MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

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Via Electronic Mail: dcodcmsefGovernance@cftc.gov

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

Dear Mr. Stawick:

Managed Funds Association ("MFA")[1] appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the "Commission") on its proposed rule related to "Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest" (the "Proposed Rule").[2]

MFA supports the Commission's efforts to ensure that key instruments for market reform – designated clearing organizations ("DCOs"), designated contracts markets ("DCMs") and swap execution facilities ("SEFs") – are governed in a manner that prevents conflicts of interest from undermining the Commission's mission "to reduce risk, increase transparency and promote market integrity within the financial system".[3] We very much appreciate the Commission's detailed appraisal of market concerns reflected in the Proposed Rule Release and believe that the Proposed Rule is a critical step towards mitigating conflicts of interest at DCOs, DCMs and SEFs while preserving their competitiveness and ability to provide the best possible services to the markets. As set out below, however, we believe that to enhance the efficacy of the Proposed Rule and to strike the optimal balance between safe risk management and comparative efficiency, the Proposed Rule should incorporate certain additional criteria.

In this spirit, we offer comments that we believe would strengthen the Proposed Rule and help the Commission to achieve the goals set forth in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

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1 MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

2 75 Fed. Reg. 63732 (Oct. 18, 2010) (the "Proposed Rule Release")

3 *Id.* at 63732.

I. Conflicts and Concerns

We believe that in the Proposed Rule Release, the Commission correctly identified certain key potential conflicts of interest that a DCO, DCM or SEF may confront as well as the effects on such DCO, DCM or SEF's operations. However, below are additional conflicts and concerns that we believe are also essential for the Commission to take into account prior to adopting a final rule.[4]

Incentives to Restrict Expansion or Efficiency of Swaps Clearing. The Proposed Rule Release recognizes that enumerated entities[5] have "economic incentives to minimize the number of swap contracts subject to mandatory clearing and trading."[6] Such economic incentives could manifest themselves not only in a more limited product expansion for cleared swaps, but also in the costs associated with clearing swaps relative to bilateral settlement.

From the customers' perspective, if the cost of clearing swaps that are not subject to mandatory clearing but which may be clearable is materially higher than transacting bilaterally, economic considerations or fiduciary obligations may prohibit such customers from clearing such clearable swaps, and this in turn will delay the expansion of clearing to the full eligible product set. DCO governance determines or influences the key costs of clearing – including the margin requirements of the DCO and the capital and other requirements for direct clearing membership that in turn both affect clearing member costs and enable or limit clearing membership access. Given that DCO governance is integral to fostering competition and determining the costs charged to customers by DCOs and indirectly the further charges by clearing members to their customers for cleared products, we request that as the Commission considers this Proposed Rule, it seek to impose governance requirements that will encourage fair pricing of products that are not subject to mandatory clearing but which may be clearable, as well products that are required to be cleared.

Additional Decisions that Impact Clearing and Execution Expansion and Efficiency. Attached as Annex 1 is a partial list of material features of swaps clearing and execution that are subject to decision by the Boards and committees of DCOs, DCMs and SEFs. The outcomes of those decisions could have a significant impact on clearing, execution, transparency and competition, as well as on cost and liquidity of cleared swaps. Because of the potential materiality of these decisions, we believe that balanced governance is essential to ensuring that these decisions are not the product of imbalanced representation on Boards and committees of DCOs, DCMs and SEFs.

II. Recommendations

In consideration of the above, we offer specific recommendations that we believe would appropriately bolster the Proposed Rule and address the concerns we have raised.

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4 *Id.* at 63737, where the Commission asks for input on other conflicts of interest that may exist and the effects of such conflicts.

5 *Id.* at 63732, which defines "enumerated entities" to include: (i) Bank holding companies with over $50,000,000,000 in total consolidated assets; (ii) a nonbank financial company supervised by the Board of Governors of the Federal Reserve System; (iii) an affiliate of (i) or (ii); (iv) a swap dealer; (v) a major swap participant; or (vi) an associated person of (iv) or (v).

6 *Id.* at 63734.

