principle D may require further refinement by the Commission, as discussed in greater detail below.[30]

A. Limitation of Exposure to Losses Following Default

Core Principle D requires DCOs to limit their exposure to potential losses following default by CMs, through margin requirements and other risk control mechanisms, to ensure that the DCO's operations would not be disrupted and that nondefaulting CMs would not be exposed to losses that nondefaulting CMs cannot anticipate or control.[31] Consistent with the Core Principle, KCC has detailed default procedures that clearly delineate the timing and priority of each action the DCO will take to limit the exposure of the DCO and other non-defaulting CMs to losses following the default of a CM.[32] Each KCC CM is aware that KCC assessment rules determine allocation of losses from major defaults.[33] The language of proposed Rule 39.13(f) is identical to that of the Core Principle itself.[34] KCC believes the Commission should clarify the purpose of duplicating the existing principle in the form of a rule.[35]

B. CM Margin Requirements

Core Principle D requires DCOs to collect from CMs and market participants sufficient margin to cover potential exposures in normal market conditions. Consistent with the Core Principle, KCC has a detailed set of margin requirements for CMs and their customers which requires adequate margin to collateralize contract exposures under normal market conditions. The Commission has proposed an extensive set of additional rules regarding the risk-sensitivity of DCO margin requirements that KCC does not believe is appropriate. KCC does not believe that the Commission's detailed requirements are consistent with the statutory mandate for margin management in the Dodd-Frank Act. The Dodd-Frank Act's changes to the CEA simply require that a DCO's margin models and parameters be "risk-based."[36]

Methodology and Coverage. Margin requirements for contracts cleared through KCC are set by KCBT. Margin is set at a 95% confidence level over a 30 day sample period of end-of-day closing prices. When the 95% confidence level is exceeded, the KCBT executive committee evaluates the most recent day-to-day changes to determine the margin adjustments appropriate and necessary to reclaim a 95% confidence level.[37]

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30 At KCC, risk management is ultimately the responsibility of the KCBT Board of Directors. KCBT maintains numerous committees with oversight responsibility for risk, research, and business related matters.

31 76 Fed. Reg. at 3703.

32 *See* KCC Rulebook, Rule 8.03 (Default Procedures).

33 *See* KCC Rulebook, Rules 8.02, 13.05, 13.06.

34 *See* 76 Fed. Reg. at 3703-04.

35 There would appear to be little cost/benefit justification for establishing such a duplicative requirement.

36 CEA § 5b(2)(D)(v)(I).

37 Further, KCC imposes daily price limits of 60 cents and generally does not reduce margin below $2,000 (40 cents) in order to cover a significant portion of what could be a daily move. In addition, KCC makes intra-day margin calls to cover significant price movements.

Proposed Rule 39.13(g)(2)(iii) would require DCOs to apply a margin model based on a 99% confidence level. KCC believes that DCOs should be accorded discretion in determining the confidence level that is appropriate for margining their products. It may be a straightforward task to develop an extremely high-confidence level margin model for certain common retail products, but other products are inherently less susceptible to high-confidence modeling. For example, certain products not listed on exchange may be "cleared-only" products, and pricing such products may be more difficult. In fact, KCC believes that ultra-high confidence level modeling does not protect against risk as well as direct margin intervention by the DCO in the case of significant market movements. For instance, KCC maintains the continuous right as against CMs to review recent price movements to re-establish margins at a higher level, and also retains the right to demand special margin from certain CMs.[38] Indeed, as the "flash crash" recently made clear, over-reliance on computer modeling may lead to unintended results when the model is confronted with "black swan" events.[39]

Independent Validation. Proposed Rule 39.13(g)(3) would require each DCO on a regular basis to have its method of generating initial margin and theoretical models tested and validated by a "qualified and independent party." KCC would request that the Commission clarify that the chief risk officer or other comparable personnel with responsibility for overall risk management at the DCO would meet the requirements of a "qualified and independent party" under the proposed rule.

Spread Margins. Proposed Rule 39.13(g)(4)(i) would permit a DCO's margin model to permit margin reductions only if (i) the DCO's model could articulate a "theoretical basis" for correlation in positions, and (ii) the DCO has in fact observed a statistical correlation between the positions. KCC views this detailed requirement as both unnecessary and difficult for the Commission to implement in practice. The requirement is unnecessary because DCOs have no incentive to offer margin reductions in the absence of high correlation between positions.[40] The proposal does not detail what level of observed statistical correlation is required to satisfy the rule, and the requirement to articulate a "theoretical basis" is highly vague. KCC does not believe the "theoretical basis" requirement has any significant bearing on the core issue with respect to spread margins – i.e., observed correlation between positions.

