



May 19, 2011

Jennifer J. Johnson  
Secretary  
Board of Governors of the Federal Reserve System  
20th Street and Constitution Avenue, NW  
Washington, DC 20551.

Re: Notice of Proposed Rulemaking – Financial Market Utilities (RIN 7100-AD71)

Dear Ms. Johnson:

Better Markets, Inc.<sup>1</sup> appreciates the opportunity to respond to the above-captioned Notice of Proposed Rulemaking (the “NPR”) of the Federal Reserve Board of Governors (“the Board”) the purpose of which is to promulgate risk-management standards governing the operations related to the payment, clearing and settlement activities of certain financial market utilities (“FMUs”) that are designated as “systemically important” by the Financial Stability Oversight Council under the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).

### **Introduction**

In the financial system mandated by the Dodd-Frank Act, financial transactions will become more standardized and the role of FMUs will be even more important than before. FMUs will provide a firewall against risks which could otherwise once again cripple the worldwide financial systems. The risk-management standards for designated FMUs established by the proposed rules set out in the NPR (the “Proposed Rules”) are at the center of this reform.

Central counterparties which are designated FMUs (“CCPs”) will bear a particularly heavy burden. They are tasked with clearing the trillions of dollars of derivatives which in recent years have been transacted in the shadow market of over-the-counter, bi-lateral swaps. The Commodity Futures Trading Commission (“CFTC”) has promulgated three proposed rules<sup>2</sup> which provide detailed standards analogous to the broader standards of the Proposed Rules. Better Markets filed comment letters with respect to each of those

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<sup>1</sup> 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.

<sup>2</sup> Financial Resources Requirements for Derivatives Clearing Organizations, 75 FR 631138; General Regulations and Derivatives Clearing Organizations, 75 FR 77576; and Risk Management Requirements for Derivatives Clearing Organizations, 76 FR 3698.

proposed rules, copies of which are attached hereto for your convenience, which are incorporated here as if set forth herein.

### **Comments**

The standards established by the Proposed Rules are largely prudent and complete. However, certain of the standards must be strengthened to provide adequate protection against systemic risk.

#### *CCP Margin Model Validation Must Be Performed by an Independent Third Party.*

The Proposed Rules require annual validation of the model which calculates margin requirements for a CCP.<sup>3</sup> To assure independence of the validation process, the individuals performing validation must, under the Proposed Rules, be independent of the individuals responsible for the model's construction and application.

The Board's focus on independence is appropriate, but the standard adopted is inadequate. Margining systems are absolutely critical to the systemic integrity of CCPs. If the systems work correctly, the financial resources of a CCP will only be needed for member defaults which occur simultaneously with extraordinary market conditions. This is the premise behind the clearing mandate in the Dodd-Frank Act. Because these models are critical elements of the clearing system, they must be validated annually by a qualified and independent organization with no financial stake in the outcome. No employee of a systemically important CCP should be expected to resist the inevitable direct and indirect pressures of management who may be incentivized to achieve a less appropriate and independent outcome.

#### *CCP Stress Test Parameters Must Be Stricter and Must Be Based on Risk, Not Numbers of Defaulting Participants.*

In the Proposed Rules, designated CCPs must maintain financial resources adequate to withstand the default of the participant to which it has the single largest risk exposure in extreme, but plausible, market conditions.<sup>4</sup>

If the Board maintains this approach - *i.e.*, standards based on a number of participants which pose large risk exposures to the CCP - the number of participants is inadequate. The recent financial crisis makes it clear that one of the central dangers which must be addressed by financial reform is *interconnectedness* of financial institutions. At a minimum, the standard must be based on the risk posed by the two participants which together pose the greatest risk of loss to the designated CCP. This is the standard adopted by the CFTC for systemically important designated clearing organizations, and the Board should be consistent with the CFTC rule.<sup>5</sup>

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<sup>3</sup> Proposed Rules, Section 234.4(a)(17).

<sup>4</sup> Proposed Rules, Section 234.4(a)(18).

<sup>5</sup> Financial Resources Requirements for Derivatives Clearing Organizations, 75 FR 631138,

However, we believe that the approach based solely on numbers of participants is logically flawed. To address the issue of interconnectedness, the test must be based on the larger of (a) the two members representing the largest exposure to the CCP, as described above, and (b) the members constituting at least 33 percent of the exposures in aggregate to the CCP.<sup>6</sup> This approach captures the risk of a diverse, but interconnected, membership.

*Legal Certainty of Netting Must Be Demonstrated.*

Each category of designated FMUs will allow netting of payments to and from individual participants. To assure that this netting will be honored in a bankruptcy or other insolvency proceeding applicable to any participant, the Proposed Rules must require that the FMU provide an analysis by outside legal counsel which is nationally recognized as an expert in matters of corporate insolvency that, under the policies, procedures and documentation of the FMU, the netting which is permitted will be given legal effect in default and insolvency situations. It is critically important that amounts owed by the participant will not be avoided while amounts owed by the FMU to the participant are enforced. The other safeguards in the Proposed Rules will be frustrated if the actual amounts owed by participants are not reliable in an insolvency proceeding.

**Conclusion**

Systemically important FMUs are among the most critical elements of the market structure mandated by the Dodd-Frank Act. The standards which govern their operations will be central to the success of this market structure. We hope that our comments on the Proposed Rules are helpful.

Sincerely,



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<sup>6</sup> See December 13, 2010 Comment Letter attached hereto.