April 29, 2011

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Clearing Agency Standards for Operation and Governance; File No. S7-08-11

Dear Ms. Murphy:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned proposed rules (the "Proposed Rules") of the Securities and Exchange Commission ("Commission"). The Proposed Rules would govern the registration, operation, and governance of clearing agencies, in accordance with Section 763 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), and in accordance with Section 17A of the Securities Exchange Act of 1934 ("Exchange Act").

INTRODUCTION

Clearing agencies will play an important role in the new regulatory framework governing security-based swaps ("SBS"). The Dodd-Frank Act requires all SBS to be submitted for clearing, subject to limited exceptions.[2]

This mandatory clearing requirement is intended to mitigate risk through the involvement of a central counterparty in each transaction and the imposition of margin requirements to reduce the likelihood and impact of default. Clearing agencies must be carefully regulated to ensure that they remain financially stable and to ensure that they afford all market participants fair access to the clearing process.

STATUTORY FRAMEWORK

Clearing agencies operating in the securities markets have been regulated for decades by the Commission under Section 17A of the Exchange Act.[3] The Exchange Act establishes the basic requirements applicable to clearing agencies, including registration, prompt and accurate clearance and settlement of transactions, safeguarding investor

[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 § 763(a).
[3] 15 U.S.C. § 78q-1.

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funds, providing fair access to participants, establishing equitable pricing, and avoiding undue burdens on competition. The Exchange Act also grants the Commission rulemaking authority with respect to clearing agencies.

Section 763(b) of the Dodd-Frank Act establishes a new registration requirement for clearing agencies that seek to clear SBS, and it authorizes the Commission to adopt new rules governing the operation of those clearing agencies. The Proposed Rules have been promulgated in accordance with the Commission's authority under both the Dodd-Frank Act and Section 17A of the Exchange Act.

OVERVIEW OF REGULATIONS

The Proposed Rules are a thorough and conscientious effort to address a wide range of regulatory issues relating to clearing agencies that handle SBS transactions. They cover—

- Registration requirements;
- Financial standards;
- Margin and related risk controls;
- Fair access to the clearing agency by market participants;
- Disclosure of the costs and risks associated with use of the clearing agency;
- Measures to address conflicts of interest; and
- Corporate governance requirements.

In fashioning the rules, and in accordance with the Dodd-Frank Act, the Commission has appropriately taken into account international standards governing clearance and settlement, as developed by the International Organization of Securities Commissions and the Bank for International Settlements.[4] In addition, the Commission has considered the requirements under Title VIII of the Dodd-Frank Act, which establishes an enhanced supervisory and risk control system for systemically important clearing agencies.[5]

SUMMARY OF COMMENTS

Our comments focus on two aspects of the Proposed Rules: those dealing with risk management and those dealing with conflicts of interest.

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[4] Release at 14476.
[5] Release at 14473-74.

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With respect to risk management, the Proposed Rules should—

- Provide substantially more detailed standards for calculating margin;
- Require intra-day calculation of credit exposures under specified circumstances;
- Define "extreme but plausible market conditions" for purposes of calculating required financial resources; and
- Require independent evaluation of margin models.

With respect to conflicts of interest, the Proposed Rules should—

- Be more specific;
- Apply to all types of clearing agencies;
- Establish an aggregate ownership limit of 25 percent by members and certain market participants;
- Require that clearing agency boards have a majority of independent directors; and
- Enhance measures to protect the chief compliance officer from improper interference and influence.

COMMENTS ON PROPOSED RULES

Rules Relating to Risk Management

Calculation of Margin. Proposed Rule 17Ad-22(b)(2) addresses margin requirements. It would require a clearing agency to establish margin requirements to limit its credit exposures to participants in "normal market conditions," to use risk-based models to set margin requirements, and to review those models at least monthly. These measures are reasonable, but they must provide considerably more guidance regarding the calculation of margin.

