July 11, 2011

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

Re: Capital Requirements for Swap Dealers and Major Swaps Participants (RIN 3038 – AD54)

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") which, among other things, impose capital requirements for swap dealers ("SDs") and major swap participants ("MSPs") for which there is no prudential regulator ("Covered SDs and MSPs"), 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

The absence of prudent margining in derivatives transactions and capital requirements by market participants led directly to the financial crisis and the forced infusion of enormous sums of money into the financial markets to avoid total collapse. At the center of the reforms mandated by the Dodd-Frank Act is the direction to the CFTC and other agencies to establish prudent capital requirements for participants in the derivatives markets to help avoid a repeat of this disaster.

Unfortunately, allowing Covered SDs and MSPs to use "tangible net equity," as the Proposed Rule would, is the opposite of the much-needed prudent margining the law requires. Unless the Proposed Rules are changed, weak to nonexistent margining will be allowed and, in a crisis or failure, taxpayers and the government are again going to be at risk of bailing out private entities – needlessly so this time because, as the NOPR itself discusses, there is a readily available, effective alternative, which should be adopted.

[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.

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The Dodd-Frank Act mandates the CFTC to establish capital requirements for Covered SDs and MSPs.[2] The Proposed Rules divide Covered SDs and MSPs into three categories: (1) those which are subsidiaries of a bank holding company; (2) those which are also futures commission merchants and therefore subject to capital requirements; and (3) others. This comment letter focuses primarily on the capital requirements applicable to the third category.

**DISCUSSION**

Under the Proposed Rules, those Covered SDs and MSPs which are not subject to other regulatory capital requirements are permitted to calculate their capital requirement using "tangible net equity."[3] This term is defined as a Covered SD or MSP's equity determined in accordance with generally accepted accounting principles, excluding goodwill and other intangible assets.[4] As a result, eligible capital includes fixed assets such as real property and equipment, among other things.[5]

The purpose for capital requirements is to address the specific risks associated with participation in the uncleared derivatives markets. In this market, risks of counterparty default and general market price risk can increase at a breathtaking pace to unlimited amounts. Often, uncleared derivatives are un-margined or under-margined. Concerns about the ability of a market participant to meet its cash obligations can result in a call for immediate full margining by its counterparts – which, unsurprisingly, often happens at the worst time, i. e., when the party can least afford it, when its capital and other assets are plunging in value, and when the demand for collateral is overwhelming.

One needs only recall the events which consumed AIG in 2008 to demonstrate the lethal consequences of such events. However, there is a long list of derivatives markets participants who have experienced similar fates, including Enron, Long Term Capital Management and Constellation, just to name a few. In the derivatives markets, readily available cash is the only firewall against disaster. It is also the only firewall that protects taxpayers and the public treasury.

As a result, capital requirements for financial markets focus heavily on the liquidity of available capital. The NOPR includes an excellent discussion of these issues.[6] The use of tangible net equity in the Proposed Rules is completely inadequate based on these principles and the many recent precedents of inadequate quantity or quality of capital, leading to bailouts funded by taxpayers, the Treasury and the Federal Reserve Board. It is not difficult to imagine a significant Covered SD or MSP unable to meet a substantial margin call in the OTC market while nonetheless having excess tangible net worth under the standards of the Proposed Rules.

The NOPR describes a far superior alternative and requests comments on it.[7] Under this alternative, a Covered SD or MSP would be required to hold (but not segregate) specified unencumbered liquid assets equal to total uncleared swap initial margin and variation margin not posted. As suggested, a minimum threshold might be appropriate, but it must be based on

[2] CEA, Section 4s(e).
[3] Proposed Rules, Section 23.101.
[4] Proposed Rules, Section 23.102.
[5] NOPR, 76 FR at page 27817.
[6] NOPR, 76 FR pages 27809-12.
[7] NOPR, 76 FR at page 27817, Request for Comment 6.

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convenience and therefore a relatively small amount. The Covered SD or MSP must be able to cover the risks that can pose a liquidity crisis to have adequate capital. This is a far superior capital requirement than the one proposed. Moreover, unlike the Proposed Rules, this method will meet the statutory requirements for prudent margining and protect taxpayers and the public treasury.

In addition, the Proposed Rules establish minimum capital requirements at the level of $20 million which can be exceeded based on the calculation of risk held by a Covered SD or MSP.[8] Conceptually, an entity could have a low level of risk as measured by the standards of the Proposed Rules, but maintain a very large swap book (i.e., the book is relatively flat and/or margined). If the entity's book had to be unwound, the sheer size of it could create an enormous loss as large numbers of positions come on the market. Therefore, the minimum should be scaled to the level of the size of the book. The Proposed Rules must be amended so that the minimum is $20 million or a percentage of the book, whichever is larger. We recommend that the percentage be set at 5 percent, in which case the increase of the minimum would commence with a book of $400 million notional amount.

**CONCLUSION**

Prudent capital requirements for derivatives markets participants could well have changed the results of the crisis encountered in 2008. At a minimum, such requirements would have reduced the amounts to which taxpayers and the government were exposed in backstopping undercapitalized entities. The Proposed Rules are critical to avoiding a recurrence of those events.

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

Sincerely,

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President & CEO

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[8] Proposed Rules, Section 23.101.