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Morgan Stanley

November 17, 2010

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

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Proposed Rules for the Mitigation of Conflicts of Interest in the Ownership and Governance of Swap Clearinghouses and Trading Platforms
(CFTC RIN 3038-AD01; SEC File No. S7-27-10)

Dear Mr. Stawick and Ms. Murphy:

We appreciate the opportunity to comment on the proposed rules (the "Proposals") of the Commodity Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission (the "SEC" and together with the CFTC, the "Commissions") with respect to the mitigation of conflicts of interest in the ownership and operation of derivatives clearing organizations ("DCOs"), clearing agencies that clear security-based swaps ("SB SCAs"), and other entities with respect to swaps and security-based swaps (together, "swaps").

It is vital that the final rules implemented by the Commissions aim to achieve each of the four objectives set forth in Sections 726 and 765 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"): to improve the governance of, and to mitigate systemic risk, promote competition and mitigate conflicts of interest in connection with, the subject entities. We generally agree with the regulatory framework contemplated by the Proposals. However, we believe that, without certain revisions, the Proposals could inadvertently reduce market competitiveness and impair the ability of these entities appropriately to manage their risks. In particular, we believe that the proposed 40 percent aggregate equity ownership limitations on clearinghouses should be eliminated in order to foster a vibrant and competitive market—or, at a minimum, an exemption should be provided from the Proposals' equity ownership limitations for start-up entities in order to enhance the ability of newly organized clearinghouses to raise

capital. In addition, we recommend that the Commissions eliminate the requirement that DCOs' and SB SCAs' risk management committees include public or independent directors (which we refer to, together, as "independent directors"),[1] and we believe that the independent director requirement for boards of directors as a whole should not be increased above 35 percent.

I. Elimination of, or Exemption from, 40 Percent Aggregate Limitation on Equity Ownership of Clearinghouses

Both of the Proposals would impose limitations on the equity ownership of clearinghouses. The CFTC's proposal provides for two alternative limitations applicable to DCOs. Under the first alternative, no individual member of a DCO would be permitted to own or vote more than 20 percent of any class of voting equity, and enumerated entities in the aggregate would not be permitted to own or vote more than 40 percent of any class of voting equity. Under the second alternative, no clearing member or enumerated entity would be permitted to own over 5 percent of any class of the DCO's voting equity. The SEC's proposal would impose similar limitations on SB SCAs, but applicable only to participants and their related persons.

We understand the Commissions' aim of mitigating conflicts of interest by limiting ownership or control of voting equity, but we believe that the proposed 40 percent aggregate ownership limitation under the "first alternative" would not be an effective tool for accomplishing this goal and would increase systemic risk. Therefore, we recommend that the Commissions eliminate this aspect of the proposed rules. Due to their exposure in the event of a default, members and participants protect their investment from undue risk. Given the complexities that arise in the default management of derivatives products, DCOs and SB SCAs require sound practices for mitigating risk through appropriate margin requirements and default fund contributions. Clearing members with significant ownership interests have the greatest incentive to dedicate the capital and personnel necessary to address these highly technical issues, so limitations on the aggregate equity of clearinghouses held by clearing members will increase risk.

We note that during the Dodd-Frank legislative process, an explicit ownership limitation on clearinghouses (the so-called "Lynch amendment") was considered but ultimately rejected.[2] Instead, Dodd-Frank provides for the implementation of ownership limitations only upon determinations by the Commissions that such limitations are necessary or appropriate to promote competition or mitigate conflicts of interest. We submit that there is no evidence indicating that unrestricted ownership of these types of entities has harmed the marketplace in any way. We note further that Dodd-Frank contemplates the imposition of ownership limitations only with respect to individual entities (such as "a bank holding company," "a swap dealer" or "a security-based swap dealer") and requires that the Commissions consider "conflicts of interest arising from the

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[1] We note that the SEC's proposal would require the participation of independent directors on a risk management committee only if the committee is delegated the authority to act on behalf of the board of directors, and our comments relate to the membership requirements that would apply to an SB SCA's risk management committee in that circumstance.

