September 30, 2011

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

Re: Clearing Member Risk Management
(RIN 3038 – AD51)

Dear Mr. Stawick:

Better Markets, Inc.[1] appreciates the opportunity to comment on matters identified in the above-captioned notice of proposed rulemaking ("NOPR") of the Commodity Futures Trading Commission ("CFTC"), relating to proposed rules (the "Proposed Rules") addressing risk management for cleared trades by futures commission merchants ("FCMs"), swap dealers ("SDs") and major swap participants ("MSPs") that are clearing members of a derivatives clearing organization ("DCO"), pursuant to and in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") amendments to the Commodity Exchange Act ("CEA").

Introduction

A fundamental premise of the Dodd-Frank Act is that the central clearing of derivatives reduces systemic risk, not perfectly and not in all cases, but decidedly better than the pre-crash arrangements and the post-crash alternatives.

In the new market structure, the vast majority of derivatives transactions will be intermediated by clearing members of DCOs, and the DCOs will be responsible for managing counterparty credit risk between the DCO and its members. Anticipating the increased volumes and complexity which the DCOs will confront, the CFTC has proposed rules which are designed to reinforce the protections against losses from member default previously imposed by regulation.[2]

[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.

[2] CFTC Notice of Proposed Rulemaking, Risk Management Requirements for Derivatives Clearing Organizations, 76 FR 3698 (January 20, 2011).

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But these rules only address part of the issue. There is no doubt that DCOs can implement procedures which monitor and manage risk exposures to members and set aside funds to cover potential losses from defaults. However, the best circumstance is one in which member defaults are prevented so that those procedures and reserves are not put to the test. Thus, to be successful, the Proposed Rules must accomplish the following stated goal:

> Given the increased importance of clearing and the expected entrance of new products and new participants into the clearing system, the Commission believes that enhancing the safeguards at the clearing member level is necessary as well. [3]

The Proposed Rules enumerate eight broad standards and allow clearing members "flexibility in developing procedures that meet their needs."[4] Flexibility is good insomuch as it will permit the clearing members to choose specific processes and procedures that suit their particular circumstances. *However, the standards* ***must*** *include risk management principles in sufficient detail to assure that the basic goals will be attained regardless of the implementation methods chosen by the clearing members.* The Proposed Rules fall short in several important categories on this point.

In summary, we propose the following additions and changes to the Proposed Rules:

- Credit risk management rules must incorporate monitoring of position sizes across all intermediaries and clearing systems so that exposure to losses from a general liquidation on default can be measured and controlled.

- Monitoring of adherence to risk-based limits as required by the Proposed Rules must be continuous and integrated with screening of orders.

- Standards for stress tests should require reference to "extreme but plausible conditions" and default rate assumptions, consistently with other stress tests required by proposed rules. In addition, reporting of the results of stress tests to the CFTC and DCO is needed if they are to be useful.

- Risk-based limits required by the Proposed Rules must incorporate multiple criteria which together accurately reflect credit risk exposures.

- Basic cash flow tests must be clarified and made more frequently.

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[3] NOPR, 76 FR at 45725.
[4] Id.

Discussion of the Proposed Rules

Credit risk management rules must incorporate monitoring of position sizes across all intermediaries and clearing systems so that exposure to losses from a general liquidation on default can be measured and controlled.

Each of the credit risk management standards set forth in the Proposed Rules operates as if the consequences of a customer default can be estimated by an analysis of that customer's portfolio of transactions in which the clearing member is the counterparty. That is an unfounded assumption. In fact, the consequences of default can involve numerous clearing members and DCOs and can extend to multiple jurisdictions.

The meaningful risk exposure to a clearing member (and therefore to a DCO) is the potential loss from the liquidation of a defaulting counterparty's position. Variation margin is recalibrated daily so that exposures from past market moves (at least through a recent mark to market) are collateralized. Initial margin is intended to collateralize losses in excess of the variation margin levels from market price moves subsequent to the mark used for variation margin calculations. Initial margin amounts are projections of adverse market moves over a time period assumed to be necessary to liquidate positions of the defaulted entity. They are based on historic precedent for market movements using (hopefully) prudent assumptions. The Proposed Rules properly adhere to this credit risk management construct.

The Proposed Rules require FCMs and SDs and MSPs which are clearing members to evaluate their ability to liquidate, in an orderly manner, positions and estimate the cost of liquidation at least once per week.[5] The liquidation risk is a core feature of credit. To the extent that initial margin amounts address this risk, recalibration of liquidity risk calculations can and should be done daily.