Under the Proposed Rules, margin requirements must be set at levels that are capable of satisfying "normal market conditions." Those conditions are defined to be conditions in which expected price movements would breach margin requirements only one percent of the time.[6] This test will require clearing agencies to review historical data

[6] Proposed Rule 17Ad-22(a)(4).

to draw conclusions about future price movements. In light of those conclusions, the clearing agency will then set initial margin at levels to avoid being breached in 99 percent of expected occurrences. The 99 percent standard, in effect, addresses expected price volatility during the period to be covered by initial margin.

This approach to setting margin lacks several important elements. First, the Proposed Rules must specify the amount of historical price data that clearing agencies must use to determine normal market conditions for a given derivative. A minimum of two to three years of data is needed.

Second, the Proposed Rules must require the clearing agencies to consider liquidity when setting margin. The clearing agencies must evaluate the expected holding period for the derivative, which must reflect the amount of time necessary to replace a position once a default has occurred. This measure of expected liquidity must be incorporated in the margin levels.

Finally, the Proposed Rules must deal with the issue of spread margins. These are the netted initial margins of long and short derivatives that are not identical but whose price movements are assumed to be correlated in "normal market conditions." The initial margin for two contracts can be netted if the price risks are significantly and reliably correlated. This is an important risk issue for clearing agencies: A dollar lost because of a mistakenly calculated relationship between prices is the same as a dollar lost because of movements in a single price.

The following summary is an accurate way to calculate spread credits based on standards that are consistent with the volatility and liquidity requirements we have suggested above. The precise methodology can be left to the clearing agency, but this approach establishes minimum standards.

The clearing agency should assemble the historic spreads between the prices of two related derivatives over the same period used to gather data for the volatility calculation discussed above. It must then calculate the correlation factors over the longest of the two holding periods associated with the related derivatives. The confidence interval should be applied so that 99 percent of the correlation factors are captured. This parallels the volatility standard expressed as a confidence interval. Finally, the lowest correlation factor in the remaining set should be applied to the gross initial margin amounts as the credit.

The steps in this calculation are set forth below:

Step 1	Set of Source Price Data	Daily spreads between prices of 2 netted contracts over a period of observations
Step 2	**Set of Data for Margin Credit Calculation – Liquidity Factor Applied**	Correlation factors over rolling 5-day holding periods calculated (assumes that 5 days is the longest of the 2 holding periods)
Step 3	**Volatility Factor Applied**	Confidence interval applied so as to capture 99% of the correlation factors in the set
Step 4	**Margin Credit Calculated**	Position Credit = Lowest Correlation Factor[7] x (Initial Margin A + Initial Margin B)

Calculations of Credit Exposures. Proposed Rule 17Ad-22(b)(1) would require a clearing agency to measure its credit risk exposures to its participants at least once each day as part of its risk management procedures. This minimum frequency is generally appropriate, but the rule should also require intra-day calculations of credit risk exposure when circumstances warrant, including situations where the SBS is illiquid, difficult to price, or highly volatile.

Financial Resources. Proposed Rule 17Ad-22(b)(3) would establish minimum financial resources requirements. The rule appropriately differentiates between SBS and non-SBS clearing agencies in this context. It would require non-SBS clearing agencies to maintain sufficient financial resources to withstand, at a minimum, a default by the participant to which they have the largest exposure in extreme but plausible market conditions. SBS clearing agencies, on the other hand, would be required to withstand, at a minimum, a default by the **two** participants to which they have the largest exposure. This heightened standard is justified in light of the unique features of the SBS markets, including the more limited historical information on pricing and the "jump-to-default" risk associated with credit default swaps.

The Proposed Rules should, however, provide guidance regarding what constitutes "extreme but plausible" market conditions. In this instance, and in general, providing clear guidance will enable the Commission to prevent market participants from adopting an overly lax or self-serving interpretation of the standard. Concrete guidance will also promote more consistent adherence to the requirements by all market participants. This, in turn, will help prevent clearing agencies from adopting lower standards to reduce costs and attract business volume, at the expense of stability and risk mitigation.

