Larry E. Thompson
General Counsel

Tel: 212-855-3240
Fax:212-855-3279
lthompson @dtcc.com

The Depository Trust & Clearing Corporation
55 Water Street
New York, NY 10041-0099

Via Agency Website & Courier

November 17, 2010

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

RE: RIN 3038–AD01 Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest

Dear Mr. Stawick:

The Depository Trust & Clearing Corporation ("DTCC") appreciates the opportunity to provide comments to the Commodity Futures Trading Commission ("Commission") on its proposed rules on requirements for derivatives clearing organizations ("DCOs"), designated contract markets ("DCMs") and swap execution facilities ("SEFs") regarding the mitigation of conflicts of interest (the "Proposed Rules").[1] The Proposed Rules contain (i) certain composition and governance requirements on the boards and specified committees of DCOs, DCMs and SEFs (the "Structural Governance Requirements") and (ii) certain limits on the ownership and voting power of members of DCOs, DCMs and SEFs and on enumerated entities[2] (the "Ownership and Voting Limitations").

I. SUMMARY OF RESPONSE

DTCC supports regulations designed to reduce risk, increase transparency and promote market integrity within the financial system. DTCC does not currently operate a DCO, DCM or SEF (each, a "Registered Entity"). However, DTCC owns a 50% equity interest in New York Portfolio Clearing, LLC ("NYPC"), which has applied to the Commission

[1] 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).

[2] "Enumerated entities" is generally defined in the Proposed Rules to mean (i) a bank holding company (as defined in Section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841)) with total consolidated assets of $50 billion or more, (ii) a nonbank financial company supervised by the Board of Governors of the Federal Reserve System, (iii) an Affiliate of such bank holding company or nonbank financial company, (iv) a swap dealer, (v) a major swap participant and (vi) an associated person of a swap dealer or major swap participant. *See* proposed regulation 17 C.F.R. § 39.25(b)(1), 75 Fed. Reg. at 63750.

for an order granting registration as a DCO.[3] DTCC is therefore concerned with the potential effect of the Proposed Rules on NYPC (specifically the Structural Governance Requirements) and the potential effect of the Proposed Rules on DTCC and its own shareholders (specifically the Ownership and Voting Limitations). DTCC also offers its comments on the Proposed Rules from its perspective at the center of the financial market as a user-owned and governed, at-cost financial market utility that seeks to reduce systemic risk and ensure financial stability.

- It is DTCC's view that reliance on the proposed Structural Governance Requirements (subject to our further comments below) offers the best solution to meet the stated goals of the Proposed Rules while avoiding the potential negative impact on capital, liquidity and increased systemic risk that could result from the Ownership and Voting Limitations.

- DTCC strongly advocates that the Ownership and Voting Limitations be eliminated in their entirety because the Structural Governance Requirements alone are sufficient to deal with the conflicts of interest identified by the Commission in its notice of proposed rulemaking. DTCC supports the mitigation of conflicts of interest through the imposition of governance requirements designed to ensure an independent perspective on the Boards of Directors and committees of Registered Entities. This approach is supported by various experts, from both the public[4] and private sector,[5] as an appropriate method to mitigate conflicts of interests.

- Should the Commission conclude that ownership restrictions are advisable to mitigate conflicts of interest, DTCC urges the Commission to adopt a definition of "parent" and correlative definition of "subsidiary" which provide that, for purposes of the "Parent Companies" provision of the Ownership and Voting Limitations, a person will only be deemed to be the parent of a subsidiary if such person owns all or a majority of the equity interest in the subsidiary and controls the day-to-day operations of the subsidiary. That is, we suggest that the Commission adopt a definition of parent and correlative definition of subsidiary

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[3] NYSE Euronext owns the other 50% equity interest. Neither DTCC nor NYSE owns a majority of the equity interests in NYPC. NYPC will have its own management team which will control the day to day operations of the company.

