January 24, 2011

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

Re: Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants (CFTC RIN 3038-AC96)

Dear Mr. Stawick:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned proposed rules (the "Proposed Rules") of the Commodity Futures Trading Commission ("CFTC"), the purpose of which are to set forth certain duties of swap dealers ("SDs") and major swap participants ("MSPs") with regard to risk management procedures, monitoring of trading to prevent violation of position limits, supervision, business continuity and disaster recovery, disclosure to regulators and antitrust considerations pursuant to provisions of the Dodd-Frank Financial Services Reform Act (the "Dodd-Frank Act").

Introduction

The Dodd–Frank Act establishes a variety of business conduct standards and duties which SDs and MSPs must comply with to maintain registration with the CFTC.[2] The Proposed Rules implement these provisions effectively. However, several key areas are not, but must be, covered:

- The Proposed Rule provides that the risk management unit of each SD and MSP, responsible for monitoring risk, must be independent from the business trading

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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 Dodd-Frank Act, Section 731.

unit.[3] The safeguards set forth in the Proposed Rules must be expanded to effectively ensure the independence of risk management units.

- Bilateral counterparty credit risk was a major cause of the destructive near-complete shut down of a variety of markets in 2008. Only intervention by the Federal Reserve and other agencies prevented total disaster in the derivatives and credit markets. The Proposed Rules require credit risk policies and procedures to take into account counterparty credit risk, but provide no standards for risk measurements.[4] Given the principles developed by derivatives clearing organizations ("DCOs") and others regarding proper measurement of derivatives counterparty credit risk, the Proposed Rules must not be silent on standards and principles. We will propose standards.

- While counterparty risk is discussed,[5] it appears that the Proposed Rules do not address the largest class of counterparties to SDs and MSPs: futures commission merchants ("FCMs"). There is no question that SDs and MSPs are exposed to the credit risk of the FCMs with whom they enter into contracts. These entities must be treated as counterparties by the Proposed Rules.

- The Proposed Rules require that policies and procedures take into account the SD's or MSP's risk associated with daily liquidity needs.[6] However, these provisions ignore the single largest liquidity risk to which SDs and MSPs are commonly exposed: credit triggers in Credit Support Annexes requiring immediate funding of collateral theretofore foregone by counterparties under specified circumstances (most often credit rating downgrades). History instructs us that this is typically the proximate cause of failure of a trading entity. Therefore, policies and procedures must continuously measure the magnitude of this risk, changes to its probability of occurrence and availability and adequacy of liquid reserves to address the consequences of a trigger event.

Regulatory Authority and Proposed Approach

The Dodd-Frank Act establishes a series of requirements that must be followed by all SDs and MSPs to maintain their registration with the CFTC, including business conduct standards and duties.[7] The Proposed Rules implement this provision.

The Proposed Rules require that each SD and MSP establish, document, maintain and enforce a system of risk management policies and procedures, referred to as a "Risk Management Program."[8] Risk Management Programs must be approved by the governing bodies of SDs and MSPs and they must be furnished to the CFTC.

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[3] Proposed Rules, Section 23.600(b)(5).
[4] Proposed Rules, Section 23.600(c)(4)(ii).
[5] *Id.*
[6] Proposed Rules, Section 23.600(c)(4)(iii).
[7] Dodd-Frank Act, Section 731.
[8] Proposed Rules, Section 23.600(b).

The Proposed Rules specify detailed required elements of Risk Management Programs and the risks required to be monitored and managed thereunder.[9] In addition, the business trading units of each SD and MSP must establish policies and procedures relating to trading practices that address specified risks.[10] The Proposed Rules require the establishment and enforcement of policies and procedures relating to monitoring of position limits, including the conversion of all swap positions into equivalent futures positions consistent with other CFTC rules.[11]

Additional sections of the Proposed Rules address supervision,[12] business continuity and disaster recovery,[13] availability to the CFTC and prudential regulators of certain information,[14] and certain antitrust considerations.[15]

Discussion of Proposed Rules

The business realities of SDs and MSPs are unique. Inherently, they involve rapid decision-making with consequences to profits and losses that can be large. Furthermore, individual compensation is often based on bonuses that are mathematically related to trading profits and losses. This compensation arrangement greatly enhances the intensity of the pressures to generate profits by taking on risk.

The duties of risk management units will often come into conflict with the perceived interests of traders and managers in an intense and pressurized environment and one in which the trading and decision-making is lightning fast. In these businesses, the express and implicit barriers to independent judgment related to compliance (which often is a perceived obstacle to profitable trading) are unusually large.