Most importantly, it should be made clear that "extreme but plausible" may not be based on statistical analysis of historical price moves. That methodology underpins

[7] This refers to the lowest correlation factor within the set of all correlation factors which are included within the 99 percent confidence interval. For instance, assume that all of the observed correlation factors range from .64 to .91. Further assume that the correlation factors ranging from .66 to .91 equal 99 percent of the total. The correlation factor to be applied in the calculation of the margin credit will be .66.

margin calculations, but it will not yield meaningful results for purposes of anticipating extreme but plausible conditions. "Extreme but plausible" conditions must focus on unprecedented periods of illiquidity, volatility, and interconnectedness leading to multiple defaults (which, because of netting, will tend to both increase and decrease exposures). Having recently experienced a financial crisis with no historic precedent, the entities at the center of derivatives risk management must not limit their resources to those sufficient to cover events of the past.

Finally, in response to a question raised in the Release, we do not believe that the financial resource requirement should be formulated in terms of a percentage of the total business conducted by the clearing agency, since business volume could be low while the risk profile is high, and vice versa.[8]

Evaluation of Margin Models. Proposed Rule 17Ad-22(b)(4) would require clearing agencies to evaluate the performance of their margin models and the assumptions associated with such models on an annual basis. The validation would have to be conducted by a person at the clearing agency who does not generally perform functions related to the margin models and does not report to a person who performs such functions.

The rule should be strengthened in two respects. First, to ensure greater objectivity, the annual model validation should be conducted by an outside, independent expert. Second, the frequency of the validations should be annual, but subject to the proviso that if at any time the clearing agency has reason to believe that the model is no longer adequate, then the model must be adjusted as necessary and revalidated.

Rules Relating to Conflicts of Interest and the Chief Compliance Officer.

The Proposed Rules include provisions on the important topics of conflicts of interest and chief compliance officers. We discuss these topics below, but two general points deserve emphasis at the outset.

First, the Proposed Rules must be more specific. Overly general standards are tantamount to minimal standards. Failure to describe regulatory obligations in sufficient detail will inevitably result in less than the optimal compliance as well as confusion and evasion.

Second, rules pertaining to conflicts of interest, corporate governance, and compliance should apply to all clearing agencies required to be registered with the Commission, whether or not they clear SBS and whether or not they offer central counterparty services. The underlying rationale for these rules is to promote open, fair, and competitive markets in strict compliance with applicable laws and regulations.

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[8] Release at 14479.

Exempting any sub-category of registered clearing agency from any of these requirements will undermine the attainment of these objectives.

Conflicts of Interest. Proposed Rule 17Ad-25 requires each clearing agency to establish and enforce written policies and procedures to identify and address existing or potential conflicts of interest. Requiring clearing agencies to adopt policies and procedures regarding the management of conflicts is a necessary and important component of an effective regulatory framework, but it is not sufficient.

The most effective way to address conflicts of interest is by imposing specific limitations on ownership of the clearing agency, coupled with minimum independence requirements for members of the board of directors.[9]

In our comment letter[10] on proposed Regulation MC, issued by the Commission on October 14, 2010, we described the conflicts of interest that have long characterized the derivatives marketplace, and we urged the Commission to adopt specific limits on the ownership of clearing agencies and the composition of their boards. In summary, the Commission should adopt the following measures:

- Members and Specified Entities[11] should not be permitted to beneficially own, directly or indirectly, any voting interest in a clearing agency that exceeds, in the aggregate, 25 percent of the total voting interest.
- Ownership by members and Specified Entities of non-voting equity in clearing agencies must be treated in the same manner as voting interests, given the powerful influence such ownership can confer apart from voting rights.
- Beneficial ownership should be defined in conformity with SEC Rule 13d-3, without limitation to persons and groups having the power to direct votes of securities or other ownership interests.
- Clearing agency boards must have at least a majority of independent directors.
- Risk management committees also must have a majority of independent directors.

[9] Proposed Rule 17Ad-26 requires each clearing agency to establish board member responsibilities, qualifications, and disqualifying criteria. These provisions are useful, but they do not address the independence of the board and therefore have no bearing on controlling conflicts of interest.