[4] *See, e.g.*, Comments from Hal Scott, Harvard Law School, ("[Ownership restrictions are] counterproductive in getting needed capital liquidity into the clearinghouses which, I think, should be our central focus in terms of systemic risk. In my view the potential conflicts should be generally handled by board governance rules and not by ownership restrictions.") Joint Public Roundtable on Governance and Conflicts of Interest in the Clearing and Listing of Swaps, August 20, 2010 ("Roundtable Transcript") at 109-110. Available at http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/derivative9sub082010.pdf.

[5] *See* Comments from Ms. Lynn Martin, NYSE Euronext, Inc., ("Specifically on the topic of ownership limitations and voting caps, NYSE Euronext opposes specific ownership limitations. We think that a more effective manner in controlling conflicts of interest is around good governance structure at a board level.") Roundtable Transcript at 120-121.

that align with the way the Structural Governance Requirements are proposed to be applied to persons which are parents of Registered Entities.

- If the Commission were to reject this approach to defining the parent/subsidiary relationship, DTCC would, in the alternative, request that the Commission include in the Proposed Rules a general exception from the Parent Companies provision of the Ownership and Voting Limitations for any entity that, like DTCC, is a financial market utility. As a complex user-owned and governed financial market utility with multiple subsidiaries, DTCC is regulated and supervised by banking and securities regulators. Its ownership and corporate governance structures (further described below) are representative of the regulated financial institutions that comprise its user shareholders. Certain of these shareholders may fall directly within the scope of the Proposed Rules and be covered accordingly so that dual coverage should not be necessary; those that are not otherwise subject to the Proposed Rules should not be indirectly regulated merely by virtue of their interests in DTCC. The Ownership and Voting Limitations under the Proposed Rules could adversely destabilize DTCC's structure and governance and conflict with its obligations under other regulatory regimes.

II. OVERVIEW OF DTCC AND ITS WHOLLY-OWNED SUBSIDIARIES

DTCC, through its subsidiaries, provides clearing, settlement, and information services for equities, corporate and municipal bonds, government and mortgage-backed securities, money market instruments and over-the-counter derivatives. DTCC is also a leading processor of mutual funds and insurance transactions, linking funds and carriers with their distribution networks.

DTCC has three wholly-owned subsidiaries which are registered clearing agencies under the Securities Exchange Act of 1934, as amended (the "1934 Act"), subject to regulation by the Securities and Exchange Commission (the "SEC"). These three clearing agency subsidiaries are The Depository Trust Company ("DTC"), National Securities Clearing Corporation ("NSCC") and Fixed Income Clearing Corporation ("FICC"). DTC is also a limited purpose trust company organized under the New York State Banking Law, subject to regulation by the New York State Banking Department (the "NYSBD"), and a State Member Bank of the Federal Reserve System, subject to regulation by the Federal Reserve Bank of New York ("FRBNY"). As the parent of DTC and another New York limited purpose trust company, DTC is a bank holding company under New York law (but not Federal law), subject to supervision by the NYSBD. Accordingly, DTCC and its clearing agency subsidiaries are collectively subject to the supervision and regulation of both banking and securities regulators.

DTC currently provides custody and asset servicing for 3.6 million securities issues from the United States and 121 other countries and territories, valued at almost $34 trillion. In 2009, DTC settled more than $1.48 quadrillion in securities transactions. NSCC provides clearing, risk management, central counterparty services and a guarantee of completion for certain transactions. FICC provides clearing, risk management and central counterparty services (through its Government Securities Division) in the fixed-

income, mortgage backed and government securities markets. These clearance and settlement services reduce risks for investors and the entire financial system by guaranteeing the completion of stock and bond transactions in the event of a participant default. Thus, DTCC, through its subsidiaries, processes huge volumes of transactions – more than 30 billion a year on an at-cost basis.

DTCC believes that its own governance structure may provide a useful model for the Commission as the Commission considers and further develops the Structural Governance Requirements for Registered Entities.

