



UNIVERSITY OF MARYLAND  
SCHOOL OF LAW

January 24, 2011

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

**Re: Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants**

Dear Mr. Stawick:

These comments are submitted in response to the Notice of Proposed Rulemaking<sup>1</sup> issued by the Commodity Futures Trading Commission (“CFTC” or “Commission”) pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act<sup>2</sup> (the “Dodd-Frank Act”). One of the central tenants of the Dodd-Frank Act is “to bring swap dealers and major swap participants under comprehensive regulation to reduce risk to the financial system and to the economy as a whole.”<sup>3</sup> In light of this, the proposed rules would implement section 731 of the Dodd-Frank Act, which adds a new section 4s(j) to the Commodity Exchange Act (“CEA”) to impose certain duties with which swap dealers (“SD”) and major swap participants (“MSP”) must comply to maintain registration as a SD or MSP. In particular, the proposed rules would require SDs and MSPs to “(1) monitor trading to prevent violations of position limits; (2) establish risk management procedures for managing their day-to-day business; (3) disclose to the Commission and to applicable prudential regulators general information relating to trading practices and financial integrity of swaps; (4) establish and enforce internal systems and procedures to obtain information needed to perform all of the duties prescribed; (5) implement conflicts of interest systems and procedures; and (6) refrain from unreasonably restraining trade or imposing an anticompetitive burden on trading or clearing.”<sup>4</sup>

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<sup>1</sup> Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, 75 Fed. Reg. 71397 (November 23, 2010) [hereinafter “Proposed Rules”].

<sup>2</sup> Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

<sup>3</sup> Statement of Gary Gensler, Chairman, Commodity Futures Trading Commission, *Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants* (Nov. 10, 2010), available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/ChairmanGaryGensler/genslerstatement111010b.html>.

<sup>4</sup> *Id.*

## I. Policies and Procedures to Monitor and Manage Various Risks

Proposed Rule § 23.600 would require SDs and MSPs to establish written policies and procedures for monitoring and managing, without limitation, market risk, credit risk, liquidity risk, foreign currency risk, legal risk, operational risk, and settlement risk.<sup>5</sup> The proposed rules require that “the risk tolerance limits must be reviewed and approved quarterly by senior management and annually by the governing body.”<sup>6</sup> The risk management unit must be an independent unit of the firm and its primary responsibility must be to monitor the firm’s risk. Again, this responsibility must not be divided and delegated to different units of the firm. Only when there is an independent risk management unit, can the firm’s overall risk be accurately monitored and evaluated. Also, as the proposed rules mandate, members of the senior management must review and approve the risk tolerance limits of the firm in order to ensure that they are aware of and appreciate the firm’s risk taking behavior. Moreover, they should be able to quickly adjust the overall risk tolerance limit of the firm.

The proposed rules mandate that SDs and MSPs assess the effectiveness, and correct any identified weaknesses, of their risk management programs.<sup>7</sup> Since these rules would require SDs and MSPs “to monitor the adequacy of their risk management under standards established by the Commission[, t]his would further the goal of avoiding market disruptions and financial losses.”<sup>8</sup>

The Commission is correct that the “business activities engaged in and risks faced by one affiliate may increase the risk exposure or alter overall risk profile of another affiliate or the entity as a whole.”<sup>9</sup> In order to be effective, “a risk management program must protect against the risks resulting from the activities of interconnected or otherwise related entities.”<sup>10</sup> Accordingly, Proposed Rule § 23.600 would require that risk management across all affiliates be integrated at the consolidated entity level, to the extent possible.<sup>11</sup>

Separating the firm’s risk management unit from the business unit is important in order to mitigate potential conflicts of interest. Clearly, the unit that monitors risk must be independent from the unit whose activities create risks. Furthermore, the Commission’s proposal would sufficiently address the potential conflicts of interest between the trading units and recording units. This is a common sense rule as it prevents a person who executes a trade from the person who records such trade . Without proper separation, trading losses can be inaccurately recorded, if not completely hidden by the trader.

Finally, Proposed Rule § 23.600(e) would require the quarterly review and testing of a firm’s risk management programs by internal audit staff or a qualified external service. The Commission is correct that such regular review would test the continued effectiveness of firms’ risk management programs.

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<sup>5</sup> See Proposed Rules at 71399, *supra* note 1.

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> See Proposed Rules at 71403, *supra* note 1.