[10] Comment Letter from Better Markets to the SEC/Elizabeth M. Murphy (Nov. 26, 2010), on Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps Under Regulation MC, SEC Release No. 34-63107 (Oct. 14, 2006),75 Fed. Reg. 65882 (Oct. 26, 2006).

[11] In the proposing Release for Regulation MC, at 65883, the Commission defined the term "Specified Entities" to include a bank holding company with total consolidated assets of $50 billion or more, a nonbank financial company, an affiliate of such bank holding company or nonbank financial company, a security-based swap dealer, or a major security-based swap participant.

Designation of Chief Compliance Officer. Proposed Rule 3Cj-1 requires each clearing agency to designate a chief compliance officer ("CCO"). Under the Proposed Rules, the CCO would report directly to the board and would be subject to removal only upon the approval of a majority of the board. The rule also lists the CCO's duties, among which is the preparation and filing of an annual report to the Commission.

Rules governing the appointment, responsibilities, and supervision of the CCO are a vital component of the new regulatory framework governing clearing agencies. Rules relating to the CCO are especially important, since an effective CCO can help control conflicts of interest as well as other violations of applicable laws and regulations.

For many years, market participants operated in an environment in which regulation was viewed as an obstacle to doing business. Changing this culture requires the involvement of a CCO who has the authority and independence to function effectively and without interference.

The Proposed Rules will help fortify the role of the CCO as an effective force in achieving clearing agency compliance, but they should be strengthened in a number of ways. We have argued for similar provisions in our comment letter on proposed rules governing SEFs.[12]

Qualifications. The Proposed Rules should require the CCO to meet competency standards to ensure that the person has the background and skills appropriate for fulfilling the responsibilities of the position. These standards should include a lack of disciplinary history, in addition to criteria demonstrating relevant knowledge and experience. Furthermore, the CCO must not be the clearing agency's general counsel or a member of its legal department.

Oversight by Independent Board Members. The independent members of the boards of directors are, by design, independent from senior management. They are more likely to view compliance as a worthy goal rather than as an obstacle. In light of these pressures that are exerted on CCOs, the Proposed Rules must include a number of provisions to help ensure the independence of the CCO.

Decisions relating to the designation of the CCO, the CCO's compensation, material changes in the CCO's responsibilities, and termination of the CCO should be the sole responsibility of the independent members of the board of directors acting by majority vote. In addition, the CCO should have a direct line of reporting to the independent directors or the audit committee.

[12] Comment Letter from Better Markets to the SEC/Elizabeth M. Murphy (Apr. 4, 2011) on Registration and Regulation of Security-Based Swap Execution Facilities, SEC Release No. 34-63825 (Feb. 2, 2011), 76 Fed. Reg. 10948 (Feb. 28, 2011).

The Proposed Rules must require that the CCO meet with the board of directors *and* the senior officer to discuss the effectiveness of compliance policies at least once each year. In addition, the CCO should meet at least quarterly with the audit committee. This will provide the foundation for the independent members of the board of directors to become truly effective allies of the CCO and it will make it much less likely that the CCO will succumb to the pressure to permit risky and inappropriate practices that serve the interests of powerful customers.

Prevention of Coercion. The Proposed Rules should include a provision explicitly prohibiting any officers, directors, or employees of a clearing agency from, directly or indirectly, taking any action to coerce, manipulate, mislead, or fraudulently influence the CCO in the performance of his or her responsibilities.

Annual Report. The Proposed Rules require the CCO to prepare a certified annual report describing the clearing agency's policies and procedures relating to compliance matters and further describing its compliance with applicable laws and regulations. The report must be submitted to the board and the audit committee before being filed with the Commission. These important provisions should be enhanced to require the board and the audit committee to review the CCO's report and either approve it or prepare a written statement of any disagreements they may have. Furthermore, any approvals or objections should accompany the report when it is filed with the Commission.

CONCLUSION

We hope these comments are helpful in your consideration of the Proposed Rules.

Sincerely,

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