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Via Electronic Mail

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

Re: RIN 3038-AC98 Risk Management Requirements for Derivatives Clearing Organizations

Dear Mr. Stawick:

This letter is submitted by The Options Clearing Corporation ("OCC") in response to the Commission's recent release (the "Release")[1] requesting comment on proposed rules establishing regulatory standards for compliance with derivatives clearing organization ("DCO") Core Principles C (Participant and Product Eligibility), D (Risk Management), E (Settlement Procedures), F (Treatment of Funds), G (Default Rules and Procedures), and I (System Safeguards);[2] imposing heightened standards in the area of system safeguards supporting business continuity and disaster recovery for systemically important DCOs ("SIDCOs"); and implementing the Commission's special enforcement authority over SIDCOs (collectively, the "Proposed Rules"). We consider the Proposed Rules to be among the most important rules proposed by the Commission to date implementing those requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[3] applicable to DCOs. While we support the Commission's efforts to carry out the statutory mandate of Dodd-Frank by establishing appropriate risk management requirements for DCOs, we find many aspects of the Proposed Rules to be seriously flawed and in need of reconsideration by the Commission. In general, we believe that the Proposed Rules reflect an effort to micro-manage the risk management function and impose requirements that are not only excessively burdensome relative to the likely benefits, but are in some cases likely to be counterproductive and to hinder rather than enhance the ability of DCOs and SIDCOs to perform their functions. We hope that

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[1] Risk Management Requirements for Derivatives Clearing Organizations, 76 FR 3698 (January 20, 2011).

[2] *See* CEA § 5b(c)(2), as amended by Dodd-Frank.

[3] Pub. L. 111-203.

the Commission, in coordination with the Securities and Exchange Commission ("SEC"), will revise the Proposed Rules to provide greater flexibility to allow DCOs to continue to provide the same degree of safety and efficiency in managing risk that has been the hallmark of their performance through their history. We look forward to working constructively with the Commission and the SEC to ensure that clearing organizations are able to fulfill the central roles Congress set out for them in Title VII of Dodd-Frank.

We also note that we believe it to be unlikely that the Commission will be OCC's "supervisory agency" for purposes of Title VIII of Dodd-Frank[4] and therefore it is also unlikely that OCC would be subject to the Commission's heightened standards applicable to SIDCOs under the Proposed Rules. We believe that the Commission should expressly state that its requirements for SIDCOs apply only to those SIDCOs for which the Commission is the supervisory agency.[5] We have nevertheless included in our letter some comments on the Commission's proposed standards for SIDCOs. We think it is important that the Commission and the SEC co-ordinate their requirements, including with respect to systemically important clearing organizations, and we therefore wish to make our views known to both agencies.

OCC Background Information

Founded in 1973, OCC is currently the world's largest clearing organization for financial derivatives. OCC is the only clearing organization that is registered with the SEC as a securities clearing agency pursuant to Section 17A of the Securities Exchange Act of 1934 (the "Exchange Act") and with the Commission as a DCO under Section 5b of the Commodity Exchange Act ("CEA"). OCC clears securities options, security futures and other securities contracts subject to SEC jurisdiction, and commodity futures and commodity options subject to the Commission's jurisdiction. OCC clears derivatives for all nine U.S. securities options exchanges and five futures exchanges.[6] OCC has always been operated as a non-profit market utility. Each year OCC returns to its clearing members the excess of clearing fees received over its operating costs plus an amount (if any) reasonably required to be retained as additional capital to support its clearing activities. OCC acts as the clearing organization for multiple exchanges, and identical

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[4] Section 803(8)(A) of Dodd-Frank provides that the Supervisory Agency of a registered clearing agency is the SEC and that the Supervisory Agency of a DCO is the Commission. Section 803(8)(B) of Dodd-Frank, however, provides that if, like OCC, a designated financial market utility would otherwise have multiple Supervisory Agencies pursuant to Section 803(8)(A), the agencies must agree on one agency to act as the Supervisory Agency. If the agencies are unable to agree, the Council must decide which agency will act as the Supervisory Agency. As over 99% of OCC's business is regulated by the SEC, we presume that the SEC and the Commission will agree that the SEC should act as OCC's Supervisory Agency.

[5] The Commission cites Section 805(a) as its authority to prescribe heightened standards for SIDCOs. Release at 3698. Under Section 805(a)(2), the Commission's or the SEC's authority to prescribe heightened regulations for clearing organizations designated as systemically important applies only to "those designated clearing entities and those financial institutions engaged in designated activities for which each is the Supervisory Agency or the appropriate financial regulator."

[6] The participating options exchanges are BATS Options Exchange, C2 Options Exchange, Inc., Chicago Board Options Exchange, Inc., International Securities Exchange, NASDAQ OMX BX, Inc., NASDAQ OMX PHLX, Nasdaq Options Market, NYSE Amex Options, and NYSE Arca Options. OCC clears futures products traded on CBOE Futures Exchange, NYSE Liffe U.S., NASDAQ OMX Futures Exchange and ELX Futures, as well as security futures contracts traded on OneChicago.

contracts traded on more than one exchange and cleared through OCC are fungible in clearing member accounts at OCC.

General Comments on the Proposed Rules

Coordination with Other Regulators

As described above, OCC is currently the only clearing organization that is registered with both the Commission and the SEC. Given this unique position, OCC often faces challenges in conforming its operations to requirements imposed by both the Commission and the SEC. We believe we have developed constructive solutions to these problems through the years, with extensive cooperation and coordination with both agencies, and we hope that we are able to similarly work with both agencies to ensure that Dodd-Frank is not implemented in ways that are hostile to dual registrants. In the present case, we are concerned that the Proposed Rules do not distinguish between the activities of a clearing organization that are undertaken as a DCO and subject to the jurisdiction of the Commission and those that are undertaken as a registered clearing agency and subject to the jurisdiction of the SEC. We strongly encourage the Commission to coordinate its implementation of the Proposed Rules to the maximum extent possible with the efforts of other financial regulators within the United States and abroad, particularly the SEC. As over 99% of OCC's business is regulated by the SEC and OCC has no present intention to clear swaps, we believe the Commission should work closely with the SEC to develop consistent regulatory requirements that will allow both agencies to meet their objectives, including implementation of Dodd-Frank, and also take into account that a DCO with an extremely limited amount of business under the Commission's jurisdiction should not be subject to rules that are at substantial variance with those of the DCO's primary regulator.

Dodd-Frank recognized that international harmonization of regulation of the OTC derivatives markets is vital to ensuring effective and consistent regulation of these markets. OCC therefore encourages the Commission to coordinate with foreign regulators and CPSS/IOSCO to ensure harmonious clearinghouse regulation. We strongly encourage the Commission to avoid taking final action on the Proposed Rules prior to receiving greater clarity on what clearinghouse regulations are ultimately adopted by European and U.K. legislators and regulators and what approaches to regulation are ultimately embraced by CPSS/IOSCO. Consistent international regulation is extremely important to ensure that current and potential clearinghouse competitors are subject to robust, yet substantially similar, regulatory standards.

