



January 20, 2011

Financial Stability Oversight Counsel
c/o United States Department of the Treasury,
Office of Domestic Finance
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Re: Advance Notice of Proposed Rulemaking – Authority to Designate Financial Market
Utilities as Systemically Important (Docket FSOC 2010-0003-0001)

Dear Ladies and Gentlemen:

Better Markets, Inc.¹ appreciates the opportunity to respond to the above-captioned Advance Notice of Proposed Rulemaking (the “ANPR”) of the Financial Stability Oversight Council (“FSOC”), the purpose of which is to invite public comment on the criteria and analytical framework that should be applied by FSOC in designating financial market utilities (“FMUs”) as “systemically important” under the provisions of the Dodd-Frank Financial Services Reform Act (the “Dodd-Frank Act”).

Introduction

Designation of FMUs as systemically important is a challenging task. While the Dodd-Frank Act lays out standards, implementation requires FSOC to confront major complexities across a wide range of financial markets. Our comments here are designed to assist that difficult implementation.

FMUs are unique because their very purpose is to interconnect market participants, primarily financial institutions. They aggregate risk so that a failure could have an enormous impact on the system. Of course, FMUs methodically measure risk and are specifically structured to survive the consequences of defaults by market participants; it is just that a failure can have large and interconnected consequences.

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.

Specifically, we propose that FSOC apply a matrix of techniques in assessing that FMUs should be designated as systemically important. Simple measurements of size based on throughput of contracts or notional quantities are not irrelevant, but they only scratch the surface of the relevant issues. We propose the following approaches, which are detailed below:

- The analysis of systemic importance must, under the standards of the Dodd-Frank Act, be based on an expansive view of the potential causes of FMU disruption or failure and estimation of their consequences.
- The interconnections among FMUs must be assessed, especially those that result from market relationships between Clearinghouses (in addition to common membership and ownership and other more straightforward relationships).
- Assessment of systemic importance based on contract and notional value volume should be supplemented by quantitative measurements of risk that take into account volatility and market liquidity.
- Conventional statistical analysis of historic market conditions is inadequate, especially in relation to Clearinghouses. Therefore, FSOC must focus on potential conditions that are not reflected in historic data and on the potential consequences of interconnection among Clearinghouses.

Legislative Background

The Dodd-Frank Act requires FSOC to designate those FMUs which *are, or likely to become*, systemically important.² “Financial market utility” is defined (subject to a number of exclusions) to mean

any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the person.³

Included within the definition are entities which clear derivatives contracts as a central counterparty and maintain margining and settlement services for their participants (“Clearinghouses”).

² Dodd-Frank Act, Section 804(a)(1).

³ Dodd-Frank Act, Section 803(6).

A key element of the Dodd-Frank Act mandate to designate systemically important FMUs is the meaning of “systemically important,” defined as

a situation where the *failure of or a disruption to the functioning* of a financial market utility or the conduct of a payment, clearing, or settlement activity *could create, or increase, the risk of significant liquidity or credit problems spreading among financial institutions or markets* and thereby threaten the stability of the financial system of the United States. [Emphasis Added]⁴

An important feature of this definition is its breadth, illustrated by the emphasized language in the quotation. Because of this and the mandate to designate FMUs that *are or are likely to become* systemically important, the scope of the designation under consideration must be viewed as broad and that the standards adopted by FSOC should reflect this.

In making the designation, FSOC is mandated by the Dodd-Frank Act to consider:

- (A) The aggregate monetary value of transactions processed by the financial market utility or carried out through the payment, clearing, or settlement activity.
- (B) The aggregate exposure of the financial market utility or a financial institution engaged in payment, clearing, or settlement activities to its counterparties.
- (C) The relationship, interdependencies, or other interaction of the financial market utility or payment, clearing, or settlement activity with other financial market utilities or payment, clearing, or settlement activities.
- (D) The effect that the failure of or a disruption to the financial market utility or payment, clearing, or settlement activity would have on critical markets, financial institutions, or the broader financial system.
- (E) Any other factors that the Council deems appropriate.⁵

⁴ Dodd-Frank Act, Section 803(9).

⁵ Dodd-Frank Act, Section 804(a)(2).

Systemic Importance from a Market Perspective

Factors based on size are relevant to systemic importance of a Clearinghouse only in the context of market-based risk and interconnectedness. Consider two Clearinghouses that clear precisely the same number of contracts having the same notional value:

- The first Clearinghouse operates in a market that is unrelated to other derivatives markets and in which individual classes of contracts trade often and with little change in price.
- The second Clearinghouse operates in a market that strongly affects prices and liquidity in other markets and in which individual classes of contracts trade infrequently with great price volatility.

The failure or disruption of the second Clearinghouse is more likely; and, because of the effect on other markets, such failure or disruption is more likely to spread to other markets and financial institutions. The second Clearinghouse has more characteristics of systemic importance far beyond mere size.

