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By Commission Website

September 29, 2011

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

Re: RIN 3038–AD51: Clearing Member Risk Management, 76 Fed.Reg. 45724 (August 1, 2011)

Dear Mr. Stawick:

The Futures Industry Association ("FIA")[1] is pleased to submit this letter in response to the Commodity Futures Trading Commission's ("Commission's") request for comment on proposed Rule 1.73, which would require clearing member FCMs to adopt and implement comprehensive risk management policies and procedures.[2] FIA has long been a proponent of strong risk management practices,[3] and we believe that clearing member FCMs' risk management policies already incorporate, in some way, most of the elements set out in the rule.

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1 FIA is the leading trade organization for the futures, options and over-the-counter ("OTC") cleared derivatives markets. It is the only association representative of all organizations that have an interest in the listed derivatives markets. Its membership includes the world's largest derivatives clearing firms as well as leading derivatives exchanges from more than 20 countries. As the principal members of the derivatives clearing organizations, our member firms play a critical role in the reduction of systemic risk in the financial markets. They provide the majority of the funds that support these clearinghouses and commit a substantial amount of their own capital to guarantee customer transactions.

FIA's core constituency consists of futures commission merchants ("FCMs"), and the primary focus of the association is the global use of exchanges, trading systems and clearinghouses for derivatives transactions. FIA's regular members, which act as the majority clearing members of the U.S. exchanges, handle more than 90 percent of the customer funds held for trading on US futures exchanges.

2 Proposed Rule 23.609 would impose similar requirements on swap dealers and major swap participants that are clearing members.

3 As the Commission is aware, FIA has published two papers to give specific guidance on various aspects of order entry and access to markets: (i) *Market Access Risk Management Recommendations*, which FIA published in April 2010; and (ii) *Risk Controls for Trading Firms*, which the FIA Principal Traders Group published in November 2010. Copies of these papers are enclosed with this letter. Soon, FIA expects to publish a third paper, *Electronic Order Handling Risk Management Recommendations for Executing Brokers*, which will recommend measures to manage the risks that executing brokers face in handling orders in algorithmic and high frequency trading environments.

However, we question whether a Commission rule is the most appropriate means to achieve this important regulatory goal at this time. Risk management best practices are continually evolving as markets and technology evolve. This is particularly true today, as the market structure for cleared swaps and the technology necessary to support these markets are uncertain at best. The Commission, therefore, should be hesitant to "freeze" the state of the art by imposing on market participants, directly or indirectly, a particular set of risk management controls. To do so may prevent certain enhancements and may stifle innovations that will make the markets safer.

As the Commission recognizes, not all FCMs are the same. The nature of their customers and the scope of their customers' (as well as their own) trading activities may vary greatly. Their respective risk management practices and procedures should reflect their varied risk profiles. We are pleased, therefore, that, in proposing this rule, the Commission has emphasized that it "does not intend to prescribe the particular means of fulfilling these obligations."[4] As a consequence, however, certain provisions of the proposed rule are unacceptably vague and fail to provide FCMs the certainty necessary to assure that they have adequate notice of their obligations under Commission rules, for which they will be held responsible.[5] As such, the rule unnecessarily exposes FCMs to regulatory risk.[6]

To resolve this conflict, we encourage the Commission to consider whether, at least in the near term, it should rely on the several derivatives clearing organizations ("DCOs") to assure that their respective clearing members have adequate risk management policies and practices, as the Commission has already proposed in its Risk Management Requirements for Derivatives Clearing Organizations.[7] Consistent with the provisions of section 5c(a)(1) of the Commodity Exchange Act ("Act"), the Commission could adopt the elements of proposed Rule 1.73 as a guideline. This process assures the Commission the necessary oversight[8] of the development of

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[4] 76 Fed.Reg. 45724, 45725 (August 1, 2011).

[5] Because the obligations that certain provisions of the proposed rule will impose on FCMs are unclear, we were unable to conduct a meaningful cost analysis and, therefore, are not commenting on the Commission's discussion of these issues.

[6] "[A] regulation carrying penal sanctions [must] give fair warning of the conduct it prohibits or requires." *DiPlacido* v. *CFTC*, 2009 WL 3326624, at *1 (2d Cir. Oct. 16, 2009).