Regulatory Flexibility and Waiver Authority

We recognize that the highly prescriptive nature of the Proposed Rules is to a certain extent mandated by Dodd-Frank. However, we continue to regret the unfortunate move away from the flexible regulatory approach historically taken by the Commission that has allowed clearing organizations to develop organically in response to market demands, subject to principles-based oversight by the Commission that is capable of tailoring regulatory approaches to each DCO's particular needs and challenges. These individually tailored solutions have proven successful in protecting clearing organizations, clearing members, and customers against loss, and have been responsible for the confidence now being shown in regulated clearing organizations, as reflected by the broad clearing mandate of Dodd-Frank. We believe it would

be unfortunate and unwise to hold clearing organizations to strict mandates that may appear, in the abstract and *ex ante*, to be sensible, but that may ultimately stifle innovation and lead to unintended consequences as applied to a particular clearing organization. We encourage the Commission to retain the maximum amount of flexibility in implementing the Proposed Rules by retaining express authority to waive any requirement of the Proposed Rules whenever the Commission believes that doing so would be consistent with the CEA as amended by Dodd-Frank.

Core Principle C (Participant and Product Eligibility)

DCO Participation Requirements

The Proposed Rules would require each DCO to establish participation requirements for its members that "require clearing members to have access to sufficient financial resources to meet obligations arising from participation in the derivatives clearing organization in extreme but plausible market conditions"[7] The term "financial resources" is not limited to net capital, and the Proposed Rules also provide that "capital requirements shall be scalable so that they are proportional to the risks posed by the clearing members."[8] OCC is in general agreement with this standard as we understand it. It is important to note in this context that the risk posed by a clearing member is very much dependent upon the size and composition of the clearing member's positions and the amount and type of collateral that is held by the DCO to support those positions. In addition, there may be non-quantitative factors that affect the DCO's judgment as to the risk presented by a particular clearing member. Accordingly, we do not believe that a DCO should be required to develop a fixed formula for determining clearing member compliance with this criterion. Rather, DCOs should continue to be able to exercise discretion and judgment based on experience and knowledge of particular clearing members. OCC believes that its current financial standards for clearing members meet the standard set by the Proposed Rule.[9]

Verification of Compliance with Participation Requirements

The Proposed Rules would require each DCO to "establish and implement procedures to verify, on an ongoing basis, the compliance of each clearing member with each participation requirement of the derivatives clearing organization."[10] The requirement is generally appropriate if reasonably interpreted. OCC and other clearing organizations have such procedures, which in OCC's case include its "Watch Level Surveillance" procedures. We believe that our current procedures are fully adequate and appropriate and should be deemed to be compliant with the requirement. OCC has certain requirements for participation that are reviewed in connection with approval of an initial application for clearing membership and that do not, in our view, require any formal ongoing review. For example, we believe there is no reason for ongoing review of operational readiness requirements beyond the DCO's day-to-day experience with the clearing member's performance.

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[7] Proposed Rules § 39.12(a)(2)(i), 76 FR at 3719.

[8] Proposed Rules § 39.12(a)(2)(ii), 76 FR at 3719.

[9] *See* the discussion below under "Core Principal D (Risk Management), including the footnotes."

[10] Proposed Rules § 39.12(a)(4), 76 FR at 3719.

Product Eligibility Requirements

The Proposed Rule would require each DCO to "establish appropriate requirements for determining the eligibility of agreements, contracts, or transactions submitted to the derivatives clearing organization for clearing, taking into account the derivatives clearing organization's ability to manage the risks associated with such agreements, contracts, or transactions. Factors to be considered in determining product eligibility include, but are not limited to: (i) Trading volume; (ii) Liquidity; (iii) Availability of reliable prices; (iv) Ability of market participants to use portfolio compression with respect to a particular swap product; (v) Ability of the derivatives clearing organization and clearing members to gain access to the relevant market for purposes of creating and liquidating positions; (vi) Ability of the derivatives clearing organization to measure risk for purposes of setting margin requirements; and (vii) Operational capacity of the derivatives clearing organization and clearing members to address any unique risk characteristics of a product."[11] We think the factors listed are already among the factors that a DCO would naturally consider when determining whether to list a given product for clearing, and OCC does indeed consider such factors. The Proposed Rule does not require that a DCO use any specific means to "establish" such requirements, and we would urge the Commission against imposing procedural requirements that would make the new product approval process overly formal and formulaic. In many cases, it is self-evident that a new product meets a particular criterion. We also believe that the application of this new rule should be limited to swaps. The criteria seem to be oriented toward swaps, and we see no reason to impose additional requirements on exchange-traded products for which most or all of the applicable criteria would be clearly met. In the case of the "trading volume" requirement, we would also note that trading volume for new products is often unknown and unpredictable, and that factor alone should not be a barrier to accepting a product for clearance.

Core Principle D (Risk Management)

We believe the Commission's Proposed Rules implementing Core Principle C[12] are overly prescriptive and, if read literally, could prevent DCOs from implementing robust risk management frameworks which, although they may fail to meet certain technical aspects of particular Proposed Rules, fulfill the spirit of the Proposed Rules and result in risk management systems that equal or exceed the Commission's overall risk management standards. Including such specific requirements in the Proposed Rules will inevitably lead to unintended consequences, and we encourage the Commission to take a much more flexible approach to implementing the new risk management standards.

OCC has operated safely and effectively for over 35 years, including through the market crises in 1987 and 2008, mitigating systemic risk associated with derivatives trading. Its risk management approach includes three principal safeguards – appropriate membership standards, prudent margin requirements, and a sizable clearing fund comprised of highly liquid U.S. Treasuries and cash. OCC fully adheres to the current international best practices applicable to central counterparties as jointly adopted in 2004 by the Committee on Payment and Settlement

[11] Proposed Rules § 39.12(b)(1), 76 FR at 3720.

[12] *See* Proposed Rules § 39.13, 76 FR at 3720.

Systems ("CPSS") and the International Organization of Securities Commissions ("IOSCO"). OCC regularly reviews the adequacy of its financial resources, taking into account numerous factors such as its projected liquidity needs and measured risk exposures covering a diverse mix of clearing members[13] and financial products. We are industry leaders in developing state of the art clearinghouse risk management solutions.

OCC's proprietary margining system was developed by OCC in house and is "state of the art" for clearing organizations. It has withstood significant market disruptions, proving itself to be consistent with the highest possible risk standards. We are concerned that, because our system does not operate in the same way as certain other risk management systems currently in use, it could be found not to meet certain of the highly prescriptive requirements of the Proposed Rules in Section 39.13.[14] Our concerns are set forth in more detail in the following paragraphs.