Therefore, the designation of Clearinghouses must be based on an understanding of the circumstances in which Clearinghouse functions can fail or be disrupted.

Clearinghouses aggregate the positions, and the resulting credit risks, of their members. The amount of that risk is directly related to market price moves. Clearinghouses assess the credit quality of their members and maintain default funds and other protections. However, the core function of a Clearinghouse is risk measurement and margining based on that measured risk. Clearinghouse credit risk exposure is a direct function price moves.

Since markets are interrelated, market price moves cause Clearinghouses to be interrelated as well. While operational risk is very real, the issue most relevant to systemic importance relates to measurement of the risk of market price volatility. Specifically, for each contract, the risk of loss on a member default is equal to the amount prices have moved against the member from the moment the contract is executed to the moment the Clearinghouse is able to cover the contract lost on default with a replacement position. At any given point in time, the loss that may be experienced on a contract equals the sum of:

- past net adverse price moves since the date of execution, *plus*
- future net adverse price moves to the point of a covering transaction.

The risk associated with past price moves is mitigated by maintenance margin that secures the Clearinghouse. Maintenance margin is collected periodically based on marks-to-markets as of a given time.

The risk associated with future net adverse price moves is mitigated by initial margin that also secures the Clearinghouse.⁶ The risk which defines the amount of initial margin is measured statistically based on (a) historic market price volatility related to the contract, (b) an assumed period (“holding period”) required to cover the contract and (c) a number of factors, such as duration, absolute price levels and seasonality, which can influence the statistical weighting, given historic volatility and holding periods.

Initial margin is adjusted based on netting of positions whose prices are assumed, based on historic correlations, to move in different directions during the holding period following a default. This would result in a gain to the Clearinghouse on one lost contract that would offset the loss on another. Thus, netting of initial margin based on correlation estimates the *net* loss on default.

A Clearinghouse will suffer no loss on default if (a) the marks which underlie maintenance margin are accurate measures of transactable prices and (b) the statistical estimate of volatility, holding period and netting of positions accurately predict the experience of the Clearinghouse as it covers positions lost as a result of the default.⁷ Of course, the statistics may fail to predict results in a stressed environment or if the positions are covered in a “fire sale.”

Clearinghouse disruption and failure is overwhelmingly a function of market dynamics and interrelationships. While size based on contracts executed and notional value is significant, it is only one factor among many that determine systemic importance. The nature of the markets, including liquidity, volatility, intra-Clearinghouse price correlations and connection to other Clearinghouses *via* market relationships, are also of critical importance.

Specific Responses

Below, we respond to a number of the specific questions posed in the ANPR:

1. What quantitative and qualitative information should the Council use to measure the factors it is required to consider in Section 804(a)(2) when making determinations under Section 804 of the DFA? How should quantitative and qualitative considerations be incorporated into the determination process?

Section 804(a)(2) includes factors other than volume-based size: exposure to counterparties, interdependencies among FMUs and effects on other markets and financial institutions, among others. Thus, FSOC is statutorily required to focus on several considerations other than size.

⁶ “Future,” as used here, actually refers to the period commencing with the time of the last mark-to-market which generated a call for maintenance margin that was actually funded by the member.

⁷ We recognize that this is somewhat overstated since other factors, such as losses on liquidation of collateral, could affect the outcome.

FMUs are unique because their very purpose is to interconnect market participants, primarily financial institutions. They aggregate risk so that a failure could have an enormous impact to the system. Of course FMUs methodically measure risk and are specifically structured to survive the consequences of defaults by market participants; it is just that a failure can have large and interconnected consequences.

The adequacy of capital structure is of far less importance to an FMU than to a financial institution. As aggregators of risk, it is far more important that their systems provide assurance that the consequences of a default are fully provided for. Failure of this system is difficult to reserve against. For example, because Clearinghouses are structured to withstand historic price moves, a loss is, by definition, based on unprecedented conditions.

Thus, to capture those considerations specified by the Act, we propose that FSOC use a matrix of criteria for individual Clearinghouses which, in addition to size, include:

- The historic liquidity, volatility and market depth (diversity of market participation by members) of the contracts cleared;
- The performance of statistical measures of potential market moves used by the Clearinghouse to measure both
 - Actual price moves during assumed holding periods and
 - Actual price movement correlations on which netting is based during assumed holding periods;
- Membership that is in common with other Clearinghouses, weighted by average risk exposures to each Clearinghouse; and
- Potential impacts on the liquidity and volatility of contracts cleared at other Clearinghouses from a disruption or failure of the subject Clearinghouse.

Only consideration of all these factors will satisfy the provisions of Section 804(a)(2).