[7] Proposed Rule 39.15(h)(5). 76 Fed.Reg. 3698, 3722 (January 20, 2011). Applicable DCO rules already require clearing member FCMs to implement risk management practices and procedures. Chicago Mercantile Exchange Rule 982, for example, provides that clearing members must "have written risk management policies and procedures in place to ensure they are able to perform certain basic risk and operational functions at all times." In particular, clearing members "must have procedures in place to demonstrate compliance in the following areas for trades executed through both electronic platforms and open outcry: (i) monitoring the credit risks of accepting trades, including give-up trades, of specific customers; (ii) monitoring the risks associated with proprietary trading; (iii) limiting the impact of significant market moves through the use of tools such as stress testing or position limits; (iv) maintaining the ability to monitor account activity on an intraday basis, including overnight; and (v) ensuring order entry systems include the ability to set automated credit controls or position limits or requiring a firm employee to enter orders."

[8] Commission oversight should ensure DCO rules are drafted to promote sound risk policies by both DCOs and FCMs and are not used to disqualify FCMs from clearing organization membership. See Proposed Rule 39.12(a)(1), "Fair and Open Access for Participation".

risk management practices and procedures as the cleared derivatives markets and related risk management best practices evolve, while assuring DCOs and their clearing members "flexibility in developing procedures that meet their needs."[9] As noted above, such flexibility is particularly critical, since the market structure for cleared swaps and the development of the technology necessary to support these markets are uncertain.

Even if the regulatory requirements were sufficiently clear, the required technology were available and the costs and benefits appropriately weighed, our members estimate that they would need at least twelve months, or possibly longer depending on the complexity of the rule's requirements, to build the systems necessary to implement the risk management procedures contemplated by the proposed rule, in particular automated pre-trade controls, discussed below. Therefore, the effective date of any such rule should be no less than twelve months following the date it is promulgated.

The Proposed Rule

Proposed Rule 1.73 will require a clearing member FCM to adopt and implement certain risk management policies and procedures, including: (1) establishing risk-based limits in the proprietary account and in each customer account based on position size, order size, margin requirements, or similar factors; (2) using automated means to screen orders for compliance with the risk-based limits; (3) monitoring for adherence to the risk-based limits intra-day and overnight; (4) conducting stress tests of all positions in the proprietary account and in each customer account that could pose material risk to the futures commission merchant at least once per week; (5) evaluating its ability to meet initial margin requirements at least once per week; (6) evaluating its ability to meet variation margin requirements in cash at least once per week; (7) evaluating its ability to liquidate, in an orderly manner, the positions in the proprietary and customer accounts and estimate the cost of the liquidation at least once per month; and (8) testing all lines of credit at least once per quarter. Each FCM will be required further to establish written procedures to comply with the rule and to keep "full, complete, and systematic records documenting its compliance with" the rule.

As discussed above, we believe certain of the provisions of the proposed rule are unacceptably vague. Paragraphs (1), (4), (5), and (6) fall within this category. Other paragraphs, although clear, appear to impose obligations on clearing member FCMs that are difficult, if not impossible, to meet.

Automated pre-execution screening is not always possible. This is particularly true of the proposed requirement that a clearing member FCM "use automated means to screen orders for

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[9] 76 Fed.Reg. 45724, 45725 (August 1, 2011).

compliance with the risk-based limits".[10] This is because, as explained below, the technology to perform such pre-execution reviews with respect to each customer order simply does not always exist.

More fundamentally, however, we note that, to the extent pre-execution reviews are technologically possible, such reviews are generally conducted by the executing broker, and not by the clearing member FCM (unless the clearing member FCM is also the executing broker). As the Commission is aware, many futures customers execute orders through one or more members, and clear the resulting trades at another. Institutional investment advisors managing multiple accounts, moreover, may allocate their customers' trades to a number of clearing member FCMs.

Clearing member FCMs have no ability to screen these customers' trades, using automated means or otherwise, before such trades are executed. To the contrary, they may not be aware of the trades until later in the day, when they are given up to the FCM. For their part, executing brokers can only be expected to enforce position size or order size controls. Because a customer may use more than one executing broker and more than one order routing system, such controls are necessarily limited.

The following additional examples demonstrate why clearing member FCMs cannot be expected to screen trades for compliance with the FCM's risk-based controls before such trades are executed.

- **Investment advisor managing multiple accounts.** Investment advisors generally execute bunched orders for all of their clients and then allocate the filled trades to their clients by the end of the trading day. Even if the clearing member FCM is the executing broker, the FCM will not know the identity of all of the customers within the bunched order, and the number

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[10] Although perhaps not entirely clear from the provisions of the Rule 1.73(a)(2) itself, the Federal Register release accompanying the proposed rule confirms that the purpose of the rule is to require a clearing member FCM to screen trades for compliance with the selected risk-based limits before the trades are executed. The Commission favorably cites from IOSCO's report entitled *Direct Electronic Access to Markets*. Specifically, Principle 6 provides:

> A market should not permit [direct electronic access] unless there are in place effective systems and controls reasonably designed to enable the management of risk with regard to fair and orderly trading including, in particular, automated pre-trade controls that enable intermediaries to implement appropriate trading limits.

