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Commodity Futures Trading Commission
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Secretary
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Re: Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 Fed. Reg. 63,732 (RIN 3038–AD01); 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, 75 Fed. Reg. 65,882 (SEC File No. S7-27-10, RIN 3235-AK74)

Dear Mr. Stawick and Ms. Murphy:

The Committee on Capital Markets Regulation (Committee) appreciates the opportunity to comment on the proposed rules of the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) regarding conflicts of interest under Sections 726 and 765, respectively, of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[1] The Committee wishes to comment in unison on the proposed rules of both the CFTC (CFTC Proposed Rules)[2] and the SEC (SEC Proposed Rules)[3] as it encourages the agencies to adopt a uniform approach to conflicts of interest rulemaking—and, where possible, rulemaking under the Dodd-Frank Act more generally. Indeed, the CFTC and SEC Proposed Rules are already quite similar, and the Committee sees no reason why they should not be identical.

Since 2005, the Committee has been dedicated to improving the regulation of U.S. capital markets. Our research has provided an independent and empirical foundation for public policy. In May 2009, the Committee released a comprehensive report entitled *The Global Financial Crisis: A Plan for Regulatory Reform*, which contains fifty-seven recommendations for making the U.S. financial regulatory structure more integrated, more effective, and more protective of investors in the wake of the financial crisis of

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 726(a), 765(a) [hereinafter Dodd-Frank Act].
[2] Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 Fed. Reg. 63,732 (Oct. 18, 2010) [hereinafter CFTC Proposed Rules].
[3] 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, 75 Fed. Reg. 65,882 (Oct. 26, 2010) [hereinafter SEC Proposed Rules].

2008.[4] Since then, the Committee has continued to make recommendations for regulatory reform of major areas of the U.S. financial system.[5]

At the outset, the Committee is concerned that both agencies have unnecessarily rushed the rulemaking process. Although we recognize the aggressive deadlines imposed by the Dodd-Frank Act, these proposals do not reflect a careful consideration of the existing governance structures of the entities the rules affect, nor are they based upon any analysis of their effectiveness or efficiency, as required by law.[6] Courts routinely overturn agency actions that lack such bases, as the D.C. Circuit did to SEC rules regarding corporate governance of mutual funds.[7]

Turning to the statute, § 726 the Dodd-Frank Act, "[i]n order to mitigate conflicts of interest," authorizes, but does not compel, the CFTC to adopt rules imposing numerical limits on the extent to which certain enumerated entities (*i.e.*, bank holding companies with assets of at least $50 billion, nonbank financial companies supervised by the Board of Governors of the Federal Reserve System, swap dealers, major swap participants, and affiliates and associates of the same)[8] can control, or exercise voting rights over, derivatives clearing organizations (DCOs), designated contract markets (DCMs), and swap execution facilities (SEFs).[9] Section 765 of the Act similarly authorizes the SEC to adopt such rules with respect to security-based swap (SBS) clearing agencies, SBS execution facilities (SB SEFs), and SBS exchanges.[10] The agencies are directed to exercise these rulemaking powers if they find "that such rules are necessary…to improve the governance of, or to mitigate systemic risk, promote competition, or mitigate conflicts of interest" with respect to the trading and clearing facilities that they oversee under Title VII.[11] Should they deem such rules necessary, the CFTC and SEC are instructed to consider conflicts of interest arising from equity ownership interests, voting abilities, and governance arrangements.[12]

The CFTC and SEC Proposed Rules focus on two key sets of issues: (A) ownership and voting limits and (B) governance requirements.[13] In short, the Committee

[4] COMM. ON CAPITAL MKTS. REG., THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM (May 2009), http://www.capmktsreg.org/research.html.
[5] *See, e.g.*, Letter from the Comm. on Capital Mkts. Regulation to Christopher Dodd, Chairman, Richard Shelby, Ranking Member, S. Comm. on Banking, Hous. & Urban Affairs and Barney Frank, Chairman, Spencer Bachus, Ranking Member, H. Comm. on Fin. Servs. (Mar. 4, 2010) [hereinafter Mar. 4 Letter] (proposing a comprehensive approach to reducing systemic risk from over-the-counter derivatives).
[6] Both the CFTC and the SEC are required by statute to evaluate the efficiency of their rules. *See* 7 U.S.C. § 19(a) (CFTC); 15 U.S.C. §§ 78c(f), 78w(a)(2) (SEC); *see also* 5 U.S.C. §§ 553, 706(2) (requirements of the Administrative Procedure Act).
[7] *See* Chamber of Commerce v. SEC, 412 F.3d 133, 143–44 (D.C. Cir. 2005); *see also* Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166, 177–78 (D.C. Cir. 2010).
[8] Dodd-Frank Act § 726(a); CFTC Proposed Rules at 63,732 n.6; *see also* Dodd-Frank Act §§ 102(a)(4)(D), 113(a)(1) (discussing Fed supervision and FSOC determination, respectively).
[9] Dodd-Frank Act § 726(a).
[10] *Id.* § 765(a).
[11] *Id.* §§ 726(b), 765(b).
[12] *Id.* §§ 726(c), 765(c).
[13] *See, e.g.,* CFTC Proposed Rules at 63,737 ("To mitigate, on a prophylactic basis, the conflicts of interest identified above, the Commission sets forth below proposed (i) structural governance requirements and (ii)