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

## II. Monitoring of Position Limits

Proposed Rule § 23.601 correctly requires SDs and MSPs to establish policies and procedures to monitor, detect and prevent violations of applicable position limits established by the CFTC, a designated contract market, or swap execution facility.<sup>12</sup> In particular, the proposed rule would require that SDs and MSPs properly train their employees, monitor trading, implement an early warning system, test the effectiveness of their policies, and provide quarterly written reports to senior management and the governing body concerning compliance with applicable position limits.<sup>13</sup>

In order for the Commission's rules on position limits to be effectively enforced, there must be cooperation by SDs and MSPs as they are the first line of defense against excessive speculation. The proposed rules do not mandate the complete prevention of violations of position limits. Rather, these rules require SDs and MSPs to adopt and enforce robust compliance and detection programs. As such, the Commission must carefully and frequently monitor these programs for effectiveness.

## III. Business Continuity and Disaster Recovery

The Commission correctly requires all SDs and MSPs to establish and maintain a business continuity and disaster recovery plan that is reasonably designed to resume normal operations within one business day.<sup>14</sup> As the Commission points out in the rulemaking, the interconnectedness of the swap markets warrants such planning in the case of disaster or emergency. Here, the Commission should clearly provide that these plans provide for resuming operational capability within one day and sustaining essential operations for a period of at least 30 days. This approach is similar to the approach taken by the SEC. The SEC approved NASD and the New York Stock Exchange rules on "requiring members to develop business continuity plans that establish procedures relating to an emergency or significant business disruption."<sup>15</sup> If properly implemented, these proposed rules would ensure that SDs and MSPs can "sustain their market operations and meet their financial obligations to market participants, thus contributing to the integrity of the financial markets."<sup>16</sup>

## IV. Availability for Disclosure and Inspection

Proposed Rule § 23.606(a) correctly requires SDs and MSPs to "make available for disclosure and inspection all information required by the Commission, including those items listed in section 4s(j)(3)."<sup>17</sup> Proposed Rule § 23.606(b) also correctly requires SDs and MSPs to

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<sup>12</sup> See Proposed Rules, *supra* note 1.

<sup>13</sup> See Proposed Rules at 71406-7, *supra* note 1.

<sup>14</sup> See Proposed Rule § 23.603, *supra* note 1.

<sup>15</sup> See Press Release, U.S. Securities and Exchange Commission, *SEC Approves NASD and NYSE Business Continuity Rules* (April 16, 2004), available at <http://www.sec.gov/news/press/2004-53.htm>.

<sup>16</sup> See Proposed Rules at 71403, *supra* note 1.

<sup>17</sup> Sections 4s(j)(3) of the CEA require a SD or MSP to (1) disclose to the Commission and to the SD's or MSP's prudential regulator information regarding the terms and conditions of its swaps, its swap trading operations, mechanisms, and practices; its financial integrity protections relating to swaps, and other information relevant to its trading in swaps. See Proposed Rules at 71401, *supra* note 1.

“establish and maintain adequate internal systems that will permit it to obtain any information required to satisfy its duties under section 4s(j) of the CEA.”<sup>18</sup> Although the Commission is authorized to delegate some of its oversight authorities to self-regulatory organizations (“SRO”), the Commission should directly handle oversight of SDs and MSPs. It is vital that the Commission has a complete and accurate understanding as to how SDs and MSPs operate and engage in swaps transactions.

## V. Antitrust Considerations

As one of the main principals shaping derivatives regulation under the Dodd-Frank Act is to provide *free and open access to clearing and exchange trading*,<sup>19</sup> parties to a swaps transaction must be able to freely decide where to clear and trade the swaps. Here, Proposed Rule § 23.607 correctly requires SDs and MSPs to “adopt policies and procedures [that would] prevent unreasonable restraint of trade, or impose any material anticompetitive burden on trading or clearing.”<sup>20</sup>

Sincerely,

A handwritten signature in blue ink that reads "Michael Greenberger". The signature is fluid and cursive, written on a light-colored background.

Michael Greenberger, J.D.  
Law School Professor  
University of Maryland School of Law

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<sup>18</sup> Sections 4s(j)(4) of the CEA establish internal systems to obtain necessary information to perform any of the functions described in section 4s and for disclosure of information to the Commission or prudential regulator upon request. *See* Proposed Rules at 71401, *supra* note 1.

<sup>19</sup> *See*, e.g., S. REP. 111-176, at 32–35 (2010) (noting that draft provisions concerning OTC derivatives were designed to minimize non-cleared, off-exchange trades); Transcript of Public Roundtable on Governance and Conflicts of Interest in the Clearing and Listing of Swap, August 20, 2010, at 33, *available at* <http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/derivative9sub082010.pdf> (statement of Randy Kroszner, University of Chicago, Booth School of Business, “And the law is clear: Open access is the fundamental principle.”).

<sup>20</sup> *See* Proposed Rules § 23.607, *supra* note 1.