OCC's Proprietary Margin System

OCC's System for Theoretical Analysis and Numerical Simulations ("STANS") includes a net asset value ("NAV") component and a risk component. The NAV component marks all positions to market and nets long and short positions to determine the NAV of every portfolio. The NAV component represents the cost to liquidate the portfolio at current prices by selling the net long positions and buying in the net short positions. The risk component is estimated by means of an expected shortfall risk measure obtained from "Monte Carlo" simulations designed to measure the additional asset value required in any portfolio to eliminate an unacceptable level of risk that the portfolio would liquidate to a deficit. STANS generates a set of 10,000 hypothetical market scenarios intended to provide a realistic statistically consistent evaluation of risk at the level of each portfolio. These simulated scenarios incorporate information extracted from the historical behavior of each individual risk factor (including underlying interests) as well as its relationship to the behavior of other risk factors. Scenarios are generated for over 7,000 risk factors, including a broad range of individual equity securities, exchange traded funds, stock indices, currencies, interest rates, bond prices, Treasury and Eurodollar futures prices, variances, volatilities, and several commodity products. OCC's "collateral in margins" system, which is implemented through STANS, differs from the systems used by most other clearing

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[13] OCC currently has 121 clearing members, with net capital ranging from $2.2 million to $11.1 billion. Clearing members are restricted to clearing only those products for which they have adequate operational expertise and financial resources. OCC restricts its financial exposure to clearing members in part through its margining policy, which is designed to ensure that a firm always has sufficient liquid collateral to meet a very extreme and immediate loss in its account (beyond what is covered by OCC's standard margins). It does this through a mechanism that collects extra margin in instances where a firm's net capital is less than the loss it could face in an extreme market move. This mechanism ensures that a firm either has available liquidity to meet an extreme move or OCC holds margin that covers such move. This serves as an effective form of credit cap on OCC clearing activity.

[14] The Commission notes that "[h]istorically, many U.S. DCOs have used Chicago Mercantile Exchange's (CME) proprietary risk-based portfolio margining system, Standard Portfolio Analysis of Risk (SPAN) as the basis for their margin models for futures and options. However, there is at least one other margin model that is currently being used for futures and options, and there are also multiple margin models that DCOs are using for swaps that are currently cleared." We presume that the "other margin model" the Commission refers to is STANS. The Commission appears to have used SPAN as its template for margin requirements under the Proposed Rules. Even though STANS meets the spirit of the Proposed Rules, we believe the Commission's focus on SPAN as a model creates many uncertainties about whether STANS or other margin systems would be in compliance with the Proposed Rules.

organizations in that it takes account of the identity of non-cash margin assets rather than merely looking to the current market value of the assets, less a fixed haircut. This system is superior in that it takes account of the fact that the market value of margin collateral may be correlated (positively or negatively) to the value of other assets and liabilities in a portfolio. OCC believes its collateral in margins program generates portfolio risk estimates that are superior to those used by other clearinghouses and represents a true portfolio margining system. Furthermore, OCC believes that this program gives clearing members an incentive to post forms of margin collateral that reduce the overall exposure of OCC to that clearing member.

Margin Coverage Confidence Levels

The Proposed Rules would require a DCO that clears swaps to establish initial margin levels for each swap portfolio, by beneficial owner, at a confidence level of 99%.[15] OCC does not presently intend to clear swaps (although it may clear security-based swaps). However, if OCC were in the future to clear swaps, it could meet this standard only by segregating each clearing member's swap positions into separate account types containing only swaps, with separate subaccounts for each customer. OCC strongly believes that segregation of swaps from positions in other products that may be highly correlated from a risk perspective is inappropriate, and we note that the Proposed Rules contemplate procedures through which a DCO might apply to the Commission to commingle such positions. We believe that the Proposed Rules should be modified to make clear that, when swaps are commingled in the same accounts or subaccounts with other positions, the 99% test need not be separately applied to the swaps positions alone.

Monitoring of Credit Exposure

The Proposed Rules would require each DCO to "[m]easure its credit exposure to each clearing member and mark to market such clearing member's open positions at least once each business day [and to] [m]onitor its credit exposure to each clearing member periodically during each business day."[16] We believe these Proposed Rules are ambiguous in that the requirement to periodically monitor exposures during the business day could be read as requiring a DCO to update clearing member positions on an intra-day basis for purposes of monitoring risk. While OCC has procedures for revaluing positions periodically during the trading day, OCC does so based upon the positions in a clearing member's accounts at the beginning of the day. Updating positions on an intra-day basis for this purpose is not practical and is not required by current best practice. We do not think it is likely that the Commission intended to impose such a requirement, and we believe that the Commission should clarify that intra-day monitoring of credit exposures based on periodic revaluation of beginning-of-day positions would be sufficient to comply with the Proposed Rule.

Margin Coverage

The Proposed Rules would mandate that the initial margin required by a DCO from each clearing member "be sufficient to cover potential exposures in *normal market conditions*."[17]

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[15] *See* Proposed Rules § 39.13(g)(2)(iii).

[16] Proposed Rules § 39.13(e)(1), (2), 76 FR at 3720.

[17] Proposed Rules §39.13(g)(1), 76 FR at 3720 (emphasis added).

Furthermore, "[e]ach model and parameter used in setting initial margin requirements [would be required to] be risk-based and reviewed on a regular basis."[18] The Commission notes that "international recommendations define 'normal market conditions' as 'price movements that produce changes in exposures that are expected to breach margin requirements or other risk control mechanisms only 1% of the time, that is, on average on only one trading day out of 100.'"[19] The Commission has invited comment on whether to adopt a definition of "normal market conditions." We do not believe that there is any need for the Commission to adopt such a regulatory definition, particularly given the existence of the cited international standard. We believe that the Commission should continue its historically flexible approach toward DCO risk management. We similarly believe that the Commission should defer to the reasonable discretion of the DCO in determining what constitutes a "regular basis" for reviewing margin models and parameters as the frequency with which such matters should be reviewed depends on factors that are specific to the particular products involved and the markets for those products, trading volume and volatility, etc.

The Proposed Rules would also require that a DCO's "actual coverage of the initial margin requirements produced by [its] models, along with projected measures of the models' performance, [must] meet an established confidence level of at least 99%, based on data from an appropriate historic time period, for: (A) Each product (that is margined on a product basis); (B) Each spread within or between products for which there is a defined spread margin rate, as described in [Proposed Rule 39.13(g)(4)]; (C) Each account held by a clearing member at the DCO, by customer origin and house origin; and (D) Each swap portfolio, by beneficial owner."[20] We find it somewhat unclear how this Proposed Rule would apply under STANS, as STANS does not calculate margin on a product or a pre-defined "spread" basis, as such. (A) and (B) therefore seem simply to be inapplicable to OCC. So long as OCC does not clear swaps, (D) would be inapplicable as well. We nevertheless wish to point out that the proposed requirement that swap portfolios be margined separately by beneficial owner would appear to require the separation of swap positions from non-swap positions, and thus could significantly limit the availability of cross-margining and portfolio margining of swaps, which could would be both a disadvantage to these same beneficial owners and could also increase systemic risk. It would be helpful if the Commission could clarify that, in the case of a margin system that margins all positions (potentially including both futures and securities products as well as margin assets) in an account on the basis of the net risk of those positions based upon historical price correlations, the 99% confidence level would accordingly be applied only on an account-by-account basis and not to individual products, product groups, or specified "spread" positions.

