BETTER MARKETS
TRANSPARENCY · ACCOUNTABILITY · OVERSIGHT

May 27, 2011

Financial Stability Oversight Counsel
Attention: Mr. Lance Auer
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Re: Notice of Proposed Rulemaking – Authority to Designate Financial Market Utilities as Systemically Important (RIN 4030-AA01)

Dear Mr. Auer:

Better Markets, Inc.[1] appreciates the opportunity to respond to the above-captioned Notice of Proposed Rulemaking (the "NPR") of the Financial Stability Oversight Council ("FSOC"), the purpose of which is to describe the criteria that will inform, and the processes and procedures established for, FSOC's designation of financial market utilities ("FMUs") as "systemically important" under the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

**INTRODUCTION**

Designation of FMUs as systemically important is a challenging task. While the Dodd-Frank Act lays out detailed standards, implementation requires FSOC to apply them in contexts which are diverse because of the several types of FMUs and the wide range of financial markets.

Previously, FSOC issued an Advance Notice of Proposed Rulemaking requesting responses from the public to ten questions relating to FMU designation. Better Markets responded to this ANPR in a letter dated January 20, 2011, a copy of which is attached (which copy is incorporated herein as if fully set forth here). We reaffirm the responses contained in the letter. Generally, we proposed that FSOC apply a matrix of techniques in assessing which FMUs should be designated as systemically important, observing that 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.

**DISCUSSION**

The proposed rules contained in the NPR (the "Proposed Rules") describe a number of criteria which address most of the issues raised in Better Markets' January 20 letter. We commend FSOC for the specific criteria identified and the breadth of the list. In particular,

[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 preamble to the NPR describing the application of the Proposed Rules appropriately uses the concept of peak intra-day and day-over-day risk as measured by changes in margin to evaluate credit exposures and focuses on the depth of the marketplace (*i.e.,* the concentration of participation among participants in the FMU).

However, the Proposed Rules fall short of defining criteria for designation of FMUs as systemically important in one critical respect: characteristics such as "liquidity" and "credit risk" are identified,[2] but the Proposed Rules provide no guidance as to the method for measuring these characteristics. While one commentator suggests an algorithmic approach which would yield an index of systemic importance for all FMUs,[3] we appreciate that FSOC may prefer a more flexible approach given the variety of FMUs to be considered.[4] Nevertheless, guidance regarding that approach to measuring systemic importance based on the specified criteria is essential.

In the Proposed Rules, systemic importance is defined by "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" as a result of "the failure or disruption of the functioning" of a particular FMU.[5] The importance of individual criteria with respect to this standard depends on financial market and economic conditions which may occur. Consider an example: an FMU is exposed to credit risk to the extent that the collateral it holds to secure it against exposure to its participants can be liquidated for the value assumed by the FMU. The FMU's systemic importance is directly related to the liquidity and volatility of the markets for the collateral under conditions prevailing at the time of participant default.

Assessment of systemic importance will thus depend on assumed conditions which are neither specified nor described.

The Proposed Rules must provide a standard such as that used by the Federal Reserve Board in its proposed rules on financial market utilities[6] and by the Commodities Futures Trading Commission in its proposed rules on financial resources of derivatives clearing organizations:[7] "extreme but plausible market conditions." The Proposed Rules must provide that the criteria will be applied to FMUs in order to evaluate systemic importance assuming that extreme but plausible market conditions exist.

As we have asserted in comments relating to this standard,[8] "extreme but plausible market conditions" must clearly be defined to refer to conditions beyond those suggested

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2 Proposed Rules, Section 1320.10.

3 Comment Letter in response to ANPR from the Pew Charitable Trust dated January 19, 2011.

4 We believe that the excellent work represented by the comment letter identified in the immediately preceding footnote could be tremendously valuable to FSOC as it evaluates the systemic importance of individual FMUs even if the specific approach is not reflected in the final rule.