Principle 7 provides:

> Intermediaries (including, as appropriate, clearing firms) should use controls, including automated pre-trade controls, which can limit or prevent a DEA Customer from placing an order that exceeds a relevant intermediary's existing position or credit limits.

of contracts allocated to each such client, in order to screen such trades for compliance with the FCM's risk-based limits before the trades are executed.[11]

- **Floor execution.** Trades executed on the floor of an exchange cannot be screened by automated means. The technology to screen such trades is simply not available. Moreover, since most orders sent to the floor are market orders, employing manual methods will necessarily delay execution, harming the customer and exposing the clearing member FCM to liability.

- **Multiple trading platforms.** An institutional customer may enter trades through multiple trading platforms. These systems may have limited risk control abilities and, as important, are not linked in any way. Consequently, although it may be possible to impose controls based on order size or limit size, it is not possible to impose or enforce aggregate controls.

The above examples are relatively simple, but the facts could easily be varied to create even more complex situations. Moreover, the examples do not consider issues that will arise in connection with cleared swaps, which may be traded OTC or on multiple swap execution facilities ("SEFs") and cleared through more than one DCO. Until SEFs, DCOs and their respective members have coordinated with each other "in developing rules and procedures to facilitate prompt, efficient, and accurate processing of all transactions submitted to [a DCO] for clearing,"[12] and the technology essential to implement these rules and procedures is developed and installed, automated pre-trade screening of orders for compliance with risk-based limits will not be possible.[13]

We wish to emphasize that the purpose of the above discussion is not to assert that pre-execution controls are not important. To the contrary, we strongly support pre-execution controls and, in the paper to be published shortly, *Electronic Order Handling Risk Management Recommendations for Executing Brokers*, we will recommend certain best practices with respect to pre-execution controls. Our point is simply that it is also important to recognize the limitations of pre-execution controls, limitations that cannot be overcome without prohibiting many well-established trade execution practices.[14] Full credit controls, in particular, can only be evaluated effectively post-trade.

Estimating the cost of liquidating defaulting customer positions is difficult if not impossible. We agree that an FCM should review regularly the positions it clears and consider whether, in the event of a customer default, it will be able to liquidate such positions without undue risk. Moreover, an FCM should be certain that it has arrangements in place to effect such liquidations when necessary. For example, an FCM should have understandings with market makers or other third parties to provide necessary assistance in such liquidations. However, even

[11] The clearing member FCM may set an aggregate limit for all trades executed by the advisor.

[12] Proposed Rule 39.12(b)(7)(i), 76 Fed.Reg. 45730, 45738 (August 1, 2011).

[13] As discussed earlier, FCMs estimate that it will take at least twelve months to build the systems necessary to implement the procedures contemplated by the proposed rule, once the necessary technology is available.

[14] The advantage of pre-execution controls at a DCO, exchange or SEF level assures that there are a minimum set of pre-execution controls available and applied to all members or participants on a uniform basis.

in normal markets, estimating the cost of liquidating such positions in an orderly manner will be difficult, at best. In times of market stress, such estimates will be impossible.

Proposed Rule 1.73 may conflict with the requirements of proposed Rule 1.72. Finally, as discussed above, the Commission suggests that an FCM could meet its obligations under Rule 1.73 "through simple numerical limits on order or position size or through more complex margin-based limits. Further examples could include price limits to reject orders that are too far away from the market, or limits on the number of orders that could be placed in a short time."

We agree that the above examples, including limits on order or position size, are appropriate risk management tools. We are concerned, however, that such limits may conflict with the provisions of proposed Rule 1.72(c), which provides that an FCM may set only "an overall limit for all positions held by the customer" at the FCM.[15] Further, such limits may indirectly "limit the number of counterparties with whom a customer may enter into a trade," in apparent violation of proposed Rule 1.72(b). If the Commission elects to promulgate the proposed rules, we encourage the Commission to assure that the broad provisions of proposed Rule 1.72 do not inadvertently prohibit an FCM's use of appropriate risk management tools or expose an FCM to unnecessary regulatory risk.

Conclusion

FIA appreciates the opportunity to submit these comments on proposed Rule 1.73. If the Commission has any questions concerning the matters discussed in this letter, please contact Barbara Wierzynski, FIA's Executive Vice President and General Counsel.

Sincerely,

John M. Damgard
President

cc: Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott O'Malia, Commissioner

Division of Clearing and Intermediary Oversight
Ananda Radhakrishnan, Director
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[15] Customer Clearing Documentation and Timing of Acceptance for Clearing, 76 Fed.Reg. 45730, 45737 (August 1, 2011).