



March 21, 2011

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

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

Dear Mr. Stawick:

Better Markets, Inc.¹ appreciates the opportunity to comment on the above-captioned proposed rules (the “Proposed Rules”) of the Commodity Futures Trading Commission (“CFTC”), implementing provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) applicable to risk management requirements for derivatives clearing organizations (“DCOs”).

Introduction

We applaud the Proposed Rules, which establish comprehensive and effective risk management requirements and processes for DCOs. A central pillar of the Dodd-Frank Act is that it calls for clearing as large a portion of the derivatives markets as possible through DCOs. This has many benefits. The risk management techniques and policies employed by DCOs provide a transparent and reliable system which protects the markets and the public from many of the consequences of credit defaults like those experienced during the financial crisis. Use of DCOs also fosters transparency and uniformity of derivatives. Finally, centralization of trade data and uniformity of valuation techniques provides a useful source of reliable information to regulators.

The continued integrity of DCOs is even more important under the Dodd-Frank Act than in the past. DCOs have always been important elements of the derivatives market infrastructure. Now they are at the center of the new system. The Proposed Rules are essential to reinforce the soundness of the DCO credit management systems.

¹ Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

In the Proposed Rules, the CFTC has taken some useful and important steps to better assure the integrity of DCOs. We congratulate the CFTC for these important steps. In particular, the use of a capital threshold and requirement of resources proportionate to risk exposure is an important change of practices which will open DCO membership while protecting the risk management system.² In addition, the requirement that a DCO collect gross margin for customer accounts is a sound practice.³

Generally, the risk metric requirements in the Proposed Rules⁴ are prudent and practical, but we propose additional factors which must be considered, as discussed below.

Further, the requirement for a Chief Risk Officer (“CRO”) is wisely included in the Proposed Rules.⁵ However, the substantive provisions of the Proposed Rules are insufficient, little more than a requirement that such an officer be appointed. The CROs of DCOs must be subject to the same rules regarding reporting and independence as the CROs of other registered entities if they are to be effective and serve their intended purpose.

Discussion

The Proposed Rules address the issue of spread margins. These are the netted initial margins of long and short derivatives whose prices are correlated.⁶ In the Proposed Rules, two contracts can be netted if the price risks are “significantly and reliably correlated.”

This is not nearly specific enough. The Proposed Rules are very specific as to the risk of price change and the associated calculation of initial margin, specifying the number of days of a required holding period (i.e., assumed liquidity) and the confidence interval (i.e., assumed volatility), all based on an historic data set. The limited requirements applied to spread credits are completely inconsistent with the specificity of the rules applied to price moves. A dollar lost because of a mistakenly calculated relationship between prices is the same as a dollar lost because of the move of a single price.

The Proposed Rules must require that the relationship be calculated using the same standards as the initial margin for the individual position. Currently, the process used by DCOs is opaque. Below is an accurate way to calculate spread credits based on standards which are consistent with the volatility and liquidity requirements of the Proposed Rules. The precise methodology can be left to the DCOs, but this approach establishes minimum standards.

DCOs should assemble the historic spreads between the prices, like the data set that underpins initial margin calculations. It must then calculate the correlation factors over each holding period. The holding period must be the largest one applicable to each of the two positions. This parallels the holding period in the initial margin calculation in order to

² Proposed Rules, Section 39.12(a)(2).

³ Proposed Rules, Section 39.13(g)(8)(i).

⁴ Proposed Rules, Section 39.13(g)(1).

⁵ Proposed Rules, Section 39.13(c).

⁶ Proposed Rules, Section 39.13(g)(4).

measure liquidity. The confidence interval should be applied so that 99 percent of the correlation factors are captured. This parallels the volatility standards expressed as a confidence interval. The lowest correlation factor in the remaining set should be applied to the gross initial margin amounts as the credit.

The steps in this calculation are set forth below:

Step 1	Set of Source Price Data	Daily spreads between prices of 2 netted contracts over a period of observations
Step 2	Set of Data for Margin Credit Calculation - Liquidity Factor Applied	Correlation factors over rolling 5-day holding periods calculated (assumes that 5 days is the longest of the 2 holding periods)
Step 3	Volatility Factor Applied	Confidence interval applied so as to capture 99% of the correlation factors in the set
Step 4	Margin Credit Calculated	Position Credit = Lowest Correlation Factor ⁷ x (Initial Margin A + Initial Margin B)

Chief Risk Officer

As stated above, the Proposed Rules provide almost no substantive parameters associated with the position of CRO. Given that credit risk is the principal business of DCOs, this is simply and indisputably inadequate.

The closest analog to a DCO is a futures contract merchant ("FCM"). The principal businesses of both DCOs and FCMs are to measure portfolio risk of derivatives, generally using the same metrics. There is simply no principled distinction that would provide a basis for the rules not to be the same. The CRO rules applicable to FCMs should be applied in full to DCOs. The CFTC has issued a proposed rule on this matter,⁸ and Better Markets, Inc. filed a comment letter in response to that proposed rule.⁹ The Proposed Rules' relation to DCO CROs must parallel the FCM CRO NOPR, as modified in accordance with our comment letter.

⁷ This refers to the lowest correlation factor within the set of all correlation factors which are included within the 99 percent confidence interval. For instance, assume that all of the observed correlation factors range from .64 to .91. Further assume that the correlation factors ranging from .66 to .91 equal 99 percent of the total. The correlation factor to be applied in the calculation of the margin credit will be .66.

⁸ CFTC Notice of Proposed Rulemaking, Designation of a Chief Compliance Officer; Required Compliance Policies; and Annual Report of a Futures Commission Merchant, Swap Dealer, or Major Swap Participant (CFTC RIN 3038-AC96) ("FCM CRO NOPR")

⁹ Better Markets, Inc. Comment Letter dated January 18, 2011 regarding FCM CRO NOPR.

Conclusion

As stated above, we commend the CFTC for its effort to ensure the continued reliability of DCOs in the new market structures mandated by the Dodd-Frank Act.

We hope that our suggestions are helpful.

Sincerely,



Dennis M. Kelleher
President & CEO

Wallace C. Turbeville
Derivatives Specialist

Better Markets, Inc.
Suite 1080
1825 K Street, N.W.
Washington, D.C. 20006
(202) 618-6464
dkelleher@bettermarkets.com
wturbeville@bettermarkets.com

www.bettermarkets.com