5 Proposed Rules, Section 1320.2.

6 76 FR 18445.

7 75 FR 63113.

8 Better Markets Comment Letter - Financial Resources Requirements for DCOs: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26698&SearchText=; Better Markets Comment Letter - General Regulations and DCOs http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27682&SearchText=; Better Markets

by historic data. A statistical analysis which focuses on historic observations is simply inadequate to evaluate threats to the stability of the financial system. The events of 2008 occurred in large part because risk was assumed to be limited to historically observed levels. Specific conditions such as market price moves, illiquidity and the consequences of interconnectedness must be based on unprecedented but possible combinations and scenarios.

This approach requires the use of scenarios and analysis of potential consequences and interconnectedness which have not occurred. For example, an extreme loss of liquidity in the foreign exchange markets as a result of credit concerns for non-U.S. banks could dramatically impact the closely related interest rate markets (as well as others, of course). To the extent that FMUs serving the interest rate market could be affected or could become the vehicles for transmission of the effects of the forex market event to other financial participants and markets, these FMUs would be properly considered to be systemically important.

It is to be expected that FMUs will manage their businesses to address historic precedents and regulators will undoubtedly monitor the methodologies that they use. ***But systemic importance must not be judged in relation to historic precedent. Historic precedent defines the minimum risk management techniques required of the FMUs. Systemic damage will more likely occur as a result of the unprecedented.***

The financial crisis in 2008 was a direct result of over-reliance on statistical analysis of historic data to measure systemic risk rather than simply as a corporate risk management tool. Banks, investors and credit ratings agencies hubristically anchored their belief (which dovetailed with their self-interests) in perpetually rising real estate values based on statistical analyses of historic data. The Proposed Rules must be broadened to recognize that standards for systemic importance require imagination as well as spreadsheet analysis.

Given the uncertainty of results under the Proposed Rules, the adequacy of the criteria for systemic importance is difficult to assess. The criteria will be successful only if organizations such as those listed below are determined to be systemically important:

- Central counterparty clearing houses such as the Chicago Mercantile Exchange and the clearing entities of the Intercontinental Exchange.
- The Depository Trust & Clearing Corporation, which reports that it services securities valued at almost $34 trillion as of 2009.[9]
- The clearing banks for tri-party repurchase agreements, Bank of New York Mellon and JP Morgan Chase, which serve as collateral agent for, and regularly

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Comment Letter - Risk Management Requirements for DCOS: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27712&SearchText=

9 See: www.dtcc.com/about/business/.

provide intra-day credit with respect to, approximately $1.7 trillion average aggregate volume of repurchase agreements.[10]

- CLS Bank which reports that it settles 58 percent of the $4 trillion per-day forex swap market.[11]

- The Clearing House which operates CHIPs, reported to facilitate more than $1.5 trillion per day of inter-bank wire transfers.[12]

- Global custody banks including Bank of New York Mellon, State Street and JP Morgan Chase, which collectively are reported to have almost $59 trillion in assets under management.[13]

While these organizations are very different in terms of size and the risks which they face, they share in common a critical characteristic: failure as a result of insolvency or operational failure put the financial system of the United States at grave risk because the consequences would rapidly be transmitted to multiple large financial institutions.

## CONCLUSION

The designation of systemically important FMUs is an important and inherently complex task. We hope that our comments are helpful in the consideration of the Proposed Rules.

Sincerely,

Dennis M. Kelleher By WCT

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10 Federal Reserve Bank of New York, White Paper – Tri-party Repo Infrastructure Reform, March 17, 2010; Task Force On Tri-party Repo Infrastructure Payments Risk Committee Report, March 17, 2010.

11 See: www.cls-group.com/SiteCollectionDocuments/CLS%20market%20share%20Feb%202011.pdf

12 See: www.chips.org/about/pages/033738.php

13 See: www.globalcustody.net/new/custody_assets_worldwide/