



December 13, 2010

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

Re: Financial Resources Requirements or Derivatives Clearing Organizations
(CFTC RIN 3038-AD02)

Dear Mr. Stawick:

Better Markets, Inc.¹ appreciates the opportunity to comment on the above-captioned proposed rules (the "Proposed Rules")² of the Commodity Futures Trading Commission ("CFTC") described above. The purpose of the Proposed Rules is to establish standards for financial resources required to be maintained by derivatives clearing organizations ("DCOs") under the Core Principles for such organizations established by the Dodd-Frank Financial Services Reform Act (the "Dodd-Frank Act").

Introduction

The CFTC is to be congratulated for the insightful proposal of rules needed for implementation of Core Principle B relating to the financial resources of DCOs, as set forth in Section 725 (c) of the Dodd-Frank Act. The Proposed Rules identify the categories of financial resources available to DCOs and provide procedures for valuing such resources for both systemically important DCOs and other DCOs, calculation of the amount of resources required and setting specific requirements relating to the liquidity of such resources. The Proposed Rules further provide requirements for reporting information related to the amount and sufficiency of such resources. We are specifically supportive of the notion of aggregating the positions of members under common control in administering the stress tests, even if the DCO margins them as separate entities. For

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 Notice of Proposed Rulemaking, 17 CFR Parts 39 and 140.

purposes of margining, it is more conservative to treat them separately to avoid netting of risk that will only occur if there is a simultaneous default. For stress testing, the risk exposure to the entire group is relevant. Netting of risk depends, for this purpose, on whether the particular test is designed to measure resource adequacy to cover simultaneous defaults or serial defaults.

We support the CFTC's approach to the financial resources of DCOs, as embodied in the Proposed Rules. We view this as an essential complement to the CFTC's proposed rules on governance and conflicts of interest (see Better Markets, Inc. Comment Letter dated November 17, 2010, proposing strong limitations on direct and informal influence by members). DCOs will play a central role in the new derivatives market infrastructure mandated by the Dodd-Frank Act. Clearinghouses have historically avoided loss from member defaults in the markets, which they cleared, even in times of substantial turbulence and crisis. However, their role in the new market structure is larger and more significant than the one they occupied before. It is necessary and appropriate for the CFTC to provide standards for measuring the resources required for DCOs to transact business prudently and for valuation of various categories of resources, all in concert with regulatory authorities from other jurisdictions.

Discussion of Comments

Our comments on the Proposed Rules are limited to four issues of tremendous importance. In the new market structure, DCOs provide a critical firewall against the type of financial catastrophe that we experienced in 2008. Their viability is essential to avoiding a repeat of the damage to the world economy and American people caused by unrecognized systemic risks. However, this firewall will only be effective if the resources of DCOs are adequate in all circumstances that might arise. The financial crisis taught us that anticipation of these circumstances is a difficult task, and particularly difficult for the profit-motivated market participants. Therefore, clear and effective regulations are essential if this firewall is to work and future taxpayer bailouts are to be avoided.

Approach to Structuring Stress Tests. While we support the analytical approach to financial resource requirements, the passive role of the CFTC embodied in the Proposed Rules to measuring the financial requirements for a DCO is completely inappropriate in light of the importance of this function.

Section 39.11(c) of the Proposed Rules provides as follows:

A derivatives clearing organization shall, on a monthly basis, perform stress testing that will allow it to make a reasonable calculation of the financial resources needed to meet the requirements of [the Proposed

Rule]. The derivatives clearing organization shall have reasonable discretion in determining the methodology used to compute such requirements, provided that the methodology must take into account both historical data and hypothetical scenarios. The Commission may review the methodology and require changes as necessary.

The potential risk of inadequate DCO resources is simply too great for a process in which the CFTC plays such a passive role. Reviewing the methodologies and the scenarios, which are proposed by the DCO, does not provide the necessary assurance that the best methodology and most prudent scenarios are employed. As proposed, it is designed to produce a methodology and scenario approach that is merely adequate based on a minimal standard.