Back-Testing. Proposed Rule 39.13(g)(7)(i) would require DCOs on a daily basis to conduct back tests with respect to products that are experiencing "significant market volatility." It may be appropriate for the Commission to further define the term "significant market volatility," but, more generally, KCC believes that any back-testing requirements should be based on a discretionary, risk-based determination by the DCO. In addition, KCC believes that the back-testing period required by the proposed rule should be subject to the discretion of the DCO in light of then-current market conditions – i.e., imposing a specific back-testing period may inappropriately reflect an exaggerated or understated level of market volatility.

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38 *See* KCC Rulebook, Rule 13.09.

39 *See* Findings Regarding the Market Events of May 6, 2010 (Joint CFTC and SEC Staff Report), *available at* http://www.sec.gov/news/studies/2010/marketevents-report.pdf.

40 KCC only allows margin reductions for intra-market spread positions, inter-market spread positions versus wheat contracts at other exchanges and versus KCBT wheat calendar swaps.

C. Customer Margin Requirements

Proposed Rule 39.13(g)(8)(i) would require the DCO to collect permanent margin on a gross basis for each CM's customer account equal to the sum of the margin amounts that would be required by the DCO for each individual customer within that account if each individual customer were a CM.[41] KCC believes that customer account margining should be the responsibility of the risk management department of the customer's CM. Managing gross customer margin at the DCO level would require each DCO to effectively assume the role of a back-office account management service, requiring continuous updates from each CM regarding customer positions.[42] The customer's CM would be required to file reports with the DCO detailing the customer's naked long and short positions less any spread positions, and also any long and short positions for spreads. Management and collection of CM gross margins would operate more efficiently and effectively if the DCO were not required to manage information regarding customer account identity and permitted to treat the customer origin as one account.

Presently, each CM's customer margin account at the DCO may be used as a financial resource in default proceedings of the CM customer account. KCC would request that the Commission clarify whether the requirement to collect gross customer margin effectively imposes an obligation on the DCO to determine defaulting customer accounts as to each CM. KCC does not believe it is appropriate to place such an obligation directly on the DCO, since it would be costly and burdensome to require DCOs to collect information from all firms in every market. Customer position reporting requirements should be left to the SROs. Having the total customer gross margin available to the DCO in the event of a large customer default is a prudent risk management technique.

Customer Initial Margin Requirements. KCC generally supports best practices that may support the concept behind Proposed Rule 39.13(g)(8)(ii), which requires CMs to collect customer initial margin at a level above the DCO's requirement for each margined product and portfolio. KCC would request further clarity from the Commission regarding the circumstances in which the Commission may deem the DCM's customer initial-to-maintenance margin requirement ratio insufficient to protect the DCO.

Withdrawal of Customer Initial Margin. KCC generally supports best practices that may support the concept behind Proposed Rule 39.13(g)(8)(iii), which prohibits CMs from permitting customer withdrawals of funds from their accounts with the CM unless the net liquidating value plus the margin deposits remaining in the customer's account after the withdrawal would be sufficient to meet the customer's initial margin requirements. DCM rules already require customers to maintain minimum margin levels. DCOs do not have full access to information regarding each customer's financial condition. KCC would remind the Commission that these

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[41] KCC would remind the Commission that the IOSCO/BIS Recommendations regarding customer margin have not taken the view that gross customer margin is preferable to net customer margin. *See* IOSCO Recommendations for Central Counterparties (November 2004), at 23.

[42] In conjunction with Proposed Rule 39.13(g)(8)(i) the Commission is proposing to amend Proposed Rule 39.19(c)(1)(iv) to require the DCO to report customer origin gross positions of each beneficial owner to the Commission.

restrictions are generally tested as well by a CM's risk department and the CM's self-regulatory organization during examinations.

Time Deadlines for Initial and Variation Margin Payments. KCC would remind the Commission that the proposed requirement that DCOs collect gross customer margin will require many DCOs to adjust the timing deadlines they have established for margin payments.[43] Placing the increased burden on DCOs to "look-through" the CM's customer account likely will decrease the DCO's ability to track margin requirements closely with market movements. In addition, DCOs that currently do not collect gross customer margin may face difficulty in relaying variation margin payment information to their settlement banks quickly.

D. Risk Management Procedures Relating to Large Traders

Large Trader Reports. Proposed Rule 39.13(h)(2) would impose the duplicative requirement that DCOs obtain from CMs all large trader reports that the CM currently submits to the Commission. This requirement is duplicative because the DCO receives large trader information from the exchange, which in turn receives the information directly from the Commission.[44] KCC would also remind the Commission that DCO compliance staff review the reportable position files that they receive on a daily basis to ascertain large trader risks that CMs face. Ultimately, it is the CM's obligation to determine the financial fitness of large trader customers.[45] CMs have better, more direct information regarding the credit quality of the customer and the exposures of the customer under positions the customer may hold outside the DCO. Imposing this duplicative requirement on DCOs achieves little risk management benefit at a high cost.