To satisfy the "fair representation" requirements of Section 17A of the 1934 Act applicable to registered clearing agencies, the participants of DTC, NSCC and FICC are required (or, in some cases, permitted but not required) to purchase and own shares in DTCC and are thereby entitled to vote for its directors. The participant community includes domestic and international broker/dealers, custodian, correspondent and clearing banks, mutual fund companies and investment banks. As a financial market utility, DTCC and its clearing agency subsidiaries operate on an "at-cost basis," charging transaction fees for services at levels sufficient to cover the utility's costs and appropriate provisions for necessary reserves. DTCC also has a number of wholly-owned subsidiaries which are not in regulated businesses and, in addition to NYPC, has a 50% equity interest in two other joint venture companies.

The 2010 DTCC Board of Directors is composed of nineteen directors. Thirteen directors are representatives of clearing agency participants, including international broker/dealers, custodian and clearing banks and investment institutions. Three directors are not representatives of participants (also referred to as "independent directors" below). Two directors are designated by DTCC's preferred shareholders, NYSE Euronext and FINRA. The remaining three directors are the Chairman and Chief Executive Officer, President, and Chief Operating Officer of DTCC. The individuals who serve as directors of DTCC also serve as directors of the three clearing agency subsidiaries.

Individuals are nominated for election as directors based on their ability to represent DTCC's diverse base of participants, and DTCC's governance is specifically structured to help achieve this objective. The non-participant board members are individuals with specialized knowledge of financial services, who bring an independent perspective since they are not affiliated with firms that use DTCC services. Board members serve on a variety of board committees with responsibility to oversee aspects of DTCC's operation. In addition, to ensure broad industry representation and expertise on key industry subjects, industry representatives who are non-board members also serve on a number of advisory committees to the board.

As DTCC serves virtually the entire financial industry, from broker/dealers to banks to insurance carriers to mutual funds, its governance structure represents the entirety of the marketplace. DTCC has approximately 330 shareholders and no single shareholder holds more than a 6% interest in the company. Shares are allocated based on usage of the clearing agency subsidiaries. Roughly every three years the shares are reallocated to align ownership with usage. DTCC shares are not traded, so no one firm or group of

firms may gain control of the Board of Directors by purchasing shares outside the periodic reallocation.

III. DISCUSSION OF PROPOSED RULES

In describing the conflicts of interest that may confront a DCO, the Commission notes concerns expressed by some market participants, investor advocates, and academics that enumerated entities may have economic incentives to minimize the number of swap contracts subject to mandatory clearing and trading.[6] As stated in the preamble to the Proposed Rules, "[t]hey contend that control of a DCO by the enumerated entities, whether through ownership or otherwise, constitutes the primary means for keeping swap contracts out of the mandatory clearing requirement, and therefore also out of the trading requirement."[7]

As described in greater detail below, DTCC believes that the Ownership and Voting Limitations are an imprecise tool with which to achieve the policy goals of the Commission regarding conflicts of interest. DTCC is concerned that the proposed ownership limitations are more restrictive than necessary to meet the stated goals of the Commission and, at the same time, create the risk of unintended adverse consequences. DTCC takes the view that the policy goals can be best met by the Structural Governance Requirements, by strengthening DCO board governance through the presence of independent board members and the establishment of certain board committees.

A. Structural Governance Requirements

Section II above of this comment letter describes the ownership and governance structure of DTCC. As a user-owned and governed financial market utility that operates on an at-cost basis, DTCC complies with certain statutory requirements of "fair representation," which require that its Board of Directors represent its participant shareholders. In addition, DTCC's governance rules require it to have three independent directors (and, as a practical matter, there are four, including FINRA). DTCC's operations are extremely sophisticated and require its Board and committee members (participant and non-participant alike) to have considerable expertise in financial markets.

Based on our experience with such governance, DTCC sees this approach as a positive model for mitigating conflicts of interest among competing constituencies within the organization. Also, for these reasons and those set forth below, DTCC would respectfully suggest that the Commission recognize the unique circumstances faced by DTCC and other financial market utilities and structure the independence and board requirements in a way that does not jeopardize their ability to identify and mitigate systemic risk while nevertheless addressing the stated concerns for conflicts of interest.

