



September 29, 2017

Mr. Christopher J. Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

VIA ONLINE SUBMISSION

Re: Request for Information Regarding KISS Initiative – Clearing

Dear Secretary Kirkpatrick:

The Minneapolis Grain Exchange, Inc. (“MGEX” or “Exchange”), a designated contract market (“DCM”) and Subpart C derivatives clearing organization (“DCO”), would like to thank the Commodity Futures Trading Commission (“Commission” or “CFTC”) for the opportunity to respond to the Commission’s request for public comment on the KISS project published in the May 9, 2017 Federal Register Vol. 82, No. 88.

MGEX commends and fully supports the Commission on its decision to review its rules, regulations, and practices to make their implementation simpler, less burdensome, and less costly. Although the Exchange recognizes the importance of Dodd-Frank and the changes that have occurred over the past several years to make the derivatives markets safer, it is concerned that unintended consequences and costs are having an adverse impact on the industry. To date, the Commission has passed nearly 70 rulemakings. These regulations have led to greater protections in certain areas, but they have also resulted in a drastic decrease in the number of futures commission merchants (“FCMs”) (nearly 50% in the last 15 years), leading to further concentration of risks.¹ The Exchange thus believes now is an appropriate time for the Commission to review the present regulatory framework and make it simpler without weakening critical market protections.

As requested, this comment letter addresses several specific areas that MGEX encourages the Commission to review. The recommendations provided below are

¹ <https://fia.org/fcm-tracker>.

intended to promote a simpler and more effective regulatory framework while not weakening the protections put in place by the Commission.

1. Review Staff Guidance

The CFTC Division of Clearing and Risk (“DCR”) has issued a number of public staff guidance letters and interpretations, as well as several unpublished memoranda, over the past five years that apply to MGEX as a DCO. The majority of these letters have been helpful, and MGEX generally supports the Commission’s use of guidance to respond to questions and clarify obligations. In such cases, staff guidance is an appropriate and welcome tool to fill any gaps left by final rules and articulate the Commission’s regulatory expectations of DCOs.

The Exchange is concerned, however, that more recent Commission-issued guidance has gone too far and created obligations and requirements that extend beyond the regulations they were intended to supplement. For example, final CFTC Regulation §39.39, which sets forth recovery and wind-down plan requirements, is approximately one page in the December 2, 2013 Federal Register Vol. 78, No. 231. In contrast, the guidance issued on July 21, 2016 to all registered DCOs from then-Acting Director Bandman regarding such plans was 19 pages. As a result, although MGEX had previously spent a significant amount of time and resources—both at an internal staff and executive management level, as well as at the Board and committee level—analyzing and implementing a plan that it believed met the spirit of Regulation §39.39, it had to spend an equal amount of time and resources in order to address each of the many points raised in the staff guidance. The regulation ensured that DCOs had effective recovery and wind-down plans and the financial resources to fund the plans; as such, it supported the greater stability of derivatives markets. The guidance, on the other hand, not only mandated the minute details plans must include, but even added new requirements. For instance, while Regulation §39.39 requires DCOs to have viable plans and assess their effectiveness, the guidance takes it a step further by requiring procedures for regularly testing the plans with the participation of clearing members when applicable,² a requirement that carries numerous challenges for smaller DCOs.

Similarly, in April of 2017, DCR issued a revised Guidebook to Part 39 Daily Reports to all DCOs. Although the CFTC created the Guidebook to provide more detailed instructions for submitting daily reports in accordance with CFTC Regulation §39.19, the revisions expand the information DCOs are required to submit far beyond what was originally contemplated and stated in the statutory text of Regulation §39.19. For instance, while the regulation focuses on reporting at the Clearing Member level, the Guidebook mandates that a DCO’s reporting obligation include client-level data, such as legal entity identifiers, even though that is not information the DCO would otherwise have available. The Exchange recognizes CFTC staff may view this information as valuable for their analytic tools, but the additions have resulted in a large undertaking for DCOs and FCMs without a cost-benefit analysis demonstrating that consideration was given to all relevant factors.

² DCR Memorandum dated July 21, 2016, p. 15.

As evidenced by the above examples, if not used appropriately, staff guidance can in effect substantively amend a final rule without providing a public notice and comment period or engaging in the necessary cost-benefit analysis required by the Commodity Exchange Act. Moreover, by expanding regulatory requirements through guidance or guidebooks, the Commission also substantially increases the costs of compliance without materially benefiting or strengthening the market. MGEX therefore recommends the Commission review existing guidance, guidebooks, and interpretations that have altered regulations and pose compliance challenges. In addition, the Exchange encourages the Commission to evaluate the procedures and practices surrounding staff's issuance of these types of guidance to ensure appropriate limitations are in place and such guidance aligns with the underlying regulations.

2. Avoid Imposing Additional Requirements through Rule Enforcement Reviews

Just as the Commission should not use guidance to effectively amend its regulations, it should also avoid imposing additional requirements on DCOs through rule enforcement reviews. MGEX appreciates the role that the examination branches, and the periodic rule enforcement reviews conducted by them, fulfill in ensuring the ongoing compliance of CFTC registrants. However, rule enforcement reviews, and the findings and recommendations issued during the course of these reviews, should not be used as a means to read new interpretations into regulations or impose further obligations on DCOs. If the Commission believes new or higher standards are necessary, it should pursue such through rulemakings or other appropriate legislative avenues.