believes that: (1) the Proposed Rules should emphasize governance requirements over ownership and voting limits, (2) both the ownership and voting limits suffer from conceptual, structural, and—in some members' views—numerical problems, and (3) the governance requirements risk sacrificing director expertise for director independence.

Ownership and Voting Limits

The Committee is to some degree split on the wisdom of having any ownership and voting limits, but all members nonetheless agree that there are certain shortcomings in the proposals. The Proposed Rules contemplate two types of restrictions: individual and aggregate caps. The CFTC Proposed Rules impose only individual caps on DCM and SEF members, restricting them from individually owning or voting more than 20% of any class of equity in their respective registered entities.[14] The CFTC Proposed Rules, however, give DCOs the choice between a framework with just an individual cap (a 5% limit on the equity and voting interests of each member and "enumerated entity"[15]) and one with an individual as well as an aggregate cap (a 20% limit on individual member equity and voting interests[16] alongside a 40% upper bound on the equity and voting interests that enumerated entities can hold in aggregate[17]). The SEC Proposed Rules are similar to the CFTC Proposed Rules with respect to both the types of caps that it contemplates and the specific numerical limits that these caps impose.

The Committee has three concerns with these proposals. First, all Committee members agree that to the extent conflicts of interest actually do pose a problem, ownership and voting restrictions are in many ways ill-suited to address the problem. If potential conflicts exist, then the focus should be on control, as a party can exercise control without either ownership or voting power simply by providing a central value-added service or by establishing legal forms that give it access to profits.[18] Thus, even those Committee members who are concerned about the potential for conflicts do not advocate across-the-board ownership and voting limitations. All members are concerned that because the capital for the entities subject to these rulemakings comes largely from market participants and there is sufficient competition among these participants to create and fund such entities, ownership and voting restrictions risk detrimentally limiting capital flows into these entities without providing an offsetting benefit.[19] Committee members who are more wary of conflicts problems believe that such a net detriment is liable to occur only with respect to exchanges and exchange-like facilities whereas members who view conflicts to be less problematic stress that clearinghouses could also be adversely starved of capital.

limits on the ownership of voting equity and the exercise of voting power."); SEC Proposed Rules at 65,882 ("[T]he Commission seeks to mitigate the potential conflicts of interest through conditions and structures relating to ownership, voting, and governance . . .").

[14] CFTC Proposed Rules §§ 37.19(d)(2), 38.851(d)(2).

[15] *Id.* § 39.25(b)(2)(ii).

[16] CFTC Proposed Rules § 39.25(b)(2)(i)(A).

[17] *Id.* § 39.25(b)(2)(i)(B).

[18] Mar. 4 Letter, *supra* note 5, at 23.

[19] *See id.*

The Committee is also concerned with the specific limitation in the Proposed Rules. Members are divided on whether there should be mandatory aggregate limits for clearinghouses. By making aggregate limits optional for clearinghouses, the Proposed Rules therefore adopt an approach that falls between these different views.

If clearinghouses do adopt mandatory limits, some Committee members are concerned that the 5% individual caps will be ineffective at limiting conflicts. In contrast, other Committee members argue that individual caps are unnecessary if aggregate caps are adopted.

Governance Requirements

Most members of the Committee believe that governance requirements are more important than ownership and voting limits. As with ownership and voting limits, the CFTC and SEC Proposed Rules on governance are quite similar. However, there is one important, and we believe unwarranted, difference. The SEC Proposed Rules mandate that a higher percentage of board directors be independent but provides for fewer mandatory committees.

The CFTC Proposed Rules require that DCO, DCM, and SEF boards of directors be composed of at least 35%, but no fewer than two, public directors.[20] (For these purposes, the CFTC's term "public director" is substantively the same as the SEC's term "independent director.")[21] It further mandates that these boards have a nominating committee composed of at least 51% public directors and a public director chair[22] and have a minimum of one disciplinary panel with a chair who could qualify as a public director.[23] Under the CFTC Proposed Rules, SEFs and DCMs must also appoint a regulatory oversight committee composed entirely of public directors,[24] and DCOs must have a risk management committee at least 35% and 10% of whose members must be public directors and customer representatives, respectively.[25] The SEC Proposed Rules are similar, but have a few differences. First, for SB SEFs, SBS exchanges, and (under one alternative) SBS clearing agencies, the SEC Proposed Rules require the boards to consist of a majority of independent directors[26] and the nominating committees to be composed solely of independent directors. [27] Under the other alternative for SBS clearing agencies, the SEC Proposed Rules require the boards to consist of 35% of independent directors and the nominating committees to have a majority of independent directors.[28] Moreover, unlike the CFTC, the SEC would not require a disciplinary panel or risk