Validation of Margin Models

The Proposed Rules would require each DCO to have its "systems for generating initial margin requirements, including its theoretical models . . . reviewed and validated by a qualified and independent party . . . on a regular basis."[21] The Commission notes that this validation

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[18] *Id.*

[19] 76 FR at 3704.

[20] Proposed Rules § 39.13(g)(2)(iii), 76 FR at 3721.

[21] Proposed Rules § 39.13(g)(3),76 FR at 3721.

should "include a comprehensive analysis to ensure that such systems and models achieve their intended goals."[22] The Commission does not attempt to define who would constitute a "qualified and independent party" or the frequency with which the comprehensive review must be undertaken to be considered "regular," although the Commission states that it would expect this validation to be undertaken prior to a DCO implementing a "new margin model" and when making any "significant change" to a model that is already in use. The Release also invites comment on whether there may be circumstances under which an employee of the DCO could be considered independent.

OCC updates its margin model on a frequent basis to reflect the addition of new underlying interests as well as new products. We do not believe that merely adding data points to our margin model would constitute either a "new margin model" or "significant changes" to the existing model. We believe that events necessitating independent verification of our margin model would actually be quite infrequent.

While we appreciate that the Commission has attempted to curtail the potentially broad scope of this requirement by indicating its view that "[s]ignificant changes would be those that *could materially affect* the nature or level of risks to which a DCO would be exposed"[23] we believe further clarification is required. We believe that the "could materially affect" standard is deficient in two respects: (i) it fails to include any reference to the likelihood that a change would actually materially affect the nature or level of risk, and (ii) it omits any reference to the direction of the change in level of risk. We think a more appropriate standard would be to provide that significant changes are those that "are reasonably likely to materially change the nature or increase the level of risks to which the DCO would be exposed." We frequently make changes to our STANS risk model, including when certain new products are introduced for clearing. These changes ordinarily involve merely the application of the existing model to the new product and do not constitute a change that could reasonably be expected to "materially affect our risks." It would be helpful for the Commission to clarify that the addition of a new product or new underlying interest would not inherently be deemed to trigger the independent evaluation requirement.

The Release does not define "qualified and independent party," and requests comment on whether such party must be a third party or whether in certain circumstances an employee of the DCO may fulfill this role.[24] We think that DCOs are capable of validating their own risk models through the use of internal personnel, provided that appropriate steps are taken to ensure objectivity, such as ensuring that the reviewers are not the same individuals as those who are or were involved in designing such models or are otherwise biased due to their involvement in implementation of the models.[25]

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[22] 76 FR at 3705.

[23] 76 FR at 3705 (emphasis added).

[24] *See* 76 FR at 3705.

[25] The Office of the Comptroller of the Currency, the Department of the Treasury, the Federal Reserve System and the Federal Deposit Insurance Corporation recently proposed revisions to their risk-based capital guidelines. These proposed revisions would require banks to validate their internal risk models initially and on an ongoing basis and would require that this "validation process . . . be independent of the internal models' development, implementation,

Spread Margins

The Proposed Rules would allow reductions in margin requirements for "related positions" only if the "price risks with respect to such positions are significantly and reliably correlated."[26] These price risks would only be deemed to be so correlated if there is a "theoretical basis for the correlation in addition to an exhibited statistical correlation." We question the appropriateness of the requirement that there be a theoretical basis for the correlation. A theoretical basis for correlation is, by definition, theoretical and may not be directly observable or verifiable except through the correlation. It is difficult to imagine a correlation for which no theoretical basis can be constructed. In many if not most cases, the theoretical basis for any significant correlation between investment products is obvious. OCC has a sound approach for mitigating concerns about the degree of correlation between contracts, which includes looking at extended data periods, use of stress tests involving assumptions of perfect dependence and zero-dependence, and conducting back-testing. STANS currently relies on over 20 million separate correlations. It would be impractical to attempt to document or even articulate the "theoretical basis" for all of these correlations even though we believe that they would be supportable on a theoretical level. We believe our systems for determining and reviewing the validity of correlations used are entirely sufficient to ensure that OCC does not allow unjustified margin offsets. We would appreciate acknowledgement from the Commission that the methodology employed by STANS, which has been presented to the CFTC staff, meets the requirements of the Proposed Rules.

Back-Testing

The Proposed Rules would require DCOs to conduct daily back tests for products that are experiencing significant volatility "for such products that are margined on a product basis."[27] As OCC does not margin on a product basis, we believe we would not be subject to this requirement. However, if the Commission intends that OCC would be subject to this requirement, we believe the requirement is impractical, given that OCC currently clears derivatives on over 7,000 underlyings. Such a requirement would amount to daily modeling, representing a significant change to current practice that we think is unwarranted and infeasible. OCC does, however, perform daily back-testing on *accounts* (*i.e.*, on a portfolio basis) and does not limit that back-testing to accounts that are experiencing significant market volatility.

Collecting Margin on a Gross Basis

The Proposed Rules would require each DCO to "collect initial margin on a gross basis for each clearing member's customer account equal to the sum of the initial margin amounts that

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and operation, or [that] the validation process . . . be subjected to an independent review of its adequacy and effectiveness." However, the proposed rules would also provide that "[t]he review personnel [would] not necessarily have to be external to the bank in order to achieve the required independence. A bank should ensure that individuals who perform the review are not biased in their assessment due to their involvement in the development, implementation, or operation of the models." Risk-Based Capital Guidelines; Market Risk, 76 FR 1890 (January 11, 2011), at 1897.

[26] Proposed Rules § 39.13(g)(4)(i), 76 FR at 3721.

[27] Proposed Rule § 39.13(g)(7), 76 FR at 3721.

would be required by the derivatives clearing organization for each individual customer within that account if each individual customer were a clearing member."[28] The clearing member would not be allowed to net positions of different customers against each other, although clearing members' house accounts could be margined on a net basis. DCOs would be required to report to the Commission on a daily basis the gross positions for each individual customer. DCOs would be required to mandate that their clearing members collect margin from their customers, for non-hedge positions, at a level greater than 100% of the DCO's margin requirements "with respect to each product and swap portfolio"[29] although DCOs would have reasonable discretion in determining this percentage.

These provisions are very inappropriate as applied to OCC. First, OCC believes that the Commission has no jurisdiction to impose margin requirements on clearing accounts at OCC that are restricted to the clearing of securities products. In order to avoid jurisdictional conflict and to appropriately recognize the position of clearing organizations such as OCC that are both DCOs and clearing agencies regulated by the SEC, we urge the Commission to restrict the applicability of this Proposed Rule to futures customer accounts at both the clearing level and at the level of the individual FCM. While this is arguably implicit in the rule as drafted, we think a specific provision to that effect would be appropriate. Secondly, the only means by which OCC could calculate margin requirements on a customer-by-customer basis within a clearing member's (omnibus) futures customers' account would be to create subaccounts for each customer. While this may be feasible for OCC with respect to futures accounts, which comprise a small percentage of OCC's clearing activity, it would be a truly daunting task and likely unachievable in a short time frame or at a reasonable cost if applied to accounts of securities as well as futures customers. On the other hand, OCC does observe certain procedures in clearing members' securities customers' accounts, which are omnibus accounts, that provide additional protection to those accounts as a whole. OCC presently "segregates" (*i.e.,* gives no margin credit for and asserts no lien against) long options positions in such customers' accounts except to the extent that the clearing member instructs OCC that particular long options are part of a spread held by a single customer and the *customer* has received a margin credit for the long position. The result is to increase the collateral held in respect of the securities customers' account relative to accounts margined on a purely net basis. While the individual customer whose positions are "segregated" has no greater protection than a customer whose positions are not segregated, customers as a group benefit because OCC will likely return more property to the estate of a failed clearing member to satisfy customer claims than if such positions had been margined on a strictly net basis.