[2] H.R. 4173, 111th Cong. § 3306 (as passed by House of Representatives, Dec. 11, 2009).

amount of equity owned by *a single investor*" (emphasis added). These statutory mandates do not extend to rulemakings imposing categorical ownership limitations on entire classes of equityholders, and we believe the Commissions' rules should not extend beyond the parameters of Dodd-Frank.

If the Commissions determine to impose numerical aggregate ownership limitations, we believe that, at a minimum, the rules should provide a targeted exemption for any start-up DCO or SB SCA during a period of at least five years following its commencement of operations. Many successful market infrastructure initiatives, such as Ice Trust, Tradeweb, CreditEx and Markit, were founded with significant capital infusions from major dealers. Our proposed exemption would foster a market in which newly formed ventures can thrive. Reducing market barriers to entry will enhance capital-raising, increase competition, decrease transaction costs, and promote liquidity by increasing the number of market options. Founding members of a clearinghouse have a number of powerful incentives to increase market competition, implement appropriate policies, and contribute the necessary financial and technical resources for the entity successfully to address risk management issues. By definition, sponsors of a new venture seek to enhance the market by expanding the competitive landscape, increasing liquidity and generating new business.

Without an exemption from the aggregate ownership limitations for newly organized clearinghouses, these entities' ability to raise sufficient capital to commence operations will be severely impaired. If clearing members' aggregate equity ownership is limited, we believe there may be insufficient capital to form and finance clearinghouses structured as market utilities, fewer new ventures will be formed, and, in turn, the dominance of existing clearinghouses will be reinforced.

A temporary, five-year exemption from the ownership limitations would still permit the limitations proposed by the Commissions to become effective and ultimately to serve their intended purpose of mitigating potential conflicts of interest. A targeted exemption from these limitations will significantly improve market competitiveness and decrease systemic risk while avoiding a material increase in conflicts of interest.

We note that the CFTC's proposal would permit a DCO to request a waiver of the ownership limitations in certain enumerated circumstances. We believe that the ability of the CFTC to grant these waivers should be retained in the rule, but we do not believe that a system of case-specific waivers will provide the market with sufficient certainty and transparency to resolve the concerns described above, nor is it likely that the CFTC would be able to grant case-by-case waivers within the time periods needed for newly organized entities to begin operating.

2. Independent Directors

The Proposals note the important balance between minimizing conflicts of interest and ensuring that the boards of directors of DCOs and SB SCAs have the necessary skills

to perform their functions.[3] Given the systemic importance of DCOs and SB SCAs in the post-Dodd-Frank world, it is critical that DCOs and SB SCAs manage risk effectively. Members of a risk management committee in particular must have extensive and up-to-date product-specific knowledge of risk management models and solutions, liquidity and margin requirements, market practices, crisis management and clearing systems. A fundamental purpose of the expanded clearing of derivatives is the reduction of systemic risk, and the decisions made by risk management committees on these matters will, in large part, determine whether this goal is accomplished. Because of their central role in analyzing and managing risk, we believe it is vital that the members of a risk management committee be the individuals best suited to this position. In many cases, these individuals will be affiliated with clearing members, whose capital is at risk and who are deeply involved in the markets at issue. Therefore, we strongly recommend that the Commissions eliminate the proposed 35 percent independent director requirements with respect to clearinghouses' risk management committees under the Proposals and also the SEC's more severe requirement that a majority of SB SCA committee members be independent directors under the "second alternative" ownership limitation.

