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Via: http://comments.cftc.gov

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

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

Dear Mr. Stawick:

State Street Corporation ("State Street")[1] appreciates the opportunity to comment on the Commodity Futures Trading Commission's (the "Commission's") proposal (the "Proposal")[2] regarding risk management standards for derivatives clearing organizations ("DCOs"). State Street's comments focus on the Commission's efforts to ensure fair and open access to DCO membership (the "Participant Eligibility Proposal").

State Street strongly supports the fair and open access for membership to clearing houses as mandated by the provisions of Section 725 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). While we suggest some changes below, we believe the Commission's Participant Eligibility Proposal would effectively implement Congress's intent in this area.

State Street intends to actively seek membership in a variety of DCOs, and plans to become a clearing member of derivative clearing organizations in advance of the effective date of the Proposal. Based upon our evaluation of membership requirements for existing clearinghouses, our ability to do so could be frustrated by membership rules and criteria that appear to be at odds with principles of fair and open access, and which, if not addressed through the current rulemaking process, could deny our institutional investor customers the potential benefits of increased competition in the market for clearing services.

[1] With over $21.5 trillion of assets under custody and administration and $2 trillion of assets under management at December 31, 2010, State Street is a leading specialist in meeting the needs of institutional investors worldwide. Our customers include mutual funds, collective investment funds and other investment pools, corporate and public retirement plans, insurance companies, foundations, endowments and investment managers. Including the United States, we operate in 26 countries and more than 100 geographic markets worldwide.

[2] Proposed Rule 39.12, Risk Management Requirements for Derivatives Clearing Organizations, 76 Fed. Reg. 3698 (proposed January 20, 2011) (amending 17 CFR Part 39) (the "**Proposal**").

While we are fully in agreement with rules that require clearinghouse members to demonstrate sufficient financial and operational resources to fulfill their obligations, particularly in times of financial stress, we also believe both the clearinghouses themselves and swap markets overall will benefit from more diversified clearinghouse memberships and the emergence of competitive, alternative models for clearing services. If such changes are properly implemented, the result will be more efficient and competitive swaps markets, greater acceptance of the new swaps regulatory regime, and lower levels of systemic risk.

Our comments today focus primarily on suggested improvements to the Commission's Proposal. In addition, however, State Street urges the Commission to take immediate action to address current marketplace developments that, if left unchecked, could contradict Congress's and the Commission's goal of requiring fair and open access to DCO membership. Specifically, as noted below, certain DCOs appear to plan to carry forward existing restrictive membership requirements during the transition period until effectiveness of the Proposal, with the implication that institutions that meet these criteria will be advantaged in establishing clearing relationships under the emerging DCO marketplace.

Dodd-Frank and the Commission's Participant Eligibility Proposal

Section 5b(c)(2)(C) of the Commodity Exchange Act, as amended by the Dodd-Frank, requires DCOs to establish "participation and membership requirements" that are "objective," "publicly disclosed" and "permit fair and open access."[3] The Section also requires that clearing members have "sufficient financial resources and operational capacity to meet obligations arising from participation in the [DCO]."[4] The Commission recognizes the apparent tension between these two goals.[5] State Street believes that these requirements should be read together to require strong, but not anticompetitive, DCO membership criteria. State Street agrees with the Commission that "more widespread participation could reduce the concentration of clearing member portfolios and diversify risk [and] also increase competition by allowing more entities to become clearing members."[6]

State Street believes that membership requirements should be targeted to the specific risks facing clearing members. We support membership criteria that are reflective of the character and risk of the positions cleared through a financial institution and the role of the clearing member as a participant in the markets for cleared swaps. State Street strongly supports rigorous membership rules for DCOs, but is concerned by potential membership criteria in two broad areas: capital requirements and default management.

Capital Requirements

In State Street's experience, DCO membership rules have often included arbitrary capital requirements, which, in our view, are inconsistent with the open and fair access principles mandated by Congress in the Dodd-Frank Act. We are concerned that such requirements may impede the development of a strong marketplace for cleared derivatives. As an alternative to fixed, arbitrary capital requirements, the Commission should adopt rules requiring risk-based capital requirements, commensurate with the levels of activity and obligations of each clearing member.

