CLEARY GOTTLIEB STEEN & HAMILTON LLP

WASHINGTON, DC
PARIS
BRUSSELS
LONDON
MOSCOW

ONE LIBERTY PLAZA
NEW YORK, NY 10006-1470
(212) 225-2000
FACSIMILE (212) 225-3999
WWW.CLEARYGOTTLIEB.COM

Writer's Direct Dial +1 212 225 2820
E-Mail: erosen@cgsh.com

FRANKFURT
COLOGNE
ROME
MILAN
HONG KONG
BEIJING

December 3, 2010

| | |
|---|---|
| Elizabeth M. Murphy | David A. Stawick |
| Secretary | Secretary |
| Securities and Exchange Commission | Commodity Futures Trading Commission |
| 100 F Street, NE | Three Lafayette Center |
| Washington, DC 20549 | 1155 21st Street, NW |
| | Washington, DC 20581 |

Re: 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, File No. S7-27-10;[1]

Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, RIN 3038-AD01.[2]

Secretary Murphy, Secretary Stawick:

This letter is submitted on behalf of the undersigned firms (the "Firms"). The Firms appreciate the opportunity to provide comments to the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC" and, together with the SEC, the "Commissions") with respect to the Proposed Rules. We understand that the Proposed Rules have been published by the Commissions pursuant to sections 726 and 765 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").

---

[1] 75 Fed. Reg. 65882 (Oct. 26, 2010) (the "SEC Proposal").

[2] 75 Fed. Reg. 33752 (Oct. 28, 2010) (the "CFTC Proposal" and, together with the SEC Proposal, the "Proposed Rules").

**INTRODUCTION**

Very generally, the Proposed Rules would, among other restrictions, impose (i) a 20% individual limit on the voting equity interest in a security-based swap clearing agency ("SBSCA") or derivatives clearing organization ("DCO" and, collectively with SBSCAs, "clearinghouses") that may be owned by any single member and a 40% aggregate limit on the voting equity interest that may be owned by members (in the case of SBSCAs) or "enumerated entities"[3] (in the case of DCOs),[4] (ii) a 20% individual limit on the voting equity interest in a security-based swap exchange ("SBS Exchange") or designated contract market ("DCM" and, collectively with SBS Exchanges, "exchanges") or security-based swap execution facility ("SBSEF") or swap execution facility ("SEF" and, collectively with SBSEFs, "execution facilities") that may be owned by any member or participant, and (iii) independence and composition requirements on the boards and certain committees of clearinghouses, exchanges and execution facilities (collectively, "Covered Facilities").

Dodd-Frank directs each of the SEC and the CFTC to promulgate rules that it determines, *after a review*, are necessary or appropriate "to improve the governance of, or to mitigate systemic risk, promote competition, or mitigate conflicts of interest" arising within clearinghouses that clear swaps and exchanges and execution facilities that post swaps or make swaps available for trading.[5] The Firms welcome the review contemplated by Dodd-Frank. The Firms would support appropriate measures designed to assure that conflicts of interest or governance structures do not interfere with the appropriate functioning of Covered Facilities or the accomplishment of Dodd-Frank's statutory objectives.

Accordingly, the Firms support the Commissions' efforts, through the August 20, 2010 roundtable[6] and publication of the Proposed Rules, to solicit public input. The Firms are concerned, however, that the Commissions, in the face of statutory deadlines and the press of

---

[3] Under the CFTC Proposal, "enumerated entities" include bank holding companies with $50 billion or more in consolidated assets, non-bank financial companies designated as systemically significant, affiliates of such bank holding companies and non-bank financial companies, swap dealers, major swap participants and persons associated with a swap dealer or major swap participant.

[4] The Proposed Rules would also permit a clearinghouse, as an alternative to the combined 20% individual and 40% aggregate limits, to adopt a 5% limit on the voting equity interest that may be owned by any member or non-member enumerated entity (in the case of a DCO) or by any member (in the case of a SBSCA).

[5] See Dodd-Frank §§ 726 and 765. For convenience, unless otherwise noted, references in this letter to "swaps" are also intended to include "security-based swaps."

[6] Transcript available at http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/derivative9sub082010.pdf.

extensive rulemakings, have not had an opportunity to conduct the empirical review contemplated by Dodd-Frank. More substantively, for the reasons more fully explained below, the Firms are concerned that the Proposed Rules would produce undesirable consequences that are inconsistent with Dodd-Frank and its policy objectives.