[20] CFTC Proposed Rules § 40.9(b)(1)(i).
[21] The CFTC itself suggests in noting that its expanded definition of "public director" "attempts to harmonize the 'public director' definition with the SEC 2004 Release and currently accepted practices." *Id.* at 63,742.
[22] *Id.* § 40.9(c)(1)(iii).
[23] *Id.* § 40.9(c)(3)(ii).
[24] *Id.* §§ 37.19(b)(1), (3), 38.851(b)(1), (3).
[25] *Id.* § 39.13(g)(1), (3)(i).
[26] SEC Proposed Rules §§ 242.701(b)(3)(i), 242.702(d)(1).
[27] *Id.* §§ 242.701(b)(4)(i), 242.702(f)(1).
[28] *Id.* §§ 242.701(a)(3)(i), 242.701(a)(4)(i).

committee but would require SB SEFs and SBS exchanges to establish a regulatory oversight committee consisting entirely of independent directors.[29]

The Committee does not believe that the CFTC and SEC Proposed Rules should differ on these matters. For example, the SEC Proposed Rules, unlike the CFTC Proposed Rules, have alternatives for SBS clearing agencies, the Voting and Governance Alternatives. Explaining its reduced 35% requirement for SBS clearing agency boards under the Voting Alternative, the SEC notes that it sought "to address potential concerns that requiring a majority independent Board for security-based swap clearing agencies would affect the Board's ability to effectively perform risk management functions," functions that the SEC believes to be more critical for SBS clearing agencies than for SB SEFs and SBS exchanges because the former pose a greater level of systemic risk.[30] But if clearing agencies are more systemically important than exchanges and exchange-like facilities—and the Committee agrees that they are—a strong case can be made that DCOs should similarly be subject to different independence requirements than SEFs and DCMs. The Committee also believes, however, that both DCOs and SBS clearing agencies—the clearinghouses—should be subject to a special risk committee requirement.

The Committee has also considered the potential lack of expertise on boards subject to these rulemakings. We agree with the SEC that there can be a tradeoff between the ability of a systemically important institution to manage its risk with experts and the independence of its board. Although the Committee is split on the inherent value of board independence in this context—with some members arguing that independent directors can play an important oversight role and others questioning whether such directors are in fact best suited to mitigate conflicts of interest[31]—all members agree on the importance of mitigating systemic risk, which, after all, is one of the overarching objectives of the Dodd-Frank Act.

Given this objective and the SEC's own recognition that clearing agencies pose systemic risk, it is unclear why SBS clearing agencies, unlike DCOs, need not appoint a risk management committee. But even under the CFTC Proposed Rules, which do call for such a group, the Committee fears that risk management may suffer. With a 35% public director and 10% customer representative requirement, the risk management committee may lack the necessary expertise to make informed decisions on the complex, far-reaching matters that clearinghouses confront. Recognizing this possibility, certain Committee members nonetheless express concern that a risk management committee without a critical mass of independent parties might have to defer to self-interested entities.

[29] *Id.* § 242.702(e).
[30] SEC Proposed Rules at 65,909.
[31] *See, e.g.*, CFTC Proposed Rules at 63,738 & n.49 (noting that participants in its August 20 Public Roundtable on Governance and Conflicts of Interest in the Clearing and Listing of Swaps "raised the possibility that conflicts of interest may also be mitigated by providing for fair representation of all constituencies in the governance of a DCO, DCM, or SEF").

Finally, the Committee as a whole is of the view that the CFTC and SEC Proposed Rules fall short in not encouraging enough openness at the board level. The SEC Proposed Rules in particular give directors a large amount of latitude in the committees that they can appoint, not to mention the activities that they or their delegates carry out through these committees. Thus, whether or not the CFTC and SEC opt to lower the independence minimums for the board as a whole or specific groups on it, the Committee supports a provision that would require all major board and committee decisions to be made public. Such a requirement would go far in promoting the transparency and accountability that the Dodd-Frank Act seeks.[32]

Thank you for considering our comments. Please do not hesitate to contact us at (617) 384-5364 if we can be of any further assistance.

Respectfully submitted,

R. Glenn Hubbard	John L. Thornton	Hal S. Scott
CO-CHAIR	CO-CHAIR	DIRECTOR

[32] *See* Dodd-Frank Act pmbl. (providing that the Act is intended, inter alia, "[t]o promote the financial stability of the United States by improving accountability and transparency in the financial system").