A. Structural Governance Recommendations

Composition of DCO, DCM and SEF Boards and Committees. We agree with the Commission that there needs to be fair representation in governance of DCOs, DCMs and SEFs to maintain impartiality.[7] We believe that the Proposed Rule makes progress towards fulfilling this goal by requiring that public directors have representation on each DCO, DCM and SEF's Board and committees and by requiring that customers have representation on each DCO's risk management committee, which we strongly support. We believe, however, that to completely effectuate fair representation and balanced governance, no group should constitute a controlling majority. In particular, we believe that it is critical that the Commission impose requirements that affirmatively limit the representation of clearing members on Boards and committees to a percentage that is less than what would constitute control under the corporate constitutive documents applicable for the relevant Board or committee.

Moreover, we respectfully request that the Commission eliminate the restriction in the Proposed Rule that would prevent employees or officers of a DCO from being members of such DCO's risk management committee or similar governance bodies. The interests of a DCO's employees and officers are aligned with such DCO's interests because such employees and officers would be motivated: (i) to expand the scope of DCO products and services, (ii) offer optimal capital, margin and cost management, and (iii) maintain DCO risk management boundaries that prevent losses to the DCO, its members and the markets.

Establishing that clearing members cannot independently control risk management committees or similar governance bodies, and that decisions are taken by a plurality of public directors, customers, DCO officers and employees, as well as clearing members, will help ensure that key decisions result from objective, risk-based criteria intended to the enhance the DCO's business and its ongoing safety and soundness.

Expressly Impose Fiduciary Obligation on Board Members. While we think it is implicit that all members of the Board of a DCO, DCM or SEF have a fiduciary duty to such registered entity,[8] we believe that the Commission should make this an express obligation. Such a fiduciary duty would reinforce the alignment of interests between the Board members and the registered entity that would help to mitigate the conflicts of interest at issue in the Proposed Rule Release.

Availability of DCO, DCM and SEF Corporate Documents. As mentioned in the Proposed Rule Release, one of the goals of the Dodd-Frank Act was to increase transparency.[9] As a result, we recommend that the Commission require DCOs, DCMs and SEFs to provide to the Commission detailed minutes of all Board, committee and subcommittee meetings, subject to the Commission providing appropriate protections to avoid public disclosure and preserve the confidentiality of sensitive commercial information. We believe this mandated transparency is essential for the Commission to have the information necessary to properly oversee these registered entities.

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7 *Id.* at 63740.

8 Securities and Exchange Commission Release No. 34- 63107; File No. S7-27-10 "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" (October 26, 2010) (the "SEC Proposed Rule"), at 24, acknowledging the existence of such fiduciary duty.

9 Proposed Rule Release at 63742.

In addition, we believe that the Commission's final rule should compel DCOs, DCMs and SEFs to make publicly available all Board and committee charters, procedural rules and similar documents as well as the identities of Board and committee members. Publication will permit monitoring of conflicts of interest. Also, since clearing will affect many market participants that will not have direct participation on the Boards or committees of DCOs, DCMs or SEFs, we believe that they have a strong interest in having this information be widely accessible.

Anti-Avoidance. We note that while currently the risk management committees are the key governance bodies at a number of DCOs, DCMs and SEFs, such entities may also vest the authority of such risk management committees in one or more other committees or subcommittees (for example, SEF participation committees). We would ask that the Commission draft the final rule so that it is both flexible and comprehensive enough to ensure that it effectively mitigates conflicts of interest as intended by the Commission and described herein, regardless of the actual Board, committee and/or subcommittee structure established at each DCO, DCM or SEF. Similarly, several DCOs have advisory committees comprised of customer representatives. While these committees have been a useful source of advice and expertise to the DCOs, they typically do not have any decisional authority and should not be used as a substitute for the 10% customer representation and other conflict mitigation requirements set out in the Proposed Rule or described herein. Finally, in this context we support the provisions of the Proposed Rule that require reporting to the Commission in any instance where a governance entity (*e.g.*, Board or risk management committee) is obliged to overrule the recommendation of a subcommittee or other recommending body.[10]

B. Ownership Recommendations

DCO Ownership Restrictions. We support the Commission's proposed "First Alternative" for limiting ownership of voting equity and the exercise of voting rights at DCOs. We believe that the First Alternative, which has both a single-member limit and an aggregate limit, is consistent with the Commission's goal of "introducing a perspective independent of competitive, commercial, or industry considerations to the deliberations of governing bodies"[11] and ensuring that clearing members do not have sole control of DCOs or an overriding profit sharing motivation to support one DCO at the expense of another. However, unlike the First Alternative, the Commission's proposed "Second Alternative" does not include an aggregate limit on ownership or voting control. Without an aggregate limit, we think the Second Alternative does not adequately address the control and profit sharing concerns that are motivating the Proposed Rule. Therefore, we recommend that the Commission either eliminate the proposed Second Alternative or revise it so that it also includes an aggregate limit.