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[6] *See* Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 Fed. Reg. at 63,734.

[7] *Id.* at 63,734.

i. Independence

The Commission indicates that the Structural Governance Requirements set forth in the Proposed Rules will mitigate conflicts of interest by "introducing a perspective independent of competitive, commercial, or industry considerations to the deliberations of governing bodies (*i.e.* the Board of directors and committees.)"[8] The Commission also notes that conflicts of interest may also be mitigated by providing for fair representation of all constituencies in the governance of a Registered Entity, as fair representation would prevent any one particular interest from dominating the governance of the entity.[9]

As described above, DTCC shareholding and Board representation are determined by the principle of fair representation under the 1934 Act. DTCC's long experience with this composition demonstrates the effectiveness of this approach in affording the industry a forum for the resolution of differing, sometimes competing, interests of the constituent users. At the same time, DTCC greatly values the perspective and contribution of independent board members. Currently, DTCC's Board of Directors includes three non-participant directors who are not affiliated with firms that use DTCC's services as well as a representative of FINRA (as a preferred shareholder). These directors include individuals with specialized knowledge of financial services, including systemic risk, and who bring an independent perspective because they are not customers of DTCC's services.

ii. Board Requirements

1. Composition

The Proposed Rules require the Boards of Directors of Registered Entities be composed of at least 35%, but no less than two, public directors.[10] Further, to prevent dilution of the composition requirements through corporate structuring, the Proposed Rules extend such composition requirements to any committee of the Board of Directors that may exercise delegated authority with respect to the management of the entity.[11] Additionally, the Proposed Rules prohibit Registered Entities from allowing themselves to be "operated" by another entity, unless that entity agrees to adhere to the composition requirements.[12]

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[8] *Id.* at 63,737.

[9] *See id.* at 63,738.

[10] *See id.* at 63,738.

[11] *See id.* at 63,738.

[12] *See id.* at 63,738. "The proposed rule defines 'operate' as 'the direct exercise of control (including through the exercise of veto power) over the day-to-day business operations of' a DCO, DCM, or SEF 'by the sole or majority shareholder of such registered entity, either through the ownership of voting equity, by contract, or otherwise. The term 'operate' shall not prohibit an entity, acting as the sole or majority shareholder of such registered entity, from exercising its rights as a shareholder under any contract, agreement, or other legal obligation." *Id.* at 63,738, fn. 54.

DTCC supports the Commission's objective of reducing conflicts of interest through the imposition of Board of Director and committee composition requirements. However, such requirements should ensure that an entity's governing body represents a broad base of market participants in the relevant markets.

DTCC would urge the Commission to remove the percentage requirement, which may be onerous for a small Board of Directors or start-up initiative. DTCC believes that mandating a 35% independent composition requirement imposes too high a threshold and creates a substantial risk of the dilution of market expertise, especially for entities that have smaller Boards of Directors.

Independent perspectives can provide substantial value to a Board of Directors, but those who do not directly participate in markets may not have sufficient, timely, and comprehensive expertise on those issues critical to the extraordinarily complex financial operations of Registered Entities. These entities require expertise at the Board of Directors level in such diverse areas as strategic planning, risk management, technology, operations, management, finance, audit, government relations, regulatory affairs, compensation and human resources, as well as legal, regulatory, and compliance expertise. Therefore, it is critical for the safety and soundness of Registered Entities that the composition of their Boards of Directors sufficiently incorporates the range of necessary expertise as well as independent judgment. DTCC believes that mandating two public directors is sufficient to introduce an independent perspective and that a percentage requirement is neither necessary nor productive. (Please also refer to our comments below at page 9 regarding the definition of "public director.")

