Occupy the SEC
http://www.occupythesec.org

June 10, 2014

Kevin M. O'Neill
Deputy Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC
20549-1090

Re: Enhanced Regulatory Framework for Covered Clearing Agencies (S7-03-14)

Dear Sir:

Occupy the SEC[1] submits this comment letter in response to the Securities and Exchange Commission ("SEC") Notice on its proposed rule regarding systemically important and security-based swap clearing agencies.

OSEC generally supports the SEC's dual framework for the regulation of registered clearing agencies, which applies more general standards under Rule 17Ad-22(d) for new entrants, and a more rigorous set of standards for covered clearing agencies under Rule 17Ad-22(e). This dual framework will allow new entrants to more firmly establish themselves as clearing agencies, which is important for the deconsolidation and diffusion of risk across the market.

At present the clearing and settlement industry, like much of the financial sector, can be described as an oligopoly, with a handful of firms controlling the market. This situation serves to inhibit price allocation for such services, which in turn inhibits liquidity. More importantly, oligopolgies result in concentration of risk, which in the case of clearing agencies can have catastrophic consequences. Thus, it is paramount that the SEC espouse policies that promote the proliferation of viable new clearing agencies, given that current oligopolists in that industry typically serve as intermediaries for trillions of dollars in trading volumes.

Even so, the Commission must be vigilant to prevent companies from engaging in regulatory arbitrage to avail of relaxed standards under Rule 17Ad-22(d), where the heightened

[1] Occupy the SEC (http://occupythesec.org) is a group of concerned citizens, activists, and financial professionals that works to ensure that financial regulators protect the interests of the public, not Wall Street.

requirements of Rule 17Ad-22(e) would be more appropriate. For instance, the Commission can expect large conglomerates to float new subsidiaries or affiliates seeking to operate under Rule 17Ad-22(d) due to the subsidiary's size, even though the risk profile of that subsidiary is actually part and parcel of the outsized risk exposure of the conglomerate at-large. Similar opportunities for regulatory arbitrage may exist based on differences between the Commission's clearing agency rules and those of the CFTC.

As is often the case more generally, the Commission's vigorous enforcement of clearing rules will ultimately remain more important in achieving real world risk reduction than the mere promulgation of detailed rules.

To that end, we commend the Commission for promulgating Rule 17Ab2-2, which affords it agency blanket authority to designate risky agencies as "covered clearing agencies" even if they do not otherwise qualify as such under one of the other criteria laid out in the rules. We urge the Commission to exercise that authority liberally given the fact that major clearing agencies, if troubled, could conceivably bring the financial system and the overall economy into stagnation. Clearing agencies, by definition, collect various counterparts risks. While the agglomeration of such risk by clearing agencies may not have played a significant role in the most recent crisis, the continued growth of trading operations and the concomitant consolidation of market power in the banking and finance sector suggest that clearing agencies could serve as the primary locus, or ground zero, for the next crisis.

We also recommend that the SEC regularly evaluate registered clearing agencies only subject to Rule 17Ad-22(d) to ensure that their activities have not risen to a level warranting broader oversight and restriction under Rule 17Ad-22(e). Similarly, the Commission should require frequent audits of the Written Supervisory Procedures (WSPs) of both Rule 17Ad-22(d) and Rule 17Ad-22(e) clearing agencies. Smaller, profitable clearing agencies may quickly outgrow their Rule 17Ad-22(d)-based WSPs. And covered clearing agencies may shift their operations materially after the crafting of robust WSPs.

We are also concerned that the Proposed Rule relies inordinately on internal risk testing and standards rather than a clear set of external, regulatory demands. Generally, our experience has been that financial firms (and especially those involved in such firms' profit centers) often view WSPs as mere inconveniences and not the guiding lodestars that one might expect them to be on their face. We recommend that the Commission remain similarly skeptical.

Moreover, even if WSPs were implemented in good faith, their efficacy could still be questionable. Numerous commentators have argued that standard measurements of credit and liquidity risk may only encourage excessive confidence in the risk profile of financial institutions.[2]

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[2] *See, e.g.*, Darryll Hendricks, *Evaluation of Value-at-Risk Models Using Historical Data*, Fed. Res. Bank of New York Economic Policy Review (April 1996) (noting incongruities between VaR modeling and actual conditions). VaR risk measurements often suffer from foundational failures, especially in light of changed conditions. *See* Taleb, Nassim Nicholas and Canetti, Elie R.D. and Kinda, Tidiane and Loukoianova, Elena and Schmieder, Christian, *A New Heuristic Measure of Fragility and Tail Risks: Application to Stress Testing* (August 2012) IMF Working Paper No. 12/216, *available at* http://ssrn.com/abstract=2156095.

The Proposed Rule seeks to enhance the independence of internal auditing practices, but external audits (whether by private actors or government) are more effective in promoting actual compliance due to the obvious, inherent conflicts of interest attendant to internal auditing procedures. The proposed internal audit procedures are useful, but should be augmented with additional external monitoring.

As numerous commentators have asserted, swaps and other exotic OTC derivatives contributed to the recent financial crisis. These often-complex instruments were traded on shadowy markets and enabled an exponential growth of leverage and unpredictable, interconnected risk. Under the banner of financial innovation and competition, these derivatives allowed sophisticated market players to exploit ordinary homeowners, municipalities and others. The Dodd Frank Act has sought to shed light on these opaque markets, by requiring derivatives to be cleared through registered agencies.

This shift could be a useful means to bring shady derivatives transactions "out of the shadows," provided of course that clearing agencies are themselves robust and stable. In some ways the risk associated with derivatives has not gone away – it has simply shifted to clearing agencies. Thus, it is vital that the Commission not only promulgate strong regulations covering such agencies, but also enforce such regulations in a vigorous manner.

Thank you.

Sincerely,
/s/
Occupy the SEC

Akshat Tewary
et al