In addition, we concur that "circumstances may exist where neither alternative may be appropriate",[12] and therefore, we do not object to the Proposed Rule's waiver procedure. In practice, we believe that the Commission should grant waivers sparingly and only after a full assessment of the potential impact of the related conflicts of interest on the DCO, the clearing regime and the financial markets.

DCM and SEF Ownership Restrictions. We support the need to encourage establishment of DCMs and SEFs so that the enhanced clearing regime is effective; and we believe that competition between DCMs and SEFs is critical for development or a sound market. As a result, we are concerned

[10] *Id.* at 63741.

[11] *Id.* at 63742.

[12] *Id.* at 63743.

that ownership and/or control of a DCM or SEF by a group of clearing members could result in a concentration of liquidity on one platform, to the detriment of healthy competition. Therefore, we request that the Commission consider whether ownership restrictions could be appropriate in certain instances. Regardless of whether the Commission imposes ownership restrictions on DCMs and SEFs, we believe that the structural governance requirements recommended above are essential to prevent founding owners from, *inter alia,* establishing anti-competitive incentives for market participants to direct liquidity to a single venue or preclude access to competing providers of liquidity.

III. Consistency of Commission and SEC Rules

We recognize that, unlike in other areas of Title VII, the Dodd-Frank Act does not require the Commission jointly to adopt rules with the Securities and Exchange Commission ("SEC") with respect to requirements for DCOs, DCMs and SEFs.[13] However, we believe that many of the key clearing entities will be subject to regulation by both the Commission and the SEC. In addition, we believe that the language in Sections 726 and 765 of the Dodd-Frank Act is nearly identical because Congress intended for the related rulemakings to be as symmetrical as possible. Therefore, we strongly recommend that the Commission coordinate and reconcile the Proposed Rule with the SEC Proposed Rule to ensure, to the extent possible, consistency of treatment for clearing and execution of swaps and security-based swaps.

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MFA appreciates the opportunity to comment on the Commission's Proposed Rule. If the Commission or its staff has questions, please do not hesitate to call Carlotta King or the undersigned at (202) 367-1140.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President, Managing Director & General Counsel

CC: The Hon. Gary Gensler, CFTC Chairman
The Hon. Michael Dunn, CFTC Commissioner
The Hon. Bart Chilton, CFTC Commissioner
The Hon. Jill E. Sommers, CFTC Commissioner
The Hon. Scott D. O'Malia, CFTC Commissioner

[13] The SEC's Proposed Rule refers to these entities as security-based swap clearing agencies, security-based swap execution facilities and national securities exchanges.

Annex 1 – Additional DCO, DCM and SEF Governance Decisions that Impact Clearing and Execution Expansion and Efficiency

- Contract Structure – Is the relationship to the clearing member one of principle-to-principle versus agency? What is the comparative cost or documentation burden of one or the other? Does the contract or the relationship to the clearing member permit close-out or transfer or netting of a position freely, or is there a requirement to seek the clearing member's consent or pay an unwind fee? Does the contract or associated trade flow require the use of third party services? If so do these services require additional fees?

- Portability – Are positions held through one clearing member freely portable, absent the default of the original clearing member, to another clearing member? Is partial portability of a portfolio permitted, or must it be the complete portfolio?

- Straight-Through-Processing – Is a trade once executed immediately accepted or rejected for clearing, or is there a period of uncertainty when the customer faces the counterparty risk of the executing dealer? If so, how long is that period of uncertainty?

- Four-Way Execution – Can trades executed between a customer and an executing broker that is not a direct clearing member be accepted for clearing? Immediately, or with delay?

- Anonymity – If a trade is executed with a broker that is not a direct clearing member, does the executing broker's identity remain anonymous to the customer's clearing member?

- Transparency – Are end-of-day settlement prices published? Is there a charge to view them when published? Are intra-day execution prices available?

- Suitability for Electronic Trading – Is the design of the cleared instrument or its trade processing flows suitable for electronic trading? Are there barriers to electronic trading?

- Execution Format – On a DCM or SEF, what is the price discovery format? Are binding prices displayed? Who is permitted to transact with whom? Are there restrictions on customers' access to liquidity providers' quotes? Are interactions anonymous or disclosed?