However, applicable provision of the Proposed Rules has an additional meaning, based on the description provided in the NOPR:

> The exercise should also address the ability of the FCM to put on appropriate hedges to mitigate risk pending liquidation. Such an exercise would take into account the size of the positions, the concentration of the positions in particular markets, and the liquidity of the markets.[6]

The NOPR suggests that the size of and types of derivatives in individual portfolios which the clearing member may have to liquidate must be used to evaluate whether the

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[5] Proposed Rules, Section 1.73(a)(7) and Section 23.609(a)(7).
[6] NOPR at page 45726.

portfolio can be readily absorbed by the market based on its liquidity and depth, and, if it cannot, the potential loss as a result.

However, at least one important flaw in this credit risk management structure is ignored in the Proposed Rules. The demand on market liquidity caused by a significant liquidation on default can render the statistical measurement of liquidation risk, which is used to calculate initial margin, meaningless. The size of price-related positions which must be liquidated in a short time can overwhelm the market.

A clearing member can observe the positions of its counterparty and limit them to manage this risk. But it cannot see the positions that the counterparty has with other clearing members or bi-lateral counterparties.

A default may not simply be an event between the clearing member and its counterparty. It would far more likely be a catastrophic credit event that triggers liquidation by all or many intermediaries and direct counterparties. As a result, without the use of a credit risk management technique which evaluates the market-price effect of a credit event followed by a general liquidation, the credit risk management of the clearing member is materially deficient.

This issue is not new, but the structure and dynamics of the markets are. Mandatory clearing will multiply the volume and credit exposures of clearing members and DCOs. The clearing system will become a primary firewall to protect the economy from financial crisis caused by the tremendous risk inherent in derivatives. At the same time, the market infrastructure will become more complex. Multiple swap execution facilities and designated contract markets will facilitate trade execution using multiple venues. In addition, multiple DCOs may arise to meet diverse needs of a market that is predominantly cleared. The potential for undetected fragmentation of the credit risk of large aggregate positions will be much greater than before, and that is what requires an addition to the Proposed Rules.

The International Organization of Securities Commissioners has established a principle to guide the development of credit risk management by intermediaries:

> Intermediaries (including, as appropriate, clearing firms) should use controls, including automated pre-trade controls, which can limit or prevent a DEA [direct electronic access] Customer from placing an order that exceeds a relevant intermediary's existing position or credit limits.[7]

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[7] Technical Committee of the International Organization of Securities Commissioners, Final Report – Direct Electronic Access to Markets, Principle No. 7, August 2010, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD332.pdf.

This is a sound principle, which will require the credit consequences of transacting based on the order be known by the intermediary given the information available to it. However, without knowledge of the scope of a general liquidation involving multiple intermediaries and counterparties, this is impossible.

The solution to this issue is at one level simple, though complicated from the perspective of confidentiality. It is manifestly inadequate for clearing members to require customers to self-police adherence to over-all limits based on contractual undertakings. However, data which measures positions comprehensively will exist in the swap data repository ("SDR") system.

The concept of credit risk management will be structurally flawed at its core unless overall positions can be tracked so that the risk of liquidation on default can be measured. Clearing members must be given access to this information, or alternatively the results of analysis of general liquidation risk by SDRs or other aggregators, and required to use it in their credit risk management systems.

Monitoring of adherence to risk-based limits as required by the Proposed Rules must be continuous and integrated with screening of orders.

The Proposed Rules require FCMs and SDs and MSPs who are clearing members to monitor adherence by counterparties to risk-based limits intra-day and overnight.[8] In light of the capabilities of modern technology and the need to keep track of risk in a high-frequency and algorithmically driven market, this standard is so weak that it is practically meaningless. To be meaningful, monitoring must be continuous.

The most important reason for continuous monitoring is that it also must be integrated with the order screening standard. The Proposed Rules require the "use of automated means to screen orders for compliance...."[9] If systems which monitor adherence to risk-based limits are not continuously updating measured adherence to limits, the automated screening system is of limited use as well.

The requirement of systems which continuously track risk-based limits is exceedingly important. High frequency and algorithmic trading is based on speed and order volume. Many tactics are designed for intra-day use, but that assumes that the tactics are effectively executed. If they are not executed as planned, large positions will result imposing great risk on clearing members. Without monitoring and order screening capability which is geared to match the market's capability, risk may not be measured and known until the knowledge is irrelevant because the catastrophe has happened already.