2. Substantive Requirements

In addition to the composition requirements discussed above, the Proposed Rules would impose certain substantive requirements on the Boards of Directors of Registered Entities to enhance the accountability of such Boards of Directors to the Commission. These additional substantive requirements include a clear articulation of the roles and responsibilities of the Board of Directors, annual performance reviews, implementation of member removal procedures, expertise mandates, and certain compensation structure prohibitions.[13]

As a complex financial market utility, DTCC recognizes and supports a regulatory requirement that Board members possess essential characteristics, including integrity, objectivity, sound judgment and leadership. DTCC also recognizes, based on its own experience, that ensuring the safe, sound and efficient oversight of operations requires that Board members also have the requisite expertise and experience.[14]

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[13] *See id.* at 63,739.

[14] *See* Comments from Ms. Heather Slavkin, AFL-CIO, ("I think having real experts on the boards of directors is a very important issue. We all saw situations in the last several years where there were boards that were two-thirds independent and made really stupid decisions about risk management. So, we need to make sure that there are people on those boards of directors that really understand the risks that exist within a clearinghouse and are prepared to perceive potential risks that may arise in the system down the road and address them. So they also need to have the personalities to stand up to a board of directors that

iii. Committees

The Proposed Rules set forth requirements for Registered Entities to establish certain committees, including a requirement that these entities establish a Nominating Committee. According to the preamble to the Proposed Rules, "[t]he role of the Nominating Committee would be to: (i) [i]dentify individuals qualified to serve on the Board of Directors, consistent with the criteria that the Board of Directors require and any composition requirement that the Commission promulgates; and (ii) administer a process for the nomination of individuals to the Board of Directors."[15] Under the Proposed Rules, public directors must comprise at least 51% of the Nominating Committee, and a public director must serve as chair of the Committee.[16]

Additionally, the Proposed Rules require that DCOs establish a Risk Management Committee to provide the expertise necessary to manage the risks associated with derivatives instruments, while ensuring the composition of the Committee mitigates potential conflicts of interest.[17] The Proposed Rules require (i) 35% of the Risk Management Committee be composed of public directors, with sufficient expertise in clearing services and (ii) 10% of the Risk Management Committee be composed of customers of clearing members who routinely execute swap contracts and have experience using pricing models for such contracts.[18] Such Risk Management Committees may delegate certain responsibilities to a Risk Management Subcommittee, while maintaining oversight authority over the Subcommittee's decisions.[19] Decisions of the Risk Management Committee and Subcommittee may not be subject to the approval of, or otherwise limited by, any body other than the Board of Directors of a DCO.[20]

Consistent with its position on public directors, DTCC is opposed to the percentage requirements and to the leadership requirements for key committees. DTCC refers to the arguments above regarding the experience and interests of public directors, which are equally applicable to the percentage requirements. While public directors may provide an important counterpoise to interested directors, they may not otherwise have the necessary investment in the success of the enterprise and/or experience to be responsible for such key functions as are proposed.

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may be entrenched and have their own interests that may differ from those that are in the best interests of the systemic stability.") Roundtable Transcript at 77.

[15] Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 Fed. Reg. at 63,740.

[16] *See id.* at 63,740.

[17] *See id.* at 63,740.

[18] *See id.* at 63,740.

[19] *See id.* at 63,741.

[20] *See id.* at 63,741.

However, DTCC supports the policy of requiring the establishment of committees (by whatever name) charged with the responsibility of increasing the quality of representation on Boards of Directors and to manage risk.

iv. Definition of Public Director

The Proposed Rules include a definition of "public director." The Commission requests comments on the proposed definition, asking whether (1) there are other ways the term should be defined, (2) there are other circumstances that should be included in the bright-line materiality test, and (3) there are circumstances that should be removed from such tests.[21]

DTCC agrees that independent directors are a valuable institutional resource and serve to balance the interests of directors who may represent particular constituents on the Board of Directors. The goal of requiring independent directors is to identify individuals of stature, experience and good conscience who will exercise independent judgment in the best interests of the Registered Entity. To this end, DTCC recommends a qualitative definition that stresses positive features of industry knowledge and experience, personal probity and prior service, while specifying a limited and objective set of disqualifications.