Stress Testing. Proposed Rule 39.13(h)(3) requires a DCO to conduct certain daily and weekly stress tests for large traders and CMs. KCC believes that the frequency of stress testing should be left to the discretion of the DCO and should be risk-based in light of prevailing market conditions.

Risk Management Policies and Procedures of CMs. Proposed Rule 39.13(h)(5) would require DCOs to periodically review each CM's risk management policies, procedures, and practices. KCC does not believe this requirement is a productive use of DCO resources. Each CM is likely to be a member of numerous DCOs; to have each DCO continuously evaluate the risk management policies and procedures of each CM would achieve little with great expenditure of resources. Such reviews are best carried out by the CM's self-regulatory organization, which has a full picture of the CM's risk management history at each DCO of which the CM is a member.

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[43] Proposed Rule 39.13(g)(9) would require DCOs to establish and enforce time deadlines for initial and variation margin payments.

[44] The Commission collects large trader information daily and certain DCMs, including KCBT, obtain such information from the Commission each day for purposes of surveillance and risk management functions carried out at both KCBT & KCC.

[45] Under Proposed Rule 39.13(h)(2), DCOs also would be required to review large trader reports on a daily basis to ascertain the risk of the overall portfolio of each large trader, across all CMs carrying an account for the large trader.

Corrective Action Against Certain CMs. KCC generally supports the concept that DCOs impose heightened risk management requirements on CMs as the risk profile of the CM changes from time to time.[46] DCOs generally have in place minimum capital requirements and reporting periods relating to changes in the CM's capital level. All CMs must maintain requirements for clearing membership on a continuous basis or face suspension or revocation of their clearing membership. KCC would request that the Commission clarify, however, whether each of the potential heightened risk management requirements enumerated in proposed Rule 39.13(h)(6)(i)-(vii) must be explicitly delineated in DCO rules or in the DCO's clearing membership agreement.

V. DCO Core Principle E: Settlement Procedures

Settlement Banks. Daily variation margin settlements are a key function of a DCO and, accordingly, it is crucial for DCOs to adequately evaluate and monitor the credit risk of settlement banks. In response to this concern, the Commission has proposed Rule 39.14(c), which would effectively require DCOs to identify additional settlement banks that may be used by CMs for posting and holding margin. KCC believes the requirement has unintended consequences that make it unsound. Specifically, KCC is concerned that the practice of identifying multiple settlement banks for use by CMs would increase *operational risk* of the DCO by potentially fragmenting the DCO's margin pool. As such, the rule compromises operational soundness in order to decrease credit risk.

Further, KCC is uncertain whether the Commission has adequately analyzed the procedures under FDIA for closure of a failed bank. KCC suggests that there would perhaps be little effect on the operations of a DCO from the failure of a non-systemically significant depository institution acting as a settlement bank for daily margin settlements of a DCO. Note that the Federal Deposit Insurance Corporation ("FDIC") generally facilitates the transfer of the accounts and operations of a failed bank to a successor institution or a bridge bank with little or no disruption to depositors at the failed bank.[47] Because a DCO's settlement account is essentially a pass-through account, in which over-margined accounts pass payments through to under-margined accounts, the DCO does not maintain large, long-term balances in its settlement account. If a DCO's settlement bank were to fail, it could reasonably be expected that the DCO would experience little or no interruption to the settlement margin payments passing through the DCO's account at the failed bank. Further, even where a DCO holds significant guarantee fund or security deposits at such a settlement bank, such assets are likely to be held in a trust or custody account, which is unavailable to creditors of a failed depository institution and generally made available to the custody or trust customer within a short period of time following

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[46] Proposed Rule 39.13(h)(6) requires DCO to impose certain risk-reducing requirements on CMs in certain circumstances as part of the DCO's broader risk-management program.

[47] *See generally* MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE, *available at* http://www.fdic.gov/bank/historical/managing/index.html.

insolvency.[48] Additionally, KCC would note to the Commission that the proposed rule will cause a significant rise in bank service fees for DCOs and CMs.

Settlement Finality. Proposed Rule 39.14(d) would require DCO's to ensure that settlement funds transfers are irrevocable and unconditional when the DCO's accounts are debited or credited. KCC believes the Commission should consider the underlying legal risk question related to settlement finality. Ultimately, the finality of a settlement payment appears to be more an issue of legal risk in the sense that a settlement payment may be deemed pursuant to applicable law (i.e., the bankruptcy code) to be an inappropriate transfer. A DCO can therefore never effectively ensure that settlement payments are irrevocable. The Commission should thus eliminate the requirement altogether or restate the rule as a requirement to monitor operational risks related to settlement finality. Furthermore, in light of the fact that KCCs commercial accounts currently have unlimited FDIC insurance protection, we ask that the Commission clarify its concerns.[49]

Recordkeeping Regarding Settlement Flows. KCC generally supports the concept of maintaining accurate records of settlement fund flows, but believes it may be prudent for the Commission to further clarify the extent to which the additional recordkeeping applies to cross-margining and netting arrangements that a DCO may have in place with certain CMs and their customers.