In recent years, MGEX has noted that an increasing number of "findings" in reports issued during rule enforcement reviews cite standards not specifically addressed in the corresponding regulations. The Exchange recognizes that Commission staff may view certain practices more favorably, but findings should be limited to those actions of a DCO that actually impair its ability to comply with CFTC regulations rather than those actions that simply may differ from others in the industry. Too often it appears that a one size fits all approach is used when comparing DCOs during rule enforcement reviews.

Consider, for example, CFTC Regulations §39.13(g)(3) and §39.36(e), which require a DCO to engage a "qualified and independent" party to perform a validation of its financial and liquidity risk management models. In accordance with these regulations, the Exchange engaged an independent expert to perform an annual validation of the required areas. Although MGEX consequently believed it was complying with the applicable regulations, CFTC staff provided an extensive list of additional actions MGEX needed to take in a rule enforcement review report. These actions included steps such as developing a validation framework, creating comprehensive written guidelines to set forth all the conditions needed to complete a review, stating what information the third party must include in any reports, and implementing new procedures for how internal staff would respond to the results; each of these items had a further list of components and factors that should be included. This level of granular detail is clearly not present in the regulations, nor had it been expressed to MGEX in the past, yet it was cited in the report as a "finding" or a failure on the Exchange's part.

This example exemplifies how rule enforcement reviews can effectively re-interpret or add further regulatory requirements to existing rules. This is particularly problematic for Subpart C DCOs. Although Subpart C of Part 39 allows non-systemically important DCOs (“SIDCOs”), to “elect” to become subject to the same regulations,³ in actuality there is little choice for smaller DCOs. Not electing into the Subpart C requirements would result in a severe competitive disadvantage to a DCO, both in terms of the market’s perception of the DCO as less safe or secondary and as it relates to Basel capital requirements for those entities using the DCO. The choice thus becomes whether the DCO will remain competitive or not. While MGEX appreciates that the CFTC established a mechanism by which non-SIDCOs could still qualify for qualified central counterparty status, it should be mindful to not apply larger-entity standards to smaller DCOs and consider when regulatory relief may be appropriate.

3. Avoid Duplicative Reporting

As a single entity that operates as both a DCM and DCO, MGEX is under the oversight of both the Division of Market Oversight (“DMO”) and DCR and has also responded to requests from the Division of Swap Dealer and Intermediary Oversight and the Office of Data and Technology. The Exchange is consequently subject to many reporting requirements, ranging from daily, quarterly, annual, and event-specific to requests made in rule enforcement reviews or horizontal reviews. As a result, a significant amount of internal staff time is spent compiling and submitting large amounts of data to the CFTC, and in recent years, an increasing amount of the information reported is duplicative or made in one-off requests. E.g., information requested by both DMO and DCR or fielding multiple requests outside of an official rule enforcement review. Part 16 and Part 39 reporting have become particularly inefficient and time-consuming, as further explained below.

MGEX is cognizant that the Commission requires information to oversee registered entities, but respectfully recommends that the CFTC review its reporting requirements to identify those areas that are duplicative or causing unnecessary burdens. Furthermore, sharing of relevant information within and between CFTC divisions would help alleviate requests for the same information. For instance, MGEX currently supplies different divisions of the CFTC with essentially the same data each day, but is required to do so using different file specifications. This process could be significantly improved and streamlined if MGEX could submit the required data one time to cover both Part 16 and Part 39 reporting.

4. Allow DCOs to Better Evaluate Margin Effectiveness

Developing models to determine appropriate initial margin requirements is an important role of a DCO, a critical first line of defense in protecting the marketplace against a default. CFTC Regulation § 39.13(g)(iii) requires that the actual coverage of a DCO’s initial margin requirements meet an established single-tailed confidence level of at least 99%, which assumes that a DCO is able to predict nearly all future market volatility. MGEX has created robust margin modeling systems that perform well under both normal

³ See CFTC Regulation §39.31.

and stressed market conditions. However, since most margin models consider historical data or implied volatility to forecast future market volatility, there are times when sudden market fluctuations cannot be predicted or anticipated by any model.

A literal reading would suggest that if an employed margin model fails to meet the 99% effective standard, the model would need to be changed in a way that it would have met the 99% standard had it been in use. In theory, MGEX understands this rationale, however, MGEX is concerned that this result will inevitably lead to higher and higher margin requirements as observed unpredictable market fluctuations need to be anticipated within a DCO's models.

Rather than require DCOs to collect more margin in anticipation of these unpredictable events, MGEX encourages the Commission to allow DCOs to consider the circumstances surrounding margin deficiencies, should they occur, to evaluate whether or not they should have been anticipated by a DCO's margin model or if its occurrence deviates beyond what would normally be expected of a situation prior to requiring any change in underlying margin models.

Furthermore, in measuring the effectiveness of margin models, MGEX urges the Commission to avoid one size fits all approaches given the differing number of products offered by DCOs. Rather, MGEX believes the CFTC should ensure each DCO's methodology meets the spirit of the regulation.

5. Ensure Rules are Applied Fairly and Pragmatically

Recent international guidance and industry conversation have raised the issue of to what extent a DCO, as a central counterparty ("CCP"), should guarantee the funds of a Clearing Member, particularly in the context of non-default losses. Although CFTC rules are currently silent on this topic, MGEX would still like to take this opportunity to address the question given its potential for far-reaching implications. The Exchange disagrees with the idea that a CCP should be responsible for a loss of cash/assets in a non-participant default situation. Clearing Members are not expected to guarantee their customers' funds in this type of situation, and it is unreasonable to hold DCOs to a higher obligation given that they are not introducing risk to the system. CCPs cannot act as guarantors for the financial system and forcing them to do so through any future regulations or guidance would make it particularly unviable for smaller DCOs like MGEX to remain in business.

Although it is similarly not specifically related to the KISS request, the Exchange urges the Commission to more thoughtfully ensure new rulemakings are fair to all market participants, including DCOs, regardless of size. Past rulemakings or orders, such as those granting SIDCOs access to Federal Reserve Banks,⁴ have created a competitive disadvantage to those DCOs that have not been designated as systemically important. While the Commission did not initiate this particular limitation, it demonstrates the disparity that results when advantages are granted based on a DCO's size. Despite the fact that even the Commission recognizes that DCOs with deposits at the Federal

⁴ See CFTC Order Exempting the Federal Reserve Banks from Sections 4d and 22 of the Commodity Exchange Act.

Reserve face much lower credit and liquidity risks, this advantage, which would also further the CFTC's goal of enhancing the protection of customer funds, has never been afforded to Subpart C DCOs.

Lastly, additional liquidity constraints exist for all DCOs based on how the CFTC defines liquidity resources. DCOs are understandably subject to strict requirements regarding the amount of liquid resources they must hold and what qualifies as a liquidity resource.⁵ Despite the tremendous size and liquidity of the U.S. Treasury market, however, Treasuries do not currently qualify as a liquidity resource unless they are subject to "prearranged and highly reliable funding arrangements." MGEX recognizes that many issues factor into the topic of "liquidity," including influences outside of the Commission, but this interpretation is both extreme and costly. To assume that in a liquidity-stressed environment, U.S. Treasuries would have no liquid value (hence the need for a prearranged and highly reliable arrangement) seems illogical. Moreover, the cost of setting up arrangements or facilities can be prohibitively high for smaller DCOs like MGEX. As a result, the Exchange encourages the Commission to revisit the wording and interpretation of CFTC Regulation § 39.33(c) to grant greater flexibility for liquidity resources as it relates to U.S. Treasuries, particularly given that doing so would not materially increase risks to the market.

6. Align System Safeguard Approaches

The Exchange appreciates the focus and efforts the Commission has made in recent years to address the growing risk cyber threats pose. In the past year, the CFTC has published new system safeguards rulemakings for both DCMs and DCOs. Although MGEX supports many parts of these rulemakings, it remains concerned about the inconsistent approaches taken in the DCM and DCO rulemakings as it applies to dual entities like the Exchange. For example, the DCM rulemaking provides certain appropriate carve outs for smaller DCMs,⁶ but the DCO rulemaking has no such exception. Since MGEX must meet the highest standard in the two rulemakings, the Commission's intended benefit for smaller DCMs is rendered useless. This lack of consistency also hinders the Exchange's ability to maintain a consistent and cohesive program for system safeguards that satisfies both rulemakings.

For the reasons stated above, MGEX urges the Commission to consider making additions or changes to the DCO rulemaking to account for combined entities, alleviate the current conflicts, and make the intended DCM exemptions effective.

Conclusion

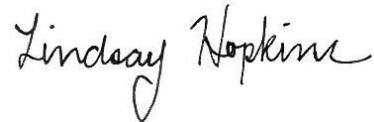
MGEX would like to reiterate its support of the KISS initiative and its appreciation for the opportunity to provide comments. The Exchange believes the Commission could make its rules and regulations simpler and more effective without weakening critical protections or the stability of the markets, and the recommendations provided above would help make improvements as it relates to clearing rules. In addition, as the CFTC implements further

⁵ See CFTC Regulation § 39.33(c).

⁶ Specifically, DCMs whose annual total trading volume is under 5% of the combined annual total trading volume of all DCMs.

rules in the future, MGEX urges the Commission to work cooperatively with other regulatory agencies and fully consider what effects such changes could have on all DCOs, not just those DCOs that are systemically important. Please feel free to contact me at 612-321-7143 or lhopkins@mgex.com with any further questions, and we look forward to working with the Commission on these and other issues in the future.

Sincerely,

A handwritten signature in black ink that reads "Lindsay Hopkins". The signature is written in a cursive style with a large initial "L" and a distinct "H".

Lindsay Hopkins

cc: Mark G. Bagan, CEO
James D. Facente, Director of Market Operations, Clearing and IT