DTCC finds the proposed definition of "public director" difficult to construe and, hence, open to misinterpretation. Further, it has the potential to be damaging to critical financial market infrastructures. The definition does not actually state a "bright-line materiality test" because the measures of materiality are illustrative and non-exclusive. DTCC recommends prescriptive guidelines, rather than overbroad and ambiguous regulations which are difficult to apply.

At the core of the definition in the Proposed Rules is the term "material relationship" which is a relationship "that reasonably could affect the independent judgment or decision-making of the director."[22] While DTCC agrees with this general guideline, the manner in which it is measured may be problematic. A definition of "material relationship" which provides a limited objective list of excluded relationships and or safe-harbors would be instructive for market participants. For instance, a provision that limits compensation to a reasonable amount is an example of an objective threshold. The criteria in clause (i) of the definition of material relationship[23] could represent an objective standard, if the terms parent, subsidiary and affiliate were defined as suggested below (please see page 12). Clause (ii) of the definition,[24] excluding members of the Registered Entity and their directors, officers or employees, is also objective, but

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[21] *See id.* at 63,734.

[22] *Id.* at 63,747.

[23] "[A]n officer or an employee of the registered entity, or an officer or an employee of its affiliate. In this context, "affiliate" includes parents or subsidiaries of the registered entity or entities that share a common parent with the registered entity…."

[24] *Id.* at 63,747.

extending this to subsidiaries, parents, affiliates and family (as defined) broadens it so far as to be nearly boundless and a challenge to implement.

In complex financial institutions, the interpretation of these exclusions may be difficult enough to determine, and even more so to imagine additional unspecified "material relationships." This over-specificity could have a chilling effect on encouraging independent representation and limit the pool of candidates in a manner adverse to the best interests of the organization.

B. Ownership and Voting Limits

i. Reject Ownership and Voting Limits

The Commission's proposed Ownership and Voting Limitations require that a DCO choose between one of two alternative limitations on ownership of voting equity and the exercise of voting rights.[25] The first alternative limits to 20% the amount of voting equity that any single member (and related persons) may own or vote, directly or indirectly and limits to 40% the amount of voting equity that the enumerated entities (and their related persons) may own in the aggregate or vote, directly or indirectly.[26] The second alternative limits to 5% the voting equity that any DCO member or enumerated entity (whether or not such entity is a DCO member), and the related persons thereof in each case, may own.[27]

The Commission's proposed Ownership and Voting Limitations also would prohibit a member of a DCM or SEF, together with its related persons, from directly or indirectly owning or voting more that 20% of any class of equity interest of the DCM or SEF, as applicable, entitled to vote.

The conflicts of interest provisions in the Proposed Rules are designed to address "a conflict of interest that a DCO may confront when determining (i) whether a swap contract is capable of being cleared, (ii) the minimum criteria that an entity must meet in order to become a swap clearing member, and (iii) whether a particular entity satisfies such criteria."[28]

a. Hard Ownership Caps Rejected by Congress; European Commission

DTCC urges that relying upon restrictions on aggregate numerical DCO, DCM and SEF ownership or governance caps on a particular class of market participants is too blunt an approach for these specific market circumstances. DTCC believes that fair representation and governance requirements (other than percentage requirements) are better suited to the achievement of the stated policy goals.

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[25] Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 Fed. Reg. at 63,743.

[26] *See id.* at 63,743.

[27] *See id.* at 63,744.

[28] *See id.* at 63,733.

Further, it is important to recognize that the Commission is proposing hard ownership restrictions which are not specifically required by Section 726 the Dodd-Frank Act.[29] Additionally, as noted by Commissioner O'Malia[30] and Commissioner Sommers,[31] an aggregate ownership cap approach was recently rejected by the European Commission (the "EC"). The language used by the EC in rejecting ownership restrictions is clear, and its logic is compelling. The EC found that there are a number of governance solutions that provide better protections against conflicts of interest than ownership restrictions, and also found that such ownership restrictions risk adverse unintended consequences. As the EC stated in its current proposed rule:

> "[A] CCP must have in place robust governance arrangements. These will respond to any potential conflicts of interest between owners, management, clearing members and indirect participants. The role of independent board members is particularly relevant. The roles and responsibilities of the risk committee are also clearly defined in the Regulation: its risk management function should report directly to the board and not be influenced by other business lines. The Regulation also requires governance arrangements to be publicly disclosed. In addition, a CCP should have adequate internal systems, operational and administrative procedures, and should be subject to independent audits. All of these measures are considered more effective in addressing any potential conflicts of interest that may limit the capacity of CCPs to clear, than any other form of regulation which may have undesirable consequence on market structures (e.g. limitation of ownership, which would need to extend also to so-called vertical structures in which exchanges own a CCP)."[32]

b. *Unintended Consequences of Aggregate Ownership Restrictions*

As a user-owned and governed financial market utility with a cooperative-style ownership structure, DTCC has significant concerns that any proposal which relies upon aggregate ownership restrictions may undermine the safety and soundness of financial markets. An effective prohibition of industry ownership of a market-created initiative

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[29] Dodd-Frank Act Section 726 ("The Commodity Futures Trading Commission shall adopt rules which **may include** numerical limits on the control of, or the voting rights with respect to, any derivatives clearing organization." [Emphasis added.])

[30] Concurring statement of Commissioner Scott O'Malia ("With that said, the European Commission released (September 15, 2010) a proposal on financial reform which does not place individual or aggregate ownership limits on DCOs under European Union jurisdiction.")

[31] Dissenting statement of Commissioner Jill Sommers ("I also note that the European Commission explicitly rejected ownership limitations in its proposal for regulating OTC derivatives announced September 15th because such limitations may have negative consequences for market structures. I agree.")

[32] Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories {SEC(2010) 1058} {SEC(2010) 1059}. Available at http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20100915_proposal_en.pdf.

would have a profound negative impact on the existing clearance and settlement system in the United States, which has served as a source of stability, resiliency and efficiency over the past 35 years and is responsible for mitigating systemic risk, driving down post-trade costs and helping attract global capital to our markets.

DTCC shares Commissioner Sommers' concern that "the proposed limitations on voting equity, especially those proposed for enumerated entities in the aggregate with respect to DCOs, may stifle competition by preventing new DCMs, DCOs, and SEFs that trade or clear swaps from being formed." [33]

ii. Clarify the Application of the Parent Companies Provision

The Ownership and Voting Limitations of the Proposed Rules also contain a provision titled "Parent Companies," which provides that (1) if a Registered Entity is a subsidiary, the Ownership and Voting Limitations shall apply to its parent, whether direct or indirect, in the same manner than they apply to such Registered Entity and (2) if any parent is publicly-listed on a domestic exchange, then such parent must follow the voting requirements promulgated by the SEC or the entity on which such parent is listed.

If the Ownership and Voting Limitations of the Proposed Rules are not eliminated in their entirety as suggested in section II(B)(i) above, then clarity is needed regarding the application of the Parent Companies provision of the Ownership and Voting Limitations.

The term "subsidiary" is not defined in the Proposed Rules. Therefore, it is unclear (1) what types of entities fall within the definition of "subsidiary" and (2) in turn, what types of entities will be deemed to be "parents" subject to the Ownership and Voting Limitations of the Proposed Rules. DTCC suggests that the definition of "subsidiary" in the Parent Companies provision of the Ownership and Voting Limitations be aligned with the application of the Parent Companies provision of the Structural Governance Requirements.

The Structural Governance Requirements of the Proposed Rules also contain a provision titled "Parent Companies." While this provision does not use or define the term "subsidiary," it provides that the Board and committee composition requirements applicable to DCOs, DCMs and SEFs will be applied to any entity that "operates" a Registered Entity. The term "operate" is defined in the Proposed Rules to mean the direct exercise of control (including through the exercise of veto power) over the day-to-day business operations of the Registered Entity by the sole or majority shareholder of such entity, whether through the ownership of voting equity, by contract, or otherwise.