Physical Delivery Requirements. KCC generally supports the concepts of proposed Rule 39.14(g), but would request that the Commission clarify that a DCO may be deemed to have satisfied its obligation to establish rules relating to physical deliveries if the rules of the exchange that lists the cleared contracts clearly delineate such physical delivery obligations. With respect to KCC, the rules of KCBT clearly delineate the delivery-related obligations of KCC.

VI. DCO Core Principle G: Default Rules and Procedures

Proposed Rule 39.16(b) would require DCOs to develop a written default management plan and test the plan annually. KCC generally agrees with the preparedness concern that drives the requirement to implement a default management plan, but believes that a DCO's existing set of default rules and procedures should adequately prepare the DCO to address default scenarios. CMs are well aware of procedures following default. KCC would request that the Commission clarify that the default management plan concepts in proposed Rule 39.16(b) may be satisfied by annual testing of the DCO's existing set of default procedures.

VII. DCO Core Principle I: System Safeguards

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[48] *See, e.g.*, Investment of Idle Custodial Funds in Repurchase Agreements by Agencies Selling Livestock on Commission Basis for Department of Agriculture, FDIC Advisory Opinion, 93-61 (Aug. 25, 1993).

[49] For settlement at KCC, funds must be wired-in using corporate drawdown transfers which are very safe and effective. Funds owed to CMs are sent out using ACH wires – which are more cost effective to the DCO and to the CM than wire transfers. This method of paying out funds to CMs has been effective for years and approved by the Directors of KCC.

Business Continuity and Disaster Recovery. Core Principle I requires DCOs to establish emergency procedures, backup facilities, and, generally, a program of risk analysis and oversight to minimize operational risk. Proposed Rule 39.18 would further establish specific components to be included in a DCO's business continuity and disaster recovery ("BC-DR") plan. KCC generally agrees with the Commission's view that risk oversight and emergency procedures should be clearly stated in writing and subject to testing, but KCC believes such procedures should be tailored to the circumstances of each DCO. Smaller DCOs such as KCC will find it difficult to marshal the resources to comply with each detailed requirement of Proposed Rule 39.18. In particular, KCC does not believe it is possible for all DCOs to fully duplicate all key job functions. The Commission's proposal appears to lead to anti-competitive outcomes, and in potential conflict with DCO Core Principle N (Antitrust Considerations), in the sense that only larger DCOs, such as SIDCOs, will have the managerial resources to comply with certain of the requirements as to backup facilities and personnel. Thus, KCC would recommend that the Commission scale back the requirements of proposed Rule 39.18.

System Testing. Proposed Rule 39.18(j) would require a DCO to conduct periodic testing and review of its systems by "qualified, independent professionals." KCC would request that the Commission specify that a DCO's chief risk officer or other similar official of the organization responsible for risk management or compliance qualify as an "independent professional" for purposes of the testing rule. Further, KCC understands the importance of delineating a clear BC-DR plan, but would recommend a phase-in period for compliance with the testing rule.

Coordination of BC-DR Plans. Proposed Rule 39.18(k) requires each DCO, to the extent practicable, to coordinate its BC-DR plan with those of its CMs, to initiate coordinated testing of BC-DR plans, and to take into account in its own BC-DR plan the BC-DR plans of its providers of essential services. The Commission should clarify that "coordination" would be deemed to be satisfied if the DCO reviews the BC-DR plans of its CMs and essential service providers and subsequently provides to such parties the DCO's own BC-DR plan. KCC does not believe that "coordination" should involve extensive efforts at achieving specific consistency between the procedures of each party, as the DCO, its CMs, and each essential service provider has a distinct business model that faces varying operational risks.

VIII. Conclusion

KCBT and KCC appreciate the opportunity to comment on the Proposed Rule, and we hope the comments we have offered will aid the Commission in further refining its ideas. Finally, should the Commission feel it necessary to proceed on the concepts proposed in the Proposed Rule, we suggest that those concepts would best be incorporated through flexible best practices, rather than through inflexible prescriptive regulations. We are available to answer any additional questions you may have at your convenience. Please feel free to contact me at 816-931-8964 or csavage@kcbt.com.

Sincerely,

Charles M. Savage
Assistant Vice President & Manager