For several reasons, we believe that representatives of clearing members will, in many cases, be the candidates most likely to have the product-specific expertise and the incentives necessary to manage a DCO's risk. First, we believe that relatively few individuals who have the requisite risk management expertise will qualify as independent directors, so clearinghouses will be unable to staff their risk committees with independent directors who have the appropriate level of expertise. Because these individuals will not, by definition, be affiliated with any of the DCO's or SB SCA's clearing members, there is a greater chance that they will not have extensive knowledge of current product-specific market practices. We expect that as the market for cleared swaps expands, the types of instruments traded will grow in complexity. Because of the rapid pace of change in derivatives markets, the lack of current involvement in the markets with a clearing firm will be a significant limitation on a committee member's ability to assist in making the necessary difficult decisions. We do not believe that the broad requirement included in the CFTC's proposal that members of the risk management committee must "where applicable, have sufficient expertise in financial services, risk management, and clearing services" sufficiently addresses this important issue.

Further, we believe that representatives of clearing members have the greatest incentive to ensure appropriate risk management by the DCO or SB SCA. The exposure that clearing members bear in the event of a default by other clearing members provides considerable motivation carefully to manage the clearinghouse's risks and to institute policies reflecting the best interests of the clearinghouse. We believe clearing members will be at a significant disadvantage if they are exposed to default risk from a DCO or SB SCA but are not able to prevent the clearinghouse's risk management practices from unduly jeopardizing the members' capital. At a minimum, we believe this scenario would result in increased systemic risk as a result of risk management committees taking less conservative positions with respect to issues of fundamental importance to clearinghouses. This uncontrolled risk exposure could also provide a harmful incentive

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[3] CFTC proposal, 75 Fed. Reg. at 63738; SEC proposal, 75 Fed. Reg. at 65887.

to avoid becoming a clearing member altogether. The increasing complexity of the derivatives markets and of swaps will further heighten these risks. Decisions as to product eligibility, margin requirements, membership and the default management process should be made by those directly affected by these judgments because they are most motivated—and thus most likely—to apply their resources in a manner that mitigates systemic risk.

We believe non-clearing members of risk management committees are more likely to adopt practices that either are overly conservative (resulting from their lack of expertise) or excessively risky (arising from a goal of expanding the clearinghouse's product offerings without a thorough understanding of the inherent risks in a given product or of the impact on the organization's risk profile). The results could range from margins being set at unsustainable levels to the admission for clearing of products that pose unacceptable systemic risk. Even if a majority of a risk management committee is composed of clearing members, a substantial minority of independent directors could make it difficult or impossible for the committee to take appropriate action.

Independent director participation in the risk management committee is not necessary to achieve the Commissions' goals of mitigating conflicts of interest. In the context of product eligibility determinations, we do not believe that members will seek to prohibit the clearing of particular products, because a competitive market will favor clearinghouses where there are fewer such limitations. Market forces should similarly prevent anticompetitive behavior with respect to margin requirements and standards for membership eligibility. With respect to decisions on matters associated with the core responsibilities of the risk management committee, if clearing members act unfairly and in accordance with their own interest rather than in the interest of the DCO or SB SCA, clearing transactions will shift to another clearinghouse whose policies are consistent with a competitive market. Moreover, we believe that the active oversight of risk management committees by clearinghouses' boards of directors, and of the clearinghouses' boards of directors by the Commissions, constitute additional layers of monitoring for compliance with applicable governance standards and provide opportunities to discover, investigate and remedy any inappropriate courses of action by a particular risk management committee.

For the same reasons as we have outlined above, we strongly recommend that the Commissions not increase the independent director requirement for boards of directors as a whole above 35 percent. We recognize the Commissions' intention to mitigate potential conflicts of interest by requiring that independent directors comprise a material portion of the board, but we believe this goal will be adequately served at the 35 percent level generally contemplated by the Proposals. We believe that any higher requirement would threaten the ability of clearing members appropriately to provide the organization with vital technical and financial support. Further limiting clearing members' participation on the board would not serve the Dodd-Frank purposes of improving governance, promoting competition and mitigating systemic risk.

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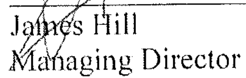
We appreciate the opportunity to comment on the Proposals and would be pleased to discuss any questions the Commissions may have with respect to the comments above. Any questions may be directed to the undersigned at 212 761 2514.

Very truly yours,



James Hill
Managing Director