Accordingly, DTCC suggests that the term "subsidiary" for purposes of the Parent Companies provision of the Ownership and Voting Limitations of the Proposed Rules should be defined to mean a wholly-owned or majority-owned entity whose sole or majority shareholder directly exercises control (including through the exercise of veto power) over the day-to-day business operations of such entity, whether through the

[33] Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 Fed. Reg. at 63,753.

ownership of voting equity, by contract or otherwise. Stated differently, a person should be deemed to be the "parent" of a subsidiary only if such person is the sole or majority shareholder of such entity and such person directly exercises control (including through the exercise of veto power) over the day-to-day business operations of such entity, whether through the ownership of voting equity, by contract or otherwise.

iii. Waiver

In the event that the Commission retains the Ownership and Voting Limitations and rejects the approach to parent and subsidiary definitions suggested in Section II(B)(ii)of this comment letter, DTCC would request that the Commission incorporate a general exception in the Parent Companies provision of the Ownership and Voting Limitations of the Proposed Rules for DTCC and other financial market utilities.

The Proposed Rules recognize that "circumstances may exist where neither [DCO ownership restriction] alternative may be appropriate."[34] In such instances, the Commission may grant a DCO a waiver from the limitations if, upon review, the Commission finds that the restrictions are unnecessary or inappropriate to improve the governance of the DCO, mitigate systemic risk, promote competition, mitigate conflicts of interest in connection with a swap dealer's or major swap participant's conduct of business with the DCO with respect to fair and open access and participation and product eligibility, or otherwise accomplish the purposes of the Commodity Exchange Act.

DTCC suggests that, in addition to considering case by case waivers from the Ownership and Voting Limitations of the Proposed Rules, the Commission include in the Proposed Rules a general exception from the Parent Companies provision for financial market utilities which are entirely owned by its members, satisfy the above-referenced governance provisions and meet the factors set forth in the Proposed Rules.[35]

iv. Alternative Approach

In response to the request for comment solicited in the Proposed Rules, DTCC suggests that the Commission consider one alternative approach that addresses the identified conflicts of interest. DTCC's proposal addresses the issue of maximizing the use of DCOs to clear swaps where regulators determine that activity could be accomplished in a safe and sound manner under Section 2(h)(2) of the Commodity Exchange Act.

The Commission could mandate that DCO governance rules require a Board of Directors to include representatives across the broad base of participants in the relevant markets

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[34] Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 Fed. Reg. at 63,743.

[35] *See id.* at 63,751. ("(1) Improve the governance of the derivatives clearing organization; (2) Mitigate systemic risk; (3) Promote competition; (4) Mitigate conflicts of interest in connection with a swap dealer or major swap participant's conduct of business with the derivatives clearing organization, including with respect to Section 2(h)(1)(B) and Section 5b(c)(2)(c) of the Act; and (5) Otherwise accomplish the purposes of the Act.")

(i.e., not from only one class of market participants and not representative of any shareholder or management of the DCO), as well as independent directors (i.e., directors who are not associated with market participants). There should also be a means of assuring, through shareholders agreements or through actual shareholding and governance documents, that directors associated with any particular class of market participants are generally acceptable to that class. This type of approach to governance has been used in the past to address the risk of non-alignment of interests among various market participants, for instance in the formation of the Government Securities Clearing Corporation in the late 1980s as an industry owned utility to clear US Government Securities.

DTCC would urge that those involved in the decision making process at DCOs regarding new instruments for clearing (other than the independent directors) be required to bear some financial risk in the event the DCO mismanages the risks associated with clearing these instruments. Otherwise parties with no financial risk could, with impunity, force others to take on risk with no motive to consider the implementation of appropriate risk mitigation.

IV. CONCLUSION

We appreciate the opportunity to comment on the Commission's Proposed Rules and provide the information set forth above. Should you wish to discuss these comments further, please contact me at 212-855-3240 or lthompson@dtcc.com.

Regards,

Larry E. Thompson
General Counsel