

# BLACKROCK

November 15, 2010

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

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 (Oct. 18, 2010)

Dear Mr. Stawick:

BlackRock submits these comments on the Commodity Futures Trading Commission's Notice of Proposed Rulemaking entitled "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) (the "Proposing Release"). In the Proposing Release, the CFTC has requested public comment on how to best mitigate conflicts of interest that arise in the operation of these "enumerated entities". Because of the importance of this issue to our clients, BlackRock welcomes the opportunity to express its view that requiring fair representation on the governance committees (such as the Risk Management Committee) of these entities, and DCOs in particular, is critical to achieving the Commission's goals.

BlackRock is one of the world's leading asset management firms, managing approximately \$3.45 trillion on behalf of institutional and individual clients worldwide, including governments, pension funds, and endowments. We provide a variety of equity, fixed income, cash management, alternative investment and advisory products. As the voice of and a fiduciary for our clients, we have a strong interest in mitigating conflicts of interest that arise in the operation of DCOs. We believe that effectively mitigating such conflicts will serve our clients' interests as well as the interests of the U.S. financial system.

At the CFTC-SEC Public Roundtable on Governance and Conflicts of Interest in the Clearing and Listing of Swaps, BlackRock observed that "as the [sole] fiduciary on this panel, we talk about membership, we talk about ownership, we believe that very strong governance with the participation of the users of these venues is critically important." *See* Comments from Richard Prager, Managing Director, Global Head of Fixed Income Trading, BlackRock, Roundtable Transcript, 131:20-132:3 (Aug. 20, 2010). The essence of BlackRock's comments is that buy-side participants, like customers of clearing members, need meaningful representation on the committees that make the critical determinations on the core functions of the organization that impact all of its participants. Such representation is more important than fair representation on the Board of Directors because the governance committees, such as the Risk Management

Committee, will have significant influence over the day-to-day affairs of DCOs. The Proposing Release would charge the Risk Management Committee with determining products eligible for clearing, setting standards and requirements for initial and continuing clearing membership eligibility, and advising the Board of Directors on the DCO's risk model and default procedures. *See* Proposed Rule 39.13(g)(1), 75 Fed. Reg. at 63,750. In other words, decisions of the Risk Management Committee will have profound and immediate impacts on all DCO constituencies, including customers.

We believe buy-side participants (investors and managers) should be guaranteed a meaningful voice in all activities of the Risk Management Committee, and we are concerned that the Proposing Release does not ensure this result. Under Proposed Rule 39.13(g)(3), 10% of seats on the Risk Management Committee would be reserved for customers of clearing members, 35% would be reserved for Public Directors, and the remaining seats – a majority of the Risk Management Committee – could be representatives of clearing members.<sup>1</sup> This proposed composition suggests that clearing member representatives could act unilaterally to adopt policies contrary to the interests of the other DCO constituencies.

The CFTC explains this outcome by observing that "[b]ecause customers do not contribute to the DCO default fund, [they] may have less capital at stake than clearing members if a DCO improperly measures risk." *See* Proposing Release at 63,740, n. 64. This justification lacks merit. Under the current central counterparty clearing house ("CCP") structure, when a futures commission merchant defaults, client collateral funds are depleted before the CCP's default fund is tapped. As holders of vulnerable stakes in DCOs, buy-side participants have real incentives to ensure prudent risk management practices exist and are observed. In addition, as a major group of intended users of cleared products, buy-side participants would be able to explain why a particular product would be useful and whether the risks associated with such a product could be prudently managed.

Moreover, failing to provide buy-side participants with meaningful representation on a DCO's Risk Management Committee could lead to unintended consequences. Currently, the over-the-counter swaps market provides many buy-side participants with a viable alternative to the FCM-based CCP model for trading derivatives. Once the Dodd-Frank Act takes effect, however, the dual clearing and exchange-trading mandates contained in Section 723 will require many, perhaps most, buy-side participants to use DCOs and DCMs or SEFs for the bulk of their derivatives trades. Without meaningful representation on the governance committees, buy-side participants will have no real voice in the operations of the registered entities Dodd-Frank requires investors and end-users to use.