## SUMMARY

Despite its omission of an express standard for the agency review required by sections 726(b) and 765(b), we believe that Congress clearly contemplated a review beyond the public comment period required under federal administrative law. While participants in the roundtable organized by the Commissions earlier this year expressed many views and opinions, no participant presented an empirical review or analysis of the governance structures of existing registrants and facilities, nor was in a position to proffer evidence as to how those governance structures succeeded or failed (or would be inadequate) to address potential conflicts of interest, nor the extent to which, in the alternative, existing regulatory authority would or might be adequate to mitigate these conflicts, given the short time frame within which the roundtable was scheduled.

The Commissions, in their notice of proposed rulemaking, do not cite any third-party review, nor summarize the results of their own review, of facts and circumstances relevant to the required determinations. We believe that the thirty-day comment period prescribed for the Proposed Rules is too short a period in which to elicit meaningful evidence or empirical information pertinent to such a review or analysis from interested parties. As a result, and understandably given the time frame within which the Commissions are operating, it is unlikely that a meaningful review of relevant facts and circumstances contemplated by sections 726(b) and 765(b) would be completed before the Proposed Rules, as the Commissions may amend them, are adopted.

The implications of the proposed rulemaking for market structure, systemic risk management, innovation, competition within U.S. markets and competition between U.S. facilities and non-U.S. facilities are potentially profound. Congress clearly recognized this when it rejected the so-called “Lynch Amendment” and replaced it with sections 726 and 765 which, as noted above, expressly require the Commissions to act so as to mitigate systemic risk and promote competition.

Accordingly, in undertaking the reviews and determinations called for by sections 726 and 765, we urge the Commissions to bear in mind that the most effective, front-line protection against undesirable market practices lies in the freedom to compete and innovate – because competition supports alternative choices and innovation enhances those choices. To be sure, there are circumstances in which regulatory oversight must supplement market discipline. We are all witness to this. But supplementing market discipline is not the same thing as stepping in to replace it entirely. Reduced competition among clearinghouses and among exchanges and execution facilities not only implies less innovation and reduced efficiencies, it also unavoidably means that the Commissions must play a more active and intrusive role in vetting sensitive

decision-making, a less desirable alternative to the forces of market discipline within a competitive marketplace, reinforced by appropriate regulatory parameters.

As the U.S. Department of Justice has observed,[7] the vertically-integrated clearinghouse-exchange structure that characterizes the existing, regulated U.S. derivatives markets has led to very significant and concerning structural impediments to competition among clearinghouses and among exchanges and, by implication, other trading venues. Recognizing this, the Commissions should endeavor to avoid regulatory proscriptions that will unnecessarily reinforce existing impediments to competition and further dilute the salutary influence of market discipline.

It is clear that Congress has placed the Commissions in a very difficult position in complying with their own statutory mandates and the foregoing is not intended to suggest otherwise. Under these circumstances, we recommend that the Commissions defer actions that have the potential for significant and long-term adverse consequences until the time when careful empirical analysis that demonstrates a clear need for those actions could be completed.

Substantively, the Firms are concerned that the proposed aggregate limit on ownership of a clearinghouse, the proposed individual limit on ownership of an execution facility and the proposed composition requirements for specified board committees (i) could increase systemic risk, (ii) would impair competition among clearinghouses and among exchanges and execution facilities, and (iii) would inhibit the development of new execution facilities. The Proposed Rules would also interfere inappropriately with capital-formation and associated commercial decision-making that does not give rise to potential conflicts with regulatory policy objectives.

The Firms question whether empirical evidence exists that would justify restrictions that could give rise to adverse consequences such as these.[8] Indeed, global

---

[7] U.S. Department of Justice, Comment Letter to the U.S. Department of the Treasury, Review of the Regulatory Structure Associated with Financial Institutions (Jan. 31, 2008) (highlighting the Department of Justice's concerns regarding the anticompetitive consequences of the current structure of the futures market in the context of regulatory reform).

[8] The Firms respectfully encourage the Commissions to reconsider some of the assertions of market failure in the swap markets. As the Commissions are aware, significant derivatives market participants commenced initiatives to promote OTC clearing before the initiation of regulatory compulsion. This reflects the reality that dealers and other market participants have very significant incentives to clear OTC swap transactions to the extent that those transactions are sufficiently standardized and liquid to support central clearing and a clearinghouse with adequate resources and infrastructure exists. Capital charges alone create significant incentives for financial institutions to clear OTC swaps through qualified central counterparties.