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8 Proposed Rules, Section 1.73(a)(3) and Section 23.609(a)(3).
9 Proposed Rules, Section 1.73(a)(2) and Section 23.609(a)(2).

Standards for stress tests should require reference to "extreme but plausible conditions" and default rate assumptions, consistently with other stress tests required by proposed rules. And stress tests results must be reported to a responsible entity.

The Proposed Rules require periodic stress tests to be undertaken with respect to all positions by FCMs and SDs and MSPs which are clearing members.[10] However, no further guidance is provided. This requirement is virtually without meaning unless standards for the stress test are articulated. And without some disclosure to regulatory authorities or DCOs, which is not required, the exercise would be unlikely to have any real-world consequence.

For example, the proposed rules for DCOs require stress tests based on the default of the clearing member with the single largest exposure to the DCO under extreme but plausible conditions (two largest exposures for systemically important DCOs).[11] It uses the same two standards that are essential to, but missing from, the Proposed Rules: a default rate assumption and an assumption of market conditions to measure the effects of the default. These standards must be included in the Proposed Rules to give meaning to the stress test.

The standard of "extreme but plausible conditions" is critical if the stress test requirement is to have meaning. FCMs and SDs and MSPs which are clearing members, like DCOs, typically margin based on statistical analysis based on historical data. The stress test must be based on conditions *beyond historic price moves* to have meaning - otherwise the test merely measures the same thing as the initial margin calculation. The Financial Stability Oversight Commission has taken the position that "extreme but plausible conditions" means just that:

> [I]n determining whether the failure or disruption of an FMU could create, or increase, the risk of significant liquidity or credit problems, it should generally consider a range of circumstances, including "extreme but plausible" events. In considering such circumstances, the Council does not anticipate limiting itself to historical data.[12]

While the particular means of fulfilling the stress test requirement need not be provided in the Proposed Rules, the meaning of the term "stress test" requires sufficient description to make it useful. The standard "extreme but plausible conditions" is needed, as well as reference to a default rate.

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[10] Proposed Rules, Section 1.73(a)(4) and Section 23.609(a)(4).

[11] CFTC Proposed Rules, Financial Resource Requirements for Derivatives Clearing Organizations, October 14, 2010, 75 FR 63113.

[12] Final Rule, Authority to Designate Financial Market Utilities as Systemically Important, July 27,2011,76 FR at page 44767.

Risk-based limits required by the Proposed Rules must incorporate multiple criteria which together accurately reflect credit risk exposures.

The Proposed Rules require that FCMs

> Establish risk-based limits in the proprietary account and in each customer account based on position size, order size, margin requirements, *or* similar factors....[13]

A substantially similar rule applies to SDs and MSPs which are clearing members.[14] Notably, the bases for the risk-based limits are listed in the disjunctive. Each of the listed factors must be included in any reasonable risk-based limit. For instance, a limit on order size may have independent value, but the potential consequences of filling an order of a given size also depends on the position and margin levels.

At a minimum, the word "or" must be changed to "and."

Basic cash flow tests must be clarified and made more frequently.

It is fundamental that the risk to entities involved in derivatives clearing is overwhelmingly a function of cash liquidity to meet margin calls. The Proposed Rules require that FCMs and SDs and MSPs which are clearing members evaluate their ability to meet variation margin and initial margin in cash once each week and "test" al lines of credit once each quarter.

These time frames must be tightened. It would be highly imprudent to evaluate access to cash any less frequently than daily. The CFTC may intend the evaluation to involve a more thorough test, but the language does not provide any such guidance. In its current form, it could easily be interpreted as providing license to behave imprudently.

Similarly, there is no guidance regarding the content of a test of liquidity facilities. It could mean simply confirming their availability with the lender. It could also refer to a test of systems which enable an automatic draw from the lender. If it is the latter, a quarterly test is inadequate. An automatic draw would be relied on as an integral part of a response to an unexpected liquidity demand. Knowing whether it is functional would be important in a stressed condition. A daily, automated test would be the prudent approach.

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[13] Proposed Rules, Section 1.73(a)(1) [emphasis added].
[14] Proposed Rules, Section 23.609(a)(1).

Conclusion

The Proposed Rules are central to the continued viability of the clearing system as a firewall against systemic consequences of market defaults. Strengthening the Proposed Rules is essential if they are to achieve their purpose.

We hope these comments are helpful in your consideration of the Proposed Rules.

Sincerely,

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