The CFTC should ensure this does not occur. We urge the Commission to adopt a mechanism to guarantee buy-side participants real input on governance committees, including DCO Risk Management Committees. This means the Commission should make certain that clearing members cannot change DCO policies and procedures without support from either customers or Public Directors. We propose two options. The Commission could provide for

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<sup>1</sup> A Public Director would chair the Risk Management Committee. *See* Proposed Rule 39.13(g)(3)(iii), 75 Fed. Reg. at 63,750.

additional customer representation on the Risk Management Committee to guarantee that customers and Public Directors constitute a majority of the Risk Management Committee. This option would provide meaningful representation to the buy-side community and would also assuage clearing member concerns that too few Public Directors have the expertise required to execute the duties of Risk Management Committee members. Alternatively, the Commission could require the Committee to act by a supermajority vote of no less than 60%.<sup>2</sup> Either method would advance the Commission's stated objective of mitigating conflicts of interest by ensuring that all the constituencies of DCOs work together to set operating policies and procedures.

The Commission should also ensure that DCOs cannot deny customers and Public Directors a meaningful voice by delegating its functions to subcommittees. Under Proposed Rule 39.13(g)(5), the Risk Management Committee may delegate three of its five functions to a subcommittee, provided that the subcommittee meets the composition requirements of Proposed Rule 39.13(g)(3). *See* 75 Fed. Reg. at 63,750.<sup>3</sup> A Risk Management Committee that chooses to delegate would no longer be subject to the composition requirements. The proposed rule is ambiguous with respect to whether the Risk Management Committee may delegate some, but not all, of its delegable functions. If the Commission intends this flexibility, it should specify that a Risk Management Committee that chooses to delegate less than all of its delegable functions must comply with the composition requirements.

We note two additional shortcomings of the proposed delegation provisions. First, the delegation authority applies only to some of the Risk Management Committee's functions, while relief from the composition requirements would apply to the Risk Management Committee as a whole. This could deprive both customers and Public Directors of any input on important operating decisions, including changes to the DCO's risk model and default procedures. As discussed, customer collateral will be among the first funds lost in the event of an FCM default so customers need a voice in determining default procedures. Second, Proposed Rule 39.13(g)(6)(i) would allow the decisions of a subcommittee to be altered or reversed by the Risk Management Committee or by the DCO's Board of Directors. This means any buy-side representation at the subcommittee level could be rendered meaningless by the Risk Management Committee, which would no longer be required to have any non-clearing member representatives. Although BlackRock does not oppose permitting the Risk Management Committee to delegate its functions to subcommittees, the Commission should ensure this delegation does not compromise buy-side input. We urge the Commission to provide real, meaningful representation – representation that clearing members cannot unilaterally disregard or ignore – to buy-side participants.

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<sup>2</sup> We note that it is not clear from the Proposing Release whether the Commission intends the Risk Management Committee to be a subcommittee of the DCO's Board of Directors. If this is the case, customers would need representation on the DCO's Board.

<sup>3</sup> The Proposed Rules would allow a Risk Management Committee to delegate its duty to: i) determine the standards and requirements for initial and continuing clearing membership eligibility; ii) approve or deny (or review approvals or denials of) clearing membership applications; and iii) determine products eligible for clearing. A Risk Management Committee could not delegate its duty to: i) advise the Board of Directors on significant changes to the DCO's risk model and default procedures or ii) review the performance of the Chief Compliance Officer and make recommendations with respect to such performance to the Board of Directors.

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We thank the Commission for the opportunity to comment on its proposed rules to mitigate conflicts of interest with respect to DCOs. We believe that requiring buy-side perspectives on the governance committees of these organizations will help mitigate conflicts of interest and we urge the Commission to include a fair representation requirement in its final rules. If you have any questions or would like further information, please contact either of us.

Sincerely,

Richard Prager  
Joanne Medero