We propose that the methodology, the historical data set and the hypothetical scenarios be jointly developed by the DCO and the CFTC. Only a joint approach will assure that all appropriate alternatives are considered. The CFTC should retain the power to require changes and approve the system to be used.

Further, it must be recognized that the market environment is subject to rapid and important changes. Therefore, we also propose that the methodology, the historic data set and the scenarios be reviewed whenever ordered by the CFTC, but no less frequently than quarterly.

Consideration of Extended Illiquidity in Stress Tests. We also recommend that the CFTC explicitly recognize the importance of illiquidity in developing hypothetical scenarios in the Proposed Rules. The potential for unprecedented events causing extended periods of illiquidity in particular markets was graphically demonstrated in the mortgage-backed securities and related credit default swap markets in the 2008 financial crisis. Inadequate assessment of the effect of long periods of illiquidity ignores the lessons of our recent history.

Assumed Default Rates in Stress Tests. Further, we propose that the default rates used in the stress test be modified for both DCOs and strategically important DCOs. Relying exclusively on the number of defaults is inadequate: the results can be tremendously different in a concentrated market as compared with a fragmented market (in which the probability of multiple defaults is arguably higher). The amount of exposure from defaults is as significant as the number of defaults. For DCOs, the default rate should be the larger of (a) the member representing the largest exposure to the DCO, and (b) the members constituting at least 25% of the exposures in aggregate to the DCO. For systemically significant DCOs, these standards should be increased to the larger of (a)

the member representing the largest exposure to the DCO, and (b) the members constituting at least 33% of the exposures in aggregate to the DCO.

In applying the foregoing default rates, the member defaults that are used may be different based on the historic and hypothetical market conditions being tested. It should be made clear that the defaults that are modeled are to be chosen based on the market conditions being tested.

In addition, when establishing the default scenarios involving more than one member to be tested, the Proposed Rules should provide that both simultaneous and serial default scenarios must be tested. In respect of simultaneous default scenarios, the Proposed Rules should explicitly address the fact that multiple simultaneous defaults can reduce aggregate risk to individual members. For example, if two members are respectively long and short on the same position, the individual risks are canceled out if they default simultaneously. In measuring the worst-case simultaneous default of multiple members, the worst-case combination of members should be used.

Valuation of Member Assessments. Finally, the haircuts proposed for valuation of member assessments are inadequate. This procedure is totally untested. In addition, assessments will be required only in conditions of extreme and historically unprecedented market stress. It would be far more prudent to require funding of risk that can be anticipated in the stress tests and to rely on the assessment as a resource for the conditions which are not anticipated in the stress tests.

The CFTC must recognize that the prediction of market conditions is inherently limited by the inability to predict all factors affecting markets, the sequence of such factors materializing, and the amplification of such factors due to contagion and market psychology, as was observed in the Fall of 2008. Reliance on the assessments for some portion of loss that is anticipated by stress tests leaves unanticipated losses unaccounted for.

Prudent Margining Practices. One element of the viability of DCOs which is not addressed in the Proposed Rules is the process of margining. If risks are properly measured and margined, other financial resources are less likely to be called upon. Indeed, prudent margin practice may be the most important resource of all. Market-based, transactable prices for maintenance margin calculations are essential. Prudent measurement of price volatility and market liquidity to calculate initial margin is also a priority. And conservative netting of maintenance margin across products is needed to balance efficiency with system reliability. We propose that the future rules and practices of the CFTC specifically and aggressively address these issues so that the first line of defense against systemic risks is the only one that will ever be needed.

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We hope that our comments are helpful in your consideration of the provisions of this Proposed Rule.

Sincerely,



Dennis M. Kelleher
President & CEO

Wallace C. Turbeville
Derivatives Specialist

Better Markets, Inc.
Suite 307
1225 Eye Street, N.W.
Washington, D.C. 20005
(202) 481-8224
dkelleher@bettermarkets.com
wturbeville@bettermarkets.com

www.bettermarkets.com