



March 21, 2011

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

Via Online Submission

SUBJECT: RIN 3038-AC98

Dear Mr. Secretary:

The Minneapolis Grain Exchange, Inc. ("MGEX" or "Exchange") would like to thank the Commodity Futures Trading Commission ("CFTC" or "Commission") for this opportunity to respond to the Commission's request for comment on the above referenced matter published in the January 20, 2011 Federal Register Vol. 76, No. 13.

MGEX is both a Designated Contract Market ("DCM") and Derivatives Clearing Organization ("DCO") and appreciates the continued efforts the Commission has put forth to address the requirements placed upon it by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

General Overview

As detailed below, there are several instances in this notice of proposed rulemaking ("NPRM") where the CFTC appears to be attempting to prescriptively regulate areas which may be better left to registered entities, futures commission merchants ("FCMs"), clearing members and DCOs to determine under a high level or broad core principle approach. The core principle approach has served the industry well for years while prescriptive regulations may lead to damaging, unintended consequences. While not inclusive of all comments made herein, three common themes throughout this letter are (1) that the CFTC should allow greater flexibility and interfere less with legitimate business decisions of DCOs and clearing members, (2) that the CFTC should not regulate DCOs into becoming an extension of or stand-in for the CFTC, and (3) the CFTC is unnecessarily adding prescriptive rules that dictate how DCOs, clearing members, FCMs and market participants should best analyze and address risk issues.

Registration Process

The proposed rule requires DCOs to complete a Derivatives Clearing Organization Application for Registration (“Form DCO”) for amendments to an existing DCO. MGEX questions the impact and extent requiring the Form DCO will have on existing DCOs should they be required to use Form DCO for amendments to their registration. Based on the Commission estimated \$100,000 cost of filing a registration¹, MGEX recommends that any required amendments be construed as narrowly as practicable. A current approved and known DCO should not have to expend as much time and resources to complete an amendment as an unknown applicant for DCO status, unless there are extenuating circumstances.

Participant and Product Eligibility

(a) Participant Eligibility

(i) Fair and Open Access

Proposed §39.12(a)(1) requires a “DCO to establish participation requirements that permit fair and open access.”² Specifically, a DCO cannot have a requirement if a less prohibitive requirement is available that would not materially increase risk to the DCO or its clearing members. However, risk measurement methods are not only objective but also subjective and both methods must be considered and permitted. While the Exchange understands the need to be wary of participants being excluded from participation, the CFTC can approach those situations when complaints arise. MGEX already has public rules in place addressing eligibility requirements and has procedures in place to assess both objective and subjective risk. If only objective, hard number factors risks are considered then DCOs may be forced to bear other risks, such as financial fraud convictions. As such, MGEX suggests providing DCOs with latitude when determining the risks it will expose itself to.

(ii) Financial Resources

Under proposed §39.12(a)(2), a DCO is required “to establish participation requirements that require clearing members to have access to sufficient financial resources to meet obligations arising from participation in the DCO in extreme but plausible market conditions” and “establish capital requirements that are based on objective, transparent, and commonly accepted standards that appropriately match capital to risk.”³ While in theory this seems reasonable, in practice the extent of this proposal presents a number of concerns. MGEX already requires Clearing Members to be in good financial standing at all times. This includes compliance with minimum capital requirements and a requirement to provide a parental guarantee in certain circumstances. If necessary, based upon financial and risk analysis, MGEX may require additional security or take other measures. However, not every risk assessment is purely objective and measurable. Also, since market conditions change quickly, testing for extreme but plausible market conditions based on historical records or future assumptions based on

¹ 76 FR 3698, 3717 (Jan. 20, 2011).

² *Id.* at 3701.

³ *Id.*

static conditions appear to have minimal value. In addition, not all risks are easily scalable.

The Exchange also has concerns as to whether the proposed rule will require a DCO to devise the tests for clearing members to use or whether the proposed rule will require a DCO to conduct the tests and provide the clearing members the results. Further, it seems unclear as to how often such tests and measurements would need to be taken as well as whether a clearing member would need to provide proof to a DCO that it conducted the test. Therefore, since the DCO already has other methods to address financial risk, such as increasing and/or decreasing margins, this specific proposed rulemaking seems unnecessary. Rather, each DCO should be permitted adequate flexibility to conduct the types of risk assessments it believes best apply, including objective and subjective assessments, and set capital, financial and operational requirements as necessary. Lastly, should the a substantially similar rule to the proposed rule become final, it will need further definition regarding how it is to be applied in practice.