2. Can the considerations listed in section 804(a)(2) be broken down into easily measured factors that the Council should use to determine whether financial market utilities are systemically important? Are there certain levels of quantitative measures (e.g., for value and exposure) or qualitative characteristics (e.g., registered clearing agencies versus exempt clearing agencies) that should trigger a review for systemic importance by the Council?

There are a number of measurement factors that should be taken into account to determine systemic importance of Clearinghouses. We will address contract volume, risk and liquidity separately.

Volume is most directly measured by number of contracts and the aggregate notional value of contracts cleared over a period of time. However, these measures lead to incomplete results. In terms of systemic importance, contracts that have been cleared but subsequently reversed are of less importance than cleared contracts that have not been reversed.

Therefore, *average and peak daily levels of open interest* are important factors in assessing systemic importance and must be included in the analysis.

Risk is also an important measure. Under the assumption that margin levels properly reflect an accurate calculation of risk, *average and peak daily levels of posted margin* are significant to systemic importance.

Another important measure of risk is the *day-over-day change in margin levels*. This reflects the amount of day-over-day change in risk. It is important to view this based on gross margin calls, excluding the netting of reduced margin credited to some members. The margin reduction for individual members is not available to reduce the consequence of a default by a member that has been called for margin but has not funded it. This measure suggests the amount of risk a Clearinghouse is exposed to as a result of normal operational lags in the margining process, the quantity of open positions and price volatility.

Liquidity of the contracts cleared by a Clearinghouse is a significant factor in measuring its susceptibility to disruption or failure. To maintain order in a default scenario, the Clearinghouse needs market access to cover lost positions. Several factors are important to contract liquidity:

the size and historic volatility of bid/ask spreads; the number of members that actively trade the contracts cleared; and the diversity of member trading volumes.

5c. For liquidity (funding), how might the Council assess the potential liquidity risks that a financial market utility may bear or liquidate risks it may impose on the broader financial system should it fail to settle as expected?

We hold the strong view that sources of liquidity for Clearinghouses, which are highly related to the underlying credit of members, should be ignored or severely discounted in any analysis. Sources of liquidity that can be adversely affected by the same conditions that generate the need for liquidity are inherently unreliable.

For example, rights to call on members for additional deposits to default funds are problematic. Calling on members to make good what is undoubtedly a major default by another member will likely be required at a time of great stress. The ability (and willingness) of members to respond is doubtful. Indeed, the right to call on members for funding can spread the consequences of the default throughout the system.

In addition, liquidity lines and credit support from banks and credit risk insurers must be

discounted. It is likely that these entities will be subject to the same forces as the members in a major default scenario.

6. How should the Council identify, measure, and assess the effects of relationships, interdependencies, and other interactions of financial market utilities listed as considerations in section 804(a)(2)?

a. What role should models of interdependencies (e.g., correlations; stress tests) play in the Council's determinations?

The inter-relationship of FMUs is a particularly challenging issue because there are numerous connections, some obvious and some indirect. Clearly, legal, corporate and contractual relationships (including cross-margining) can provide direct pathways along which the disruption or failure of an FMU can affect one or more additional FMUs. In addition, common membership is obviously a consideration, especially with respect to Clearinghouses.

FSOC raises the issue of stress tests and correlations in Question 6. This issue requires careful consideration as it applies to Clearinghouses. The fundamental business of Clearinghouses is to measure and margin risk based on stress tests and price correlations. As a result, the systemic importance of a Clearinghouse cannot be easily measured by conventionally applying those techniques.

We propose that the analysis reach beyond projection of future events based on historic data. Underlying assumptions of the risk algorithms must be understood and challenged. In particular, extreme cases of market illiquidity as a result of events that are not captured by historic experience must be applied. If this is not a major feature of the analysis, it would mean that the events leading to the financial crisis, particularly in the mortgage markets, will have been ignored.

7. How should the Council assess whether failures or disruptions to a financial market utility could potentially threaten the financial system of the United States?

Question 7 poses issues of enormous complexity and breadth. Recent history has demonstrated that modern markets are interconnected and that crises can easily spread like an infection. A system that quantitatively measures the results of specific scenarios caused by interconnectedness may be so difficult to construct that its predictive reliability is doubtful.

We propose that FSOC identify specific scenarios that could lead to cascading effects. An example is the sudden loss of liquidity in foreign exchange markets as a result of severe inter-bank counterparty credit concerns. Based on this scenario, FSOC should game the cascading results. Using one application of the scenario in the example, the effect on liquidity in energy markets because of the impact of the foreign-exchange crisis on banks that are central to that liquidity could profoundly affect energy Clearinghouses. As a result,

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be considered more systemically important because of potential cascading effects.

Conclusion

The designation of systemically important FMUs is an important and inherently complex task. We hope that our responses to your questions are helpful in the development of proposed rules.

Sincerely,



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