The importance of independence from business trading units simply cannot be overstated, as highlighted by a telling observation in Raghuram Rajan's award-winning book Fault Lines: How Hidden Fractures Still Threaten the World Economy:

> "I remember a meeting between risk managers of the major banks and academics in the spring of 2007 at which we academics were surprised that the managers were not more worried about the risks stemming from the plunging housing market. After our questions elicited few satisfactory replies, one astute veteran risk manager took me aside during the break and said: 'You must understand, **anyone who was worried was fired long ago** and is not in this room.' Top management had

9 Proposed Rules, Section 23.600(b-c).
10 Proposed Rules, Section 23.600(d).
11 Proposed Rules, Section 23.601.
12 Proposed Rules, Section 23.604.
13 Proposed Rules, Section 23.603.
14 Proposed Rules, Section 23.606.
15 Proposed Rules, Section 23.607.

> removed all those who could have restrained the risk taking precisely at the point of maximum danger."[16]

In the Proposed Rules, the issue of independence is addressed solely by the following language: "The risk management unit shall report directly to senior management and shall be independent from the business trading unit."[17] By any measure and in any circumstance, this is totally inadequate. In the context of an industry with a history of conflicts and frequent borderline illegal conduct, such minimal guidance is an invitation to trouble. That simply cannot be tolerable at critically important SDs and MSPs.

CFTC's recently proposed rule regarding compliance officers of SDs, MSPs and FCMs would establish a number of requirements that ensure independence.[18] In that proposed rule, reporting, compensation and job evaluation processes were all addressed. We suggest that the same approach be adopted for credit risk management units and the chief risk officer. We filed a comment letter regarding the chief compliance officer proposed rule which includes a number of suggestions to improve the approach taken in that proposed rule (including increasing the role of independent directors and audit committees), which we incorporate as if fully set forth here. A copy of that comment letter is attached hereto.

Daily Risk Measurement

The Proposed Rules require that the credit risk policy and procedures take into account "[d]aily measurement of overall credit exposures to comply with counterparty credit limits…."[19] But there is no guidance on the extraordinarily important question on how to approach the measurement of risk.

DCOs employ sophisticated risk measurement techniques and they provide guidance on this point. At a minimum, counterparty risk should be measured by marks-to-market *plus* an estimate (analogous to initial margin) of loss that may be experienced if the positions being measured must be liquidated on default. Netting of credit risk must also be consistent with DCO approaches. To require less would be to ignore obvious "best practices" principles that all market participants are familiar with.

FCMs as Counterparties

The Proposed Rules require SDs and MSPs to continuously measure their exposure to the risk of counterparties. Central counterparties are addressed separately, including a requirement of "investigation into the adequacy of the financial resources and risk management procedures" of those employed.[20]

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16 See, Rajan, Id. At 165. ("[A] board can obtain better information if the risk managers in the firm are required to report directly to it on a regular basis.").

17 Proposed Rules Section 23.600(b)(5).

18 75 FR 70881.

19 Proposed Rules, Section 23.600(c)(4)(ii)(A).

20 Proposed Rules, Section 23.600(c)(5)(iii).

However, counterparty credit exposure to FCMs is just as real as exposure to counterparties in uncleared transactions. The Proposed Rules must make clear that FCMs should be treated as counterparties for purposes of credit risk policies and procedures.

Daily Liquidity Needs

The Proposed Rules require that credit risk policies and procedures include daily measurements of liquidity needs, testing of procedures to liquidate non-cash collateral and haircut valuations.[21]

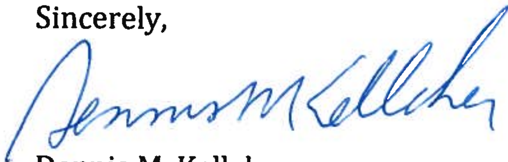
While these are reasonable subjects, they ignore the liquidity issue which poses the greatest single threat to a trading entity: triggers which require immediate funding of foregone collateral under specified circumstances (generally credit rating down grades).

These provisions have been the direct cause of defaults in the derivative markets many times in the past. The credit risk policies and procedures must continuously measure the magnitude of this risk, changes to its probability of occurrence and availability and adequacy of liquid reserves to address the consequences of a trigger event.

Conclusion

Inadequate credit risk policies and procedures have been a great burden on the markets for many years. We hope these comments are helpful in your consideration of the Proposed Rules so that this burden can be lifted.

Sincerely,



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[21] Proposed Rules, Section 23.600(c)(4)(iii).