(iv) Monitoring, Reporting, and Enforcement

While proposed §39.12(a)(4) is required by the Dodd-Frank, other sections of proposed §39.12 appear to go beyond the requirements of the Dodd-Frank Act. Specifically, MGEX believes that §§39.12(a)(5) and (6) go beyond the language of the Dodd-Frank Act and inappropriately inserts the DCOs as a conduit between the Commission and clearing members. As such, the Exchange submits that §39.12(a)(4) alone should be sufficient and the Commission should allow the DCOs flexibility in how to enforce the regulation. However, if the CFTC intends to regulate clearing members under this proposal the better alternative is for the Commission to do it directly and not force the DCOs to be their proxy or stand-in. Also, the proposed rules appear to require clearing members report to each DCO they clear with, which clearly would create an additional, duplicative burden on clearing members. As an alternative, the Exchange would recommend a new industry group similar to the Joint Audit Committee in which each DCO would be represented and participate in developing an overall risk management program which would be used in fulfilling the new proposed requirements.

(b) Product Eligibility

Core Principle C requires each DCO establish “appropriate standards for determining the eligibility of agreements, contracts, or transactions submitted to the [DCO] for clearing.”⁴ Therefore, the CFTC is proposing §39.12(b)(1) to require each DCO “establish appropriate requirements for determining the eligibility of agreements, contracts, or transactions submitted to the DCO for clearing, taking into account the DCO’s ability to manage the risks associated with such.” The CFTC provides a list of seven non-exclusive factors to consider when analyzing product eligibility. The CFTC also requires that a DCO select a contract size that maximizes liquidity, open access and risk management. These are legitimate factors to consider, but requiring a DCO to establish requirements is not necessary, other than contract size for swaps. Rather, DCOs already use these factors as part of their sound business judgment in making

⁴ *Id.* at 3702.

these types of decisions. Alternatively, the CFTC could issue suggested guidelines or core principles and allow the CFTC to request the DCO to file with the CFTC the rationale for why a contract qualifies for clearing on an as-needed basis.

Risk Management Requirements

(a) General

Core Principle D requires that each DCO be able to manage the risk associated with discharging its responsibilities. Further, Core Principle D mandates that the DCO will measure the credit exposure of the DCO to each clearing member and participant of the DCO at least once per day and monitor each such exposure periodically during the business day. The Exchange already performs these functions and believes that all DCOs should already be doing such risk management. However, proposed §39.13(b) requires each DCO establish and maintain written policies, procedures and controls approved by its board of directors which establish an appropriate risk management framework. The proposal also mandates that all risks be identified, monitored and a mechanism for internal audit be developed. Further, the Commission believes the DCO's framework must be comprehensive, including the manner in which all the risks relate to each other. As such, the proposed rule's benefits of reasonable business practice are weighed down by the heavy costs of the documentary and procedural requirements. While having a framework containing all the various policies can be beneficial for DCOs, the development and implementation of such policies must be flexible and left to each DCO. The goal of practical risk management seems to be turning into one of paperwork compliance.

(e) Limitation of Exposure to Potential Losses from Defaults

Proposed §39.13(f) requires DCOs to limit their exposure to potential losses from defaults by their clearing members, through margin requirements and risk control mechanisms, to ensure that (1) the DCOs operations would not be disrupted; and (2) non-defaulting clearing members would not be exposed to losses that they cannot anticipate or control. MGEX believes that the proposed rule appears reasonable so long as it is applied appropriately. In order to be applied appropriately, MGEX suggests that the Commission clearly adopt an interpretation that each clearing member by simply becoming a clearing member can reasonably "anticipate" that another clearing member of the DCO may potentially default and that the DCO can have and apply rules accordingly. Becoming a clearing member carries inherent risks. In a default scenario, time is of the essence and parties cannot be arguing over what may have been anticipated or controllable.

(f) Margin Requirement

(ii) Methodology and Coverage

Proposed §39.13(g)(2)(iii)(C) requires that the actual coverage of the initial margin requirements meet a confidence level of 99% for each clearing member account at a DCO. MGEX requests clarification that the Commission intends this requirement to reach the net account of each clearing member and not the underlying customer

accounts at each clearing member. Assuming this interpretation is correct, MGEX does not oppose requiring a DCO to have a 99% confidence level for each clearing member. If the Exchange's understanding is incorrect, MGEX does not support a DCO being required to have a 99% confidence level in the customer accounts held by their clearing members.

(iii) Independent Validation

Further, the Commission requests comment regarding whether a "qualified and independent party" must be a third-party or whether there may be circumstances which an employee of the DCO may be considered independent. MGEX maintains that an employee can be independent in determining whether a DCO's systems for generating initial margin requirements meet their intended goals as long as that employee was not engaged in designing the program. Determining whether a margin program works or not should not require an additional layer of cost by using a third-party. However, MGEX appreciates the flexibility that the Commission provides by allowing changes to the DCO's systems to be done prior to the independent evaluation if circumstances require. Further, MGEX would appreciate clarification as to whether the Commission is applying this requirement to the primary risk-based portfolio system such as SPAN, or each DCO's analysis program for determining margins. Requiring independent tests on the latter seems excessive.

(vi) Daily Review and Back Tests

Proposed §39.13(g)(7) requires at least monthly back testing for the adequacy of the initial margin requirements for each clearing member's accounts, by customer origin and house origin, and each swap portfolio, by beneficial owner, over the previous 30 days. As mentioned under proposed §39.13(g)(2)(iii)(C), MGEX understands this to mean that the DCO must look at its clearing member's net account and not each underlying customer account with the exception of swaps. If this understanding is correct, MGEX is not opposed to the proposed rule. However, if the Exchange's understanding is incorrect, MGEX does not support any rule that would require DCOs to back test individual non-swap customer accounts of their clearing members.

(vii) Customer Margin

(2) Customer Initial Margin

Proposed §39.13(g)(8)(ii) requires a DCO "to require its clearing members to collect customer initial margin from their customers for non-hedge positions at a level that is greater than 100% of the DCO's initial margin requirements with respect to each product and swap portfolio." While MGEX currently maintains a 130% requirement, this is a decision that may be left to each DCO and their clearing members to determine. The designated self-regulatory organization ("DSRO") already monitors for margin collection to ensure FCMs timely receive initial margin requirements and maintenance margin requirements.

(3) Withdrawal of Customer Initial Margin

Related, proposed §39.13(g)(8)(iii) requires a DCO “to require its clearing members to prohibit their customers from withdrawing funds from their accounts with such clearing members unless the net liquidating value plus the margin deposits remain in the customer’s account after the withdrawal would be sufficient to meet the customer initial margin requirements with respect to the products or portfolios in the customer’s account.” Each DCO should not have to review every detail of the clearing member’s business, nor is it economically feasible to do so. Further, DCOs are not an extension or proxy stand-in for the CFTC. To demonstrate compliance with this proposal, each DCO will have to show they are reviewing and requiring their clearing members to adhere to the regulations. Therefore, there is a potential double cost to the DCOs – one cost to review and audit the clearing members and second cost to respond to CFTC inquiries on the same. If this rule must be adopted, the DSRO is in a better position to monitor compliance.

(g) Other Risk Control Mechanisms

(i) Risk Limits

Under proposed §39.13(h)(1)(i), a DCO shall impose risk limits on each clearing member, by customer and house origin. Again, MGEX understands this requirement to be based on net clearing member accounts with the DCO and not the underlying customer accounts. Even with this understanding, the proposed rule might not be practical beyond that which DCOs are currently doing to address credit and default risk via margins and security deposits on a daily basis. In addition, MGEX, as a DCO, already completes different types of risk reviews and adding further mandated risk limits seems to add only additional cost with little benefit. Instead of policing every potential risk regardless of value and becoming bogged down thus making the review unworkable, the DCO should be looking for risk signs and focus on those most relevant.

(ii) Large Trader Reports

Proposed §39.13(h)(2) would require a DCO to obtain from its clearing members copies of all large trader reports that they were required to file. However, if each DCO has to obtain large trader reports it is likely that clearing members will have a multitude of redundant filings. Therefore, instead of filing the reports with each DCO, the CFTC should streamline the process and become the receptacle for all reports while distributing information to each DCO.

(iii) Stress Tests

Next, proposed §39.13(h)(3) requires daily stress tests for large traders and weekly stress tests for each clearing member account of a DCO. While MGEX does not necessarily oppose daily stress testing of large traders, it seems slightly trivial since the data may be dated even after one day and may not be more relevant than doing an average stress test over a weekly or monthly basis. In addition, MGEX understands that, except for swap portfolios and large traders, DCOs are only required to review and stress test net clearing member accounts and not underlying customer accounts of their

clearing members. The value of stress testing large traders is also diminished if they have accounts with different clearing members. Therefore, this requirement seems excessive.

(v) Clearing Members' Risk

Lastly, proposed §39.13(h)(5) requires a DCO to not only obtain and review its clearing members' risk management policies and procedures, it requires that the DCO also have rules requiring the clearing member make such information available to the CFTC. The Exchange believes a DCO should not act as an unnecessary conduit between the CFTC and clearing members. Should the CFTC wish to have access to a clearing member's risk management policies and processes, they can do so directly. If the Commission elects to retain this proposal, MGEX suggests that either they take on the responsibility hereunder or at least allow the formation of a DCO industry group similar to the DSRO concept to implement and oversee the risk review program which would help eliminate the burden a clearing member may be faced with due to duplication of efforts and associated costs.

Settlement Procedures

To enact Core Principle E, as amended by the Dodd-Frank Act, the Commission proposed §39.14. Specifically, under proposed rule §39.14(c), a DCO shall employ settlement arrangements to limit risk to its settlement bank and shall have documented criteria with respect to settlement banks, including capitalization, access to liquidity, operational reliability, creditworthiness. Further, a DCO will be required to monitor the bank's financial condition on an on-going basis to ensure compliance with the documented criteria. However, the Federal Reserve and other banking authorities are in the best position to review a bank's financial condition; not a DCO. In addition, the DCO would be required to use multiple settlement banks and approve multiple settlement accounts. However, given the limited number of settlement banks in the industry, it isn't that simple to easily comply with establishing backup settlement banks, not to mention the additional financial cost associated with doing so. Additionally, requiring a DCO to oversee clearing members' banks and establishing credit or concentration limits is also intrusive. For example, a single clearing member that clears with multiple DCOs is potentially subject to multiple compliance requirements. Therefore, the Exchange requests the Commission consider the practical implications of this proposal. At a minimum, a lot of flexibility must be allowed with respect to this requirement.

System Safeguards

Proposed §39.18(j) would required a DCO "to conduct regular, periodic, objective testing and review of its automated systems to ensure that they are reliable, secure and have adequate scalable capacity, and of its [business continuity and disaster recover ("BC-DR")] capabilities, using testing protocols adequate to ensure that the DCO's backup resources are sufficient to meet the [recovery time objective ("RTO)]."⁵ The proposed rulemaking goes on to state that the testing would be required to be

⁵ *Id.* at 3713.

performed by “qualified, independent professionals.” (Id.) While the Commission offers that such qualified, independent professionals can be employees, they restrict the use of any employee who participated in the development or operation of the systems or capabilities that are being tested. MGEX believes that the most qualified persons to run the tests are those that, at a minimum, operate the systems. In an effort to protect the proprietary nature of the clearing system, MGEX proposes the CFTC allow wide latitude to DCOs to conduct tests and not force a third-party review onto DCOs. Furthermore, the CFTC can request the test results to verify accuracy.

Further, the Commission proposes DCOs must coordinate its BC-DR plan with those of its clearing members. MGEX proposes testing of such plans via industry sponsored events should suffice to meet this Commission proposed requirement. Each DCO could ensure participation by each of its clearing members.

Related Matters/Burden

The CFTC estimates the total hours for the proposed collection of information under this NPRM to be 50 hours per year per respondent for the additional reporting requirements at an annual cost of \$500 per respondent (50 hours × \$10) to comply with the proposed rules. MGEX believes these estimates – both in hours and cost – are extremely low considering the CFTC does not appear to account for the costs of the set up, enforcement, documentation and CFTC review of compliance for the proposed rulemaking. Clearly the costs are not limited to reporting to the CFTC for many of the proposed rulemaking and, if fact, reporting may be the least expensive facet. Further, should the CFTC make the proposed rulemaking final as is, or relatively unchanged, the Exchange requests and recommends a prolonged implementation period given the depth and scope of the potential changes necessary.

Conclusion

The Exchange thanks the Commission for the opportunity to comment on the notice of proposed rulemaking. If there are any questions regarding these comments, please contact me at (612) 321-7169 or lcarlson@mgex.com. Thank you for your attention to this matter.

Regards,



Layne G. Carlson
Corporate Secretary

cc: Mark G. Bagan, CEO, MGEX
Jesse Marie Bartz, Assistant Corporate Secretary, MGEX
Eric J. Delain, Legal Advisor, MGEX
James D. Facente, Director, Market Operations, Clearing & IT, MGEX