*(continued on next page)*

supervisors (including the Federal Reserve Bank of New York) recently concluded that, based on their review of different clearinghouse ownership models, "there is *insufficient evidence* (either theoretical or empirical) to state that one ownership model is superior to another, either in terms of risk management or in terms of product expansion" and "there is *not enough evidence* to suggest that one model is less systemically stable than another, or less suitable for achieving the socially optimal provision of central clearing services."[9] Furthermore, exchanges and clearinghouses lacking the proposed restrictions performed remarkably well from a governance perspective before, during and following the financial crisis.

The Firms are also concerned that the Proposed Rules, if adopted in their current form, would essentially front-run ongoing efforts at systemic risk management and cross-border coordination of OTC derivatives market reform. Many (perhaps most) of the clearinghouses subject to the Proposed Rules are likely to be designated as systemically important financial market utilities under Title VIII of Dodd-Frank and, consequently, will be subject to risk management standards overseen not just by the Commissions, but also the Board of Governors of the Federal Reserve System (the "Board") and the Financial Stability Oversight Council (the "Council").[10] However, the Council has only just begun to address Title VIII,[11] and, as a result,

---

*(continued from previous page)*

Additionally, the Office of the Comptroller of the Currency's Quarterly Report on Bank Trading and Derivatives Activities – the source most commonly cited in support of claims of undue concentration in the derivatives markets (including in support of such claims in the SEC Proposal) – notes that concentration is a natural side-effect of the sophisticated tools and substantial resources necessary to engage in derivatives activities in a safe and sound manner. See OCC's Quarterly Report on Bank Trading and Derivatives Activities, Second Quarter, available at www.occ.treas.gov/topics/capital-markets/financial-markets/trading/ derivatives/dq210.pdf. In addition, the OCC's Quarterly Report observes that its measure of derivatives market activities is not exhaustive, but rather captures only those institutions that file Call Reports (primarily U.S. commercial banks). More comprehensive measures of derivatives activity show that the swap market is significantly less concentrated than the OCC's Quarterly Report may suggest. See ISDA Market Survey Results (Oct. 25, 2010), available at http://www.isda.org /media/press/2010/press102510.html, and Letter from Kenneth E. Bentsen, Jr., Executive Vice President, Public Policy and Advocacy, SIFMA, to David A. Stawick, Secretary, the CFTC, and Elizabeth M. Murphy, Secretary, the SEC, dated November 12, 2010, at pages 6-8.

[9] Bank for International Settlements, Committee on Payment and Settlement Systems, Report of the Working Group on Post-Trade Services, Market Structure Developments in the Clearing Industry: Implications for Financial Stability (Nov. 2010), at page 69 (emphases added).

[10] The Firms agree with observations by others that the Board should have significant input into the Proposed Rules. See Letter from Professor Hal S. Scott, President and Director, Committee on Capital Markets Regulation, to Gary Gensler, Chairman, the CFTC, dated August 25, 2010.

[11] The Council released its first request for comment on Title VIII as recently as last week. See Advanced Notice of Proposed Rulemaking Regarding Authority to Designate Financial Market Utilities as Systemically Important (Nov. 23, 2010) (publication forthcoming in the Federal Register).

the Firms urge the Commissions to coordinate with other members of the Council in order to avoid the adoption of far-ranging rules that may prove, in the future, to be inconsistent with the broader framework of systemic risk management.

Additionally, as the Commissions are doubtless aware, the Bank for International Settlements' Committee on Payment and Settlement Systems and the International Organization of Securities Commissions plan to address governance issues in their consultation on revised standards for financial market infrastructures, which is expected to occur in early 2011.[12] The Commissions would be in a far better position to make decisions on the issues raised by the Proposed Rules after the conclusion of that consultation. If they act before that time, the Commissions stand likely to short-circuit the consultative process (by establishing an inappropriate benchmark before evidence has been presented) and create the foundation for regulatory arbitrage and impaired U.S. competitiveness.

Accordingly, at least pending the opportunity to conduct a more thorough empirical review of Covered Facilities, their governance characteristics and historical developments and to coordinate with their U.S. and global counterparts, we urge that the Commissions not impose requirements on Covered Facilities that are more restrictive than those currently applicable to comparable facilities in the futures and securities markets. Specifically, although the Firms are not persuaded that evidence has been adduced that demonstrates a need for the proposed limitations, the Firms do not oppose the proposed 20% individual ownership limit for clearinghouses and exchanges or the 35% public/independent director requirement for boards of directors. Absent demonstrated need