Further, requiring clearing members to calculate margin on "non-hedge positions" at a level greater than 100% of the DCO's margin requirement would be virtually impossible for OCC to do and is a radical break from existing practice in that DCOs have not historically imposed margin requirements at the customer level. The amount of margin that FCMs or broker-dealers are required to obtain from their customers has historically been established under the rules of exchanges and not under clearing organization rules. There is good reason for that in that, among other things, clearing organizations would ordinarily have no means to enforce

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[28] Proposed Rule § 39.13(g)(8), 76 FR at 3721.

[29] Proposed Rule 39.13(g)(8)(ii), 76 FR at 3721.

customer level margin requirements. Further, as discussed in other contexts above, OCC's STANS system calculates margin based on all positions in an account and not on a position-by-position basis. OCC has no present ability to furnish clearing members with a number representing the initial margin on a particular position—whether hedged or un-hedged. Moreover, as STANS requirements are data-driven on a month-to-month, and even a day-to-day, basis they can vary in ways that customers cannot readily predict.

In general, we believe that the Commission's Proposed Rules are equivalent to requiring separate subaccounting for all customer accounts. While the Commission held a Roundtable on such a proposal for swap accounts[30] and recently sought comment on it,[31] we are surprised to see the Commission proposing such an approach for non-swap futures customer accounts without a thorough vetting of its impact on both DCOs and FCMs. We respectfully suggest that if the Commission intends to require separate subaccounting for non-swap futures customer accounts it should do so only after seeking additional comment on this aspect of the Proposed Rules.

Withdrawal of Margin

The Proposed Rules would require each DCO to "require its clearing members to ensure that their customers do not withdraw funds from their accounts with such clearing members unless the net liquidating value plus the margin deposits remaining in a customer's account after such withdrawal are sufficient to meet the customer initial margin requirements with respect to all products and swap portfolios held in such customer's account which are cleared by the derivatives clearing organization."[32] While we find the drafting of this provision to be unclear, we assume that what is intended is that the customer not be permitted to withdraw funds unless the liquidating value in the customer's account exceeds that amount of initial margin required on the customer's positions at the DCO. Again, (i) we believe that DCO rules should not set customer level margin requirements, and (ii) the requirement assumes the availability of a number that OCC's margin system does not presently calculate and would effectively require subaccounting for each customer.

Risk Thresholds

The Proposed Rules would require each DCO to "impose risk limits on each clearing member, by customer origin and house origin, in order to prevent a clearing member from carrying positions for which the risk exposure exceeds a specified threshold relative to the clearing member's and/or the derivatives clearing organization's financial resources."[33] While we believe that these requirements are generally consistent with OCC's existing position risk margin call policy (*i.e.*, our policy that provides for the collection of additional margin when a clearing member's net capital is less than the amount we estimate the firm could be expected to face in a margin call made during a stressed "tail event"), we note again that this requirement on

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[30] *See* CFTC Staff Roundtable on Customer Collateral Protection, October 22, 2010.

[31] See Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies, Advanced Notice of Proposed Rulemaking, 75 FR 75162 (December 2, 2010).

[32] Proposed Rules § 39.13(g)(8)(iii), 76 FR at 3721.

[33] Proposed Rules § 39.13(h)(1)(i), 76 FR at 3721.

its face would apply to all accounts of a clearing member, including securities clearing accounts of broker-dealers that are not FCMs and do no futures business. We are certain that the Commission did not intend the Proposed Rule to apply in this situation. We ask the Commission to clarify the Proposed Rule in this regard.

Large Trader Reports

The Proposed Rules would require each DCO to "obtain from its clearing members, copies of all reports that are required to be filed with the Commission by such clearing members pursuant to [the Commission's large trader reporting rules]."[34] DCOs would be required to "review such reports on a daily basis to ascertain the risk of the overall portfolio of each large trader, including positions at all clearing members carrying accounts for each such large trader, and [to] take additional actions with respect to such clearing members, when appropriate, as specified in [Proposed Rule 39.13(h)(6)], in order to address any risks posed by any such large trader."[35] Each DCO must also conduct stress tests for each large trader determined to pose significant risk to a clearing member or the DCO.[36]

While it is useful to a clearing organization to identify customer accounts that could potentially cause a clearing member to default, it has traditionally been the role of a clearing member's Designated Self-Regulatory Organization ("DSRO") (referred to in the securities industry as the Designated Examining Authority or "DEA") to require that an FCM submit sufficient information to permit the DSRO or DEA to identify such situations. The shared regulatory functions of multiple self-regulatory organizations are largely managed through the joint audit committee ("JAC") and the clearing organization's obligations should be satisfied by its participation in the JAC. If DCOs were required to perform all such tasks alone, they would be required to build new surveillance systems and significantly increase their surveillance staffing in order to comply with these Proposed Rules. Further, we do not see a sufficient benefit to justify the increased DCO resources that would be required to undertake daily stress tests on each large trader, the cost of which will be passed on to clearing members and ultimately on to the clearing members' customers.

Weekly Stress Testing

The Proposed Rules would require DCOs to conduct weekly stress tests on "each clearing member account, by customer origin and house origin, and each swap portfolio, by beneficial owner, under extreme but plausible market conditions."[37] STANS incorporates *daily* stress tests on all positions, including margin assets, in each clearing member account to assure a positive liquidating value of the account at more than a 99% confidence level. Largely for regulatory reasons associated with OCC's status as a dual SEC/Commission registrant, OCC's system does not consolidate all positions into a single "customer origin" and "house origin" for each clearing member, but rather permits multiple account types including a firm (proprietary) account that

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[34] Proposed Rules § 39.13(h)(2), 76 FR 3722.

[35] 76 FR at 3722.

[36] *See* Proposed Rule 39.13(h)(3), 76 FR at 3722.

[37] Proposed Rules § 39.13(h)(3)(ii), 76 FR at 3722.

incorporates both securities and futures positions, a securities customers' account, a regular futures customer segregated funds account subject to Section 4d of the CEA, separate segregated funds accounts for cross-margining arrangements as provided in various Commission orders approving such arrangements, and others. We request that the Commission clarify in its Proposed Rules or the adopting release that this method of stress testing at the unconsolidated account level based on appropriate historical data meets the standard of the Proposed Rules. Because of the mathematical properties of the risk measures used by OCC, unconsolidated account level stress testing is more rigorous than if such stress testing were conducted at the level of each origin as a whole. Further, it makes sense to aggregate positions for stress testing in the same manner as they would be aggregated or netted for liquidation purposes.