While DCOs should clearly set capital requirements for clearing membership to ensure that members are able to meet their obligations and that systemic risk is mitigated, a fixed minimum capital requirement is poorly suited to this task. Setting an arbitrary minimum capital requirement that is not clearly correlated to the real potential risk of the member to the clearinghouse may function as an anti-competitive barrier to

[3] Commodity Exchange Act Section 5b(c)(2)(C), as amended by Section 725 of Dodd-Frank.
[4] *Id.*
[5] *See* Release at 3701.
[6] *See* Release at 3701.

entry, undermining the mandate that DCOs provide "fair and open access." Conversely, setting a floor that is well below the potential systemic risk posed by a financial institution would introduce concerns into the marketplace regarding the soundness and stability of the market for cleared swaps. An arbitrary minimum capital requirement is also poorly designed to achieve the Commission's goal of ensuring that clearing members have "sufficient financial resources and operational capacity to meet obligations arising from participation" in a DCO.[7]

We encourage the Commission to adopt rules requiring risk-based capital requirements for DCO members that reflect measures of financial exposure, such as the calculation of members' obligation to a clearing house's guarantee fund (or similar contingent funding obligations). While we expect a reasonable risk-based capital requirement will exceed the Commission's proposed $50 million cap, and note that numerous market participants view the proposed cap as too low, moving to a purely risk-based requirement will eliminate the need for a fixed minimum capital requirement of any kind, whether excessively high or unsuitably low.

A member's obligations to a DCO's guarantee fund are based upon the total risk of the DCO and each member's contribution to that risk, in terms of both its own proprietary positions and those of its customers. A member's actual and potential liability to the DCO changes over time. A fixed capital requirement does not take into account the real risk posed by a member to a DCO. The capital requirement should reflect these changing risks.

Basing a clearing member's capital requirement on guarantee fund obligation is also administratively simple and attractive. DCOs currently monitor a member's margin and guarantee fund obligations on a continuous basis, each of which are predicated upon the volume and an assessment of the risk of the positions being cleared through that member, and consequently, the risk posed by potential default by the member. The guarantee fund considers the potential exposure of a clearing member both at the DCO level and at the level of the individual member. The standards that govern the guarantee funds at major DCOs take into account notional exposure, concentration across membership, stress-testing and collateral, among other factors.

Capital requirements for DCO membership could be calibrated to a member's anticipated contribution to the risk pool, and calculated as some multiple of the member's guarantee fund contribution. Linking a member's capital requirement to its guarantee fund contribution would ensure consistency and transparency across DCO members, providing an administratively manageable, easily monitored system for aligning capital requirements with real potential risk.

Risk Management and Default Management

Membership rules relating to the risk management and participation in the default management obligations of clearing members also need to be carefully balanced to achieve both management of systemic risk and a vibrant marketplace. We strongly support DCO membership rules necessary to ensure that clearing members demonstrate the risk and default management capabilities necessary to ensure they will meet their obligations to the DCO, especially in times of financial crisis.

For default management, for example, a clearing member must be able to demonstrate it can carry out its obligations under a default scenario to a DCO. While that demonstration could include having the capacity to trade swaps using experienced swap traders, the ability to execute transactions in the market by having appropriate trading relationships, the ability to take on risk positions the member's balance sheet within the regulatory framework, and the appropriate infrastructure to support such activity are also

[7] *Supra* note 3.

appropriate methods to achieve default management and should not be excluded in membership rule making.

For risk management, a clearing member must demonstrate ability to monitor positions, calculate potential losses and market risk, perform stress tests, and maintain liquidity, among numerous other requirements. All of these requirements are necessary to protect the integrity of the DCO, and to minimize systemic risk.

Risk and default management rules, however, should not be used to frustrate Congress's mandate for fair and open access, or to limit competition from alternative clearing member business models in the marketplace. For example, DCO default management membership rules typically require the clearing member to demonstrate its ability to participate in an actionable auction process to set prices, and to accept proportional allocations of swap positions in the event of a clearing member default. Typically, existing clearing member firms rely on non-clearing member affiliates (*e.g.*, a swap dealer banking affiliate) to demonstrate this capacity. Potential clearing members with alternative business models, however, may not have such dealer affiliates, but may choose to enter into committed arrangements with non-affiliated firms to perform the same functions as a dealer firm's affiliate. Assuming the legal and financial arrangements between such firms are sufficiently robust to ensure performance when needed, there is no appreciable difference between the default management capacity of the traditional dealer-affiliated clearing member and a non-dealer clearing member outsourcing certain functions to a non-affiliate.

State Street also supports the Commission's prohibition of membership requirements that include minimum swap portfolio or transaction volume sizes. These requirements are intended to systematically favor membership for financial institutions that are also substantial dealers in swaps. These requirements do not take into account the risk management capabilities of many DCO members such as State Street, which are able to closely monitor risk exposures and effectively liquidate exposures through networks of interdealer relationships. Effectively mandating that only large swap dealers may also provide clearing services undercuts the objectives of the Act and are inconsistent with the principals of the Participant Eligibility Proposal.

The Commission should carefully monitor DCO rule changes and suspend self-certification pending the effectiveness of the Participant Eligibility Rules

As the Commission is undoubtedly aware, market participants (including, of course, State Street) are currently positioning themselves for the eventual adoption of final rules implementing Title VII of the Dodd-Frank Act. The Commission's rules on DCO membership eligibility criteria will become effective no earlier than July 16, 2011 and possibly months later than that date. We are concerned that some rule changes being adopted by DCOs during this transitional period are contrary to the Commission's, and Congress's, goals, and violate the spirit of the amended Commodity Exchange Act, even if those rules are invalidated several months later.

As an illustration of unnecessary restrictive interim requirements that are inconsistent with the spirit and intent of the Participant Eligibility Proposal, one proposed Futures Commission Merchant ("FCM") service for derivatives would require that clearing members maintain adjusted net capital of at least $1 billion,[8] far in excess of the Proposal's $50 million adjusted net capital membership minimum cap.[9] In addition, it requires that FCM clearing members have an affiliate that is a member of its existing clearing

[8] Regulation 3(c)(iii) in the LCH FCM Rulebook, available at http://www.lchclearnet.com/Images/FCM%20Regulations_tcm6-57089.pdf.
[9] Proposed Rule 39.12(a)(2)(iii)).

offering (a "Clearing Member").[10] Its Clearing Members must have, or be a member of a corporate group that has, an interest rate swap portfolio of at least $1 trillion.[11] Requiring a FCM clearing member to have an affiliate that is a Clearing Member could thus indirectly violate the Commission's proposal that a DCO "shall not require that clearing members maintain a swap portfolio of any particular size, or that clearing members meet a swap transaction volume threshold."[12]

Presumable, these DCO-adopted rules would be temporary and would need to be revised once the Proposal comes into effect. However, allowing a marketplace for cleared swaps to develop on this interim basis without complying with the Proposal undercuts the Commission's stated objective of promoting competition within the developing marketplace for cleared swaps. Allowing a DCO to proceed with this type of clearing service would provide unfair advantages to established dealers and their affiliates, which would last far beyond the date on which the DCO would be forced to change its rules due to effectiveness of the Participant Eligibility Proposal. We suggest the Commission carefully monitor all DCO rule change proposals and suspend self-certification with respect to rule changes in the period leading up to the effective date of the Participant Eligibility Proposal.

Once again, while we strongly support the Commission's fair access requirements, we suggest the Commission adopt changes to its Proposal to establish a risk-based capital requirement for DCO membership and to ensure the viability of a broad range of clearing member business models in establishing default management requirements. In addition, we urge the Commission to closely monitor all proposed DCO rule changes throughout this transitional period, to avoid changes in current DCO rules which may hinder the development of an open and competitive marketplace for clearing services in the future.

I would be happy to discuss the foregoing at your convenience.

Sincerely,

Stefan M. Gavell

cc: Jeffrey N. Carp, State Street Corporation, EVP and Chief Legal Officer
David C. Phelan, State Street Corporation, EVP and General Counsel

[10] Regulation 3(c)(vi) in the LCH FCM Rulebook.
[11] LCH Regulation 1.2.3(b), available at http://www.lchclearnet.com/Images/Section%201_tcm6-43738.pdf.
[12] Proposed Rule 39.12(a)(1)(v).