While the requirement of conducting stress tests under "extreme but plausible" market conditions may be appropriate for determining the adequacy of a clearing organization's resources for withstanding the default of its largest participant, it would be inappropriate for measuring the adequacy of an individual clearing member's margin deposits. We believe that stress testing accounts on a daily basis to ensure a positive liquidating value at more than a 99% confidence level is adequate and appropriate. DCOs should have the ability to cover for more extreme market conditions through the use of additional financial resources, including clearing fund deposits.

Risk Management Documentation

The Proposed Rules would require each DCO to "establish and maintain written policies, procedures, and controls, *approved by its Board of Directors*, which establish an appropriate risk management framework that, at a minimum, clearly identifies and documents the range of risks to which the derivatives clearing organization is exposed, addresses the monitoring and management of the entirety of those risks, and provides a mechanism for internal audit."[38] OCC's risk management policies are highly complex and are embodied in multiple separate written documents totaling many hundreds of pages of materials. Much of OCC's day-to-day operations are related to risk management. Requiring that every document related to risk management be approved by OCC's Board of Directors would be burdensome and inappropriate for staff and would impose an inappropriate requirement on Boards of Directors to micro-manage the detailed day-to-day functions of running a DCO. We think that the Commission should make clear that no such requirement is intended to be imposed by the Proposed Rule. The committee of OCC's Board of Directors that is responsible for oversight of OCC's risk management activities is a very critical, active and highly valued element in the management of OCC. We believe that it currently functions well, and we do not believe that its function will be enhanced by the creation of additional written policies, procedures and controls that have no function other than to satisfy the requirements of the Proposed Rule.

Clearing Member Risk Management Policies and Procedures

The Proposed Rules would require each DCO to adopt rules requiring its clearing members to maintain risk management policies and procedures.[39] DCOs would need to have the

[38] Proposed Rules § 39.13(b), 76 FR at 3720 (emphasis added).

[39] *See* Proposed Rules § 39.13(h)(5).

authority to request and obtain information and documents from clearing members "regarding their risk management policies, procedures, and practices, including, but not limited to, information and documents relating to the liquidity of their financial resources and their settlement procedures[.]"[40] DCOs would need to require their clearing members to make this information and documentation available to the Commission upon the Commission's request, notwithstanding whether the relevant clearing member is an [FCM]. Furthermore, a DCO would be required to review its clearing members' risk management policies on a periodic basis and to document these reviews.[41] Requiring DCOs to conduct periodic reviews of clearing members' risk management policies would represent a significant expansion of DCOs' responsibilities and the cost of implementing such requirement would be very high for any DCO that is not integrated with a designated contract market. The Commission has provided no guidance as to the depth, method or frequency of these reviews, nor has the Commission limited the scope of the examination requirement to those members that clear products subject to the Commission's jurisdiction. In addition, virtually all OCC clearing members are also members of multiple other DCOs. Requiring each DCO to review the risk management policies of each of its clearing members would result in a massive duplication of efforts among multiple DCOs and would, we believe, be burdensome for the clearing members, whose employees would be forced to endure repeated DCO examinations covering identical subject matter. We believe that reviews of clearing members' risk management policies are much more appropriately conducted by the SEC, the Commission, the clearing member's DSRO or DEA (*e.g.*, CME or FINRA), or the National Futures Association.

Core Principle E (Settlement Procedures)

The Proposed Rules would require each DCO to "employ settlement arrangements that *eliminate or strictly limit* its exposure to settlement bank risks, including the credit and liquidity risks arising from the use of such banks to effect settlements with its clearing members."[42] Each DCO would also be required to have "documented criteria with respect to those banks that are acceptable settlement banks for the derivatives clearing organization and its clearing members, including criteria addressing the capitalization, creditworthiness, access to liquidity, operational reliability, and regulation or supervision of such banks."[43] DCOs would also be required to "monitor each approved settlement bank on an ongoing basis to ensure that such bank continues to meet [these] the criteria."[44] Further, a DCO would be required to "monitor the full range and concentration of its exposures to its own *and its clearing members'* settlement banks and assess its own and *its clearing members'* potential losses and liquidity pressures in the event that the settlement bank with the largest share of settlement activity were to fail."[45] DCOs must also take certain actions to eliminate or strictly limit such exposures, including imposing concentration limits or maintaining arrangements with multiple settlement banks. OCC recognizes the

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40 Proposed Rules § 39.13(h)(5)(i)(B), 76 FR at 3722.

41 *See* Proposed Rule 39.13(h)(ii), 76 FR at 3722.

42 Proposed Rules § 39.14(c), 76 FR at 3722 (emphasis added).

43 76 FR at 3722.

44 Proposed Rules § 39.14(c)(2), 76 FR at 3722.

45 Proposed Rules § 39.14(c)(3), 76 FR at 3723 (emphasis added).

importance of selecting settlement banks with care, diversifying risk among them to the extent practicable, and monitoring their financial status. However, we believe it is impossible, strictly speaking, to "eliminate" all exposure to settlement bank risks. The Commission has provided no guidance as to what it means to "strictly limit" this exposure.

While we believe it is sensible to require DCOs to have written policies on the selection of clearing banks, the Commission should appreciate that under certain conditions, particularly during major market disruptions, it may be necessary for a DCO to deviate from those written policies as the DCO seeks to use those settlement banks that are the best options available at the time, notwithstanding that such banks may not meet the technical settlement bank criteria set forth in the DCO's written policies.

The requirements that a DCO monitor the settlement banks used by its clearing members and that the DCO monitor its clearing members' exposure to such settlement banks could result in the same kind of massive duplication of effort described above with respect to DCOs' review of their clearing members' risk management policies. While monitoring clearing members' exposure to their settlement banks appears to us to be a sensible measure to ensure that such banks are not an additional source of risk to clearing organizations, we believe it would be very burdensome for each DCO to conduct this monitoring. This responsibility is better placed on a clearing member's own primary regulator or on the clearing members themselves.

Furthermore, the Proposed Rules would require DCOs to "(i) Maintain settlement accounts at *additional settlement banks*; (ii) Approve *additional settlement banks* for use by its clearing members; (iii) Impose concentration limits with respect to its own or its clearing members' settlement banks; and/or (iv) Take any other appropriate actions, if any such actions are reasonably necessary in order to eliminate or strictly limit such exposures."[46] Although the Release indicates that the foregoing actions would be required only "[i]f action were reasonably necessary in order to eliminate or strictly limit exposures to settlement banks",[47] no such limitation is included in the Proposed Rule itself, which on its face applies in all cases. We believe that these requirements would be reasonable if the Proposed Rule were expressly limited in the manner indicated in the Release and question whether it was merely an oversight that the limitation was not incorporated into the Proposed Rule.

Core Principle F (Treatment of Funds)

The Proposed Rules would limit the types of assets that a DCO may accept as initial margin to those with "minimal credit, market, and liquidity risks."[48] DCOs would be prohibited from accepting letters of credit as initial margin, because letters of credit are "unfunded financial resources with respect to which funds might be unavailable when most needed."[49] Letters of credit have been allowed as initial margin for many years and we do not understand why the Commission would take such broad action in prohibiting them across the board. We do believe

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[46] Proposed Rules § 39.14(c)(3), 76 FR at 3723 (emphasis added).

[47] 76 FR at 3709.

[48] Proposed Rules § 39.15(c)(1), 76 FR at 3724.

[49] 76 FR at 3710.

that it is appropriate for DCOs to set criteria with respect to the issuers of letters of credit, diversify concentration of risk among issuers, and limit the total proportion of a clearing member's margin requirement that can be represented by letters of credit. OCC already imposes such criteria and restrictions, and we question whether there is any need for the Commission to impose additional regulation other than perhaps to require that DCOs have such standards. We think it would be appropriate for the Commission to prohibit a DCO from accepting letters of credit from a clearing member that are issued by institutions that are affiliated with the clearing member. We note that, in the recent financial crisis—the most severe since the 1930's—OCC successfully drew down on letters of credit deposited by a clearing member already known at the time of the draw to be insolvent, and the letters of credit were honored by all three of the issuing banks.

More generally, we believe the Proposed Rules place an excessive focus on the types of assets that may be used as margin supporting cleared positions. We view the distinction between margin assets and the cleared positions they support as artificial. Both are subject to fluctuation in value, and both may either exacerbate or ameliorate the risk of other positions in the account depending upon their correlation with the risk of those other positions. The Commission's central focus should be on whether the procedures and risk management systems of a DCO are sufficient to provide a high degree of assurance that a portfolio (including margin assets) can be liquidated without resulting in a negative liquidation value.

We are particularly concerned that some of the collateral currently accepted by OCC would no longer be permitted under a literal reading of the Proposed Rules. For example, OCC currently accepts less-liquid stocks and long-dated Treasury securities as initial margin. OCC applies appropriate valuation to these forms of margin to reflect the volatility and other characteristics of the instruments and their contribution to the overall risk of the portfolio. Even though XYZ stock may be less liquid than other stocks, it may have greater value than a much more liquid stock when pledged to secure a short position in XYZ call options. OCC's "collateral in margins" or "CIM" program is unique in that it treats margin assets in an account in the same way that it treats positions, recognizing both positive and negative correlations with other assets and liabilities in the account to obtain a more accurate assessment of the probable liquidating value of the account. We believe that this potential diversification of and recognition of the specific characteristics of particular margin assets reduces clearing organizations' risk and therefore systemic risk. We urge the Commission not to impose a standard of "minimal credit, market, and liquidity risk," or adopt an interpretation of any such standard that is imposed, in a manner that would reduce the opportunities for diversification of collateral and use of assets that may have specific risk-reducing properties in the portfolio. OCC strongly believes that its CIM program, which looks at each type of collateral as an asset with specific risk characteristics rather than as a fixed value, is a superior method of risk management.

Any limitation on the types of collateral that may be posted by clearing members will increase the cost of clearing to the clearing members and these costs will inevitably be passed on to customers. Where a DCO is capable of reflecting the risk of certain assets in its margin model, we see no reason why less liquid instruments or instruments with higher than average credit or market risks should not be acceptable for initial margin. In fact, the Proposed Rules expressly recognize this by requiring DCOs to "apply appropriate reductions in value to reflect market and credit risk (haircuts), including in stressed market conditions, to the assets that it

accepts in satisfaction of initial margin obligations, and [to] evaluate the appropriateness of such haircuts on at least a quarterly basis."[50] We think the Commission has struck an overly restrictive balance in drafting the Proposed Rules, if the rules are interpreted inflexibly.[51] If a DCO can only accept instruments with minimal risk, then haircuts should either not be required at all or should be very small. By contrast, applying an appropriate valuation to a relatively lower quality asset can, we believe, make such asset perfectly acceptable as initial margin.

Haircuts

The Proposed Rules would also require each DCO to "apply appropriate reductions in value to reflect market and credit risk (haircuts), including in stressed market conditions, to the assets that it accepts in satisfaction of initial margin obligations, and [to] evaluate the appropriateness of such haircuts on at least a quarterly basis."[52] While we believe that STANS should be deemed to be compliant with this requirement, OCC believes that there is ambiguity as to exactly what it would be required to test on a quarterly basis since it does not apply fixed haircuts to securities deposited as collateral. As previously discussed, STANS treats collateral as part of a clearing member's overall portfolio (*i.e.*, true portfolio margining). STANS revisits each "haircut" or valuation on a security-by-security, account-by-account, and day-by-day basis. Moreover, the adequacy of the CIM haircuts is checked through back-testing and not by periodic review of the kind implied by the Proposed Rule.

Concentration Limits

The Proposed Rules would require each DCO to "apply *appropriate* limitations on the concentration of assets posted as initial margin, *as necessary*, in order to ensure its ability to liquidate such assets quickly, with minimal adverse price effects, and [to] evaluate the appropriateness of any such concentration limits, on at least a monthly basis."[53] Although certain concentration "charges" are applied under STANS, it is not clear on the face of the rule whether it would be sufficient to impose charges rather than imposing fixed limits on concentration. We ask that the Commission either clarify the meaning of this provision or take a flexible approach in interpreting it. Again, we think it important that the Commission keep in mind that STANS treats collateral assets in the same way as cleared products for purposes of determining risk. Provided that the margin system adequately penalizes concentration of risk, either in cleared positions or collateral, we do not believe that fixed concentration limits are required.

Core Principle G (Default Rules and Procedures)

The Proposed Rules would require each DCO to maintain a "written default management plan that delineates the roles and responsibilities of its Board of Directors, its Risk Management Committee, any other committee that has responsibilities for default management, and the

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[50] Proposed Rules § 39.15(c)(3), 76 FR at 3724.

[51] *cf.* Proposed Rules §§ 39.13(c)(1), 39.15(c)(3).

[52] Proposed Rules § 39.15(c)(3), 76 FR at 3724.

[53] Proposed Rules § 39.15(c)(4), 76 FR at 3724 (emphasis added).

derivatives clearing organization's management, in addressing a default, including any necessary coordination with, or notification of, other entities and regulators."[54] The plan would be required to "address any differences in procedures with respect to highly liquid contracts (such as certain futures) and less liquid contracts (such as certain swaps)."[55] Furthermore, each DCO would be required to test its default management plan at least annually and to document such tests. We believe such annual tests are a useful exercise and we commend the Commission for including annual testing in the Proposed Rules.

DCOs would also be required to adopt rules that would define the sequence in which the funds and assets of a defaulting clearing member and the financial resources maintained by the DCO would be applied in the event of a default. OCC concurs that this is an appropriate requirement and believes that it is met by OCC's existing rules.

Core Principle I – System Safeguards

SIDCO Recovery Time Objective

The Proposed Rules would require a DCO's business continuity and disaster recovery plan ("DRP") to "have the objective of, and the physical, technological, and personnel resources described therein shall be sufficient to, enable the derivatives clearing organization to resume daily processing, clearing, and settlement no later than the next business day following [a] disruption."[56] We think a next business day recovery time objective ("RTO") is reasonable and is achievable by most DCOs currently in operation. However, for SIDCOs, Section 39.30(a) of the Proposed Rules would shorten this RTO to two hours.[57] The two hour RTO would apply to SIDCOs irrespective of the scale of the disruption.

While a two hour RTO for SIDCOs is a laudable goal and one that is achievable in some cases, we believe that it is not consistently achievable without sacrificing core DCO functions and increasing the risk of errors and backlogs. OCC currently practices disaster recovery ("DR") procedures on almost a monthly basis and, while OCC strives to meet a two hour RTO, experience has shown that it often takes approximately three hours to fully recover and conduct operation checks. In our experience, this RTO period is sufficient to allow OCC to meet its responsibilities and avoid significant market disruption. OCC has considered options for further streamlining DR procedures and has concluded that the effort to further reduce RTO would not be cost-effective and could increase rather than decrease reliability risk.

Forcing SIDCOs to achieve a two hour RTO may cause them to take shortcuts, including skipping vital operations checks, and/or return to operations at less than full capacity. We believe that this would be ill-advised and could exacerbate disruptions.

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[54] Proposed Rules § 39.16, 76 FR at 3724.

[55] *Id.*

[56] Proposed Rules § 39.13(e)(3), 76 FR at 3725.

[57] *See* Proposed Rule 39.30(a), 76 FR at 3726.

We appreciate that SIDCOs are, by their nature, vital nodes in the global financial system and that SIDCOs experiencing a disruption should endeavor to return to full operating capacity as quickly as possible. However, resumption of full clearing activities may take longer than two hours depending on the type, timing and magnitude of the disruption. We encourage the Commission to coordinate with other regulators in applying the previously established guidelines to SIDCOs as well as other DCOs and in adopting system safeguard requirements in general. As a dual registrant, OCC is particularly sensitive to any regulatory effort that seems to get ahead of the efforts of other regulators or that seems to be undertaken with little coordination with other regulators. As noted above, we believe it is unlikely that the Commission will be OCC's "supervisory agency" for purposes of Title VIII of Dodd-Frank and therefore we believe that OCC would not be subject to the heightened SIDCO RTO described above. We nevertheless offer our comments on the proposed standard because we believe that the SEC and the Commission should adopt similar standards.

Periodic Testing by DCOs

The Proposed Rules would require each DCO to test and review its "automated systems to ensure that they are reliable, secure, and have adequate scalable capacity; and . . . [i]ts business continuity and disaster recovery capabilities, using testing protocols adequate to ensure that the derivatives clearing organization's backup resources are sufficient to meet the requirements of [Section 39.18(e) of the Proposed Rules]." This testing would be required to be "*conducted* by qualified, independent professionals."[58] These independent professionals could be "independent contractors or employees of the derivatives clearing organization, but [would be required not to be] persons responsible for development or operation of the systems or capabilities being tested."[59]

While we believe that qualified and independent professionals should be involved in testing DCOs' systems and disaster recovery capabilities, we also believe that the employees of the DCO who have developed and operated the systems and capabilities being tested must be heavily and centrally involved in such tests. These employees have a degree of knowledge and familiarity with the DCO that an independent professional simply would not have and their involvement in the tests will make the tests more meaningful, while providing valuable training and practice to the employees. In order to ensure that the involvement of such employees in testing systems and capabilities does not result in myopia, we encourage the Commission to amend Section 39.18(j)(2) of the Proposed Rules to read, in relevant part: "Testing shall be ~~conducted~~ **overseen** by qualified, independent professionals." We believe this strikes an appropriate balance.

Coordination of DRP

The Proposed Rules would require each DCO to "(1) coordinate its business continuity and disaster recovery plan with those of its clearing members, in a manner adequate to enable effective resumption of daily processing, clearing, and settlement following a disruption; and, (2) [i]nitiate and coordinate periodic, synchronized testing of its business continuity and disaster

[58] Proposed Rules § 39.18(j)(2), 76 FR at 3725.

[59] *Id.*

recovery plan and the plans of its clearing members[.]"[60] OCC participates in the annual industry-wide business continuity and disaster recovery test. The test is coordinated by the Securities Industry and Financial Markets Association and the Futures Industry Association. The annual test is a collaborative effort between these industry groups, securities and futures clearing organizations, securities and futures exchanges, clearing member firms, trading firms, technology vendors and others designed to test the resiliency of the industry's business continuity and disaster recovery systems and planning. The industry completed its seventh annual test in October of 2010 and is scheduled to complete its eighth test in October of 2011. We think it would be helpful if the Commission addresses this annual industry-wide test and provides guidance as to whether such tests will fulfill the requirement that DCOs "coordinate periodic, synchronized testing" of their DRPs and the DRPs of their members, as technically no DCO could be said to be "coordinating" these tests. They are generally coordinated by industry groups and DCOs merely participate. Requiring DCOs to separately organize and coordinate their own periodic testing of their member firms would be an unnecessary burden on the DCOs, but in particular would be an unnecessary burden on clearing and trading firms, as they would need to participate in separate tests conducted by multiple DCOs.

Effective Dates

The Release proposes that the Proposed Rules would generally become effective 180 days after final rules are published in the Federal Register. The system safeguard requirements for SIDCOs, however, would become effective on the later of one year after publication of final rules or July 30, 2012. This is a very short and burdensome deadline that will be very difficult to meet, particularly given that the SIDCO system safeguards will not be implemented in a vacuum. DCOs will be engaged in implementing huge volumes of new rules over the next several years and system safeguard requirements are an area in which we believe it is unwise to rush. Obviously OCC and other DCOs would like to ensure that our system safeguards are as robust as possible and to do so as quickly as is feasible. However, rushing the extensive development and testing that goes into systems design and implementation is likely to result in systems that malfunction, do not work as expected, or that create more chaos than they are designed to prevent. We encourage the Commission to adopt a full 24 month compliance period for the requirements applicable to SIDCOs under the Proposed Rules.

Conclusion

OCC has generally been regarded as a model clearing organization. Operated as a public market utility for the benefit of its participating exchanges, clearing members and the investing public, OCC is effectively a non-profit organization. We have a proud history of providing safe, reliable and low cost clearing services for increasing volumes of transactions through turbulent markets and market crises since 1973. Congress in effect acknowledged the success of OCC and other clearing organizations in mitigating systemic risk and contributing to the safety of financial markets by making central clearing of OTC derivatives a central tenet of Dodd-Frank. Given OCC's experience and track record, OCC believes substantial weight should be afforded to the comments and requests made in this comment letter. We look forward to working closely with

[60] Proposed Rules § 39.18(k)(1), (2), 76 FR at 3725.

the Commission to provide any additional input that might be useful to the Commission in determining the final form of the Proposed Governance Rules.

Sincerely,

Wayne P. Luthringshausen
Chairman and Chief Executive Officer

cc: Gary Gensler
Chairman
Commodity Futures Trading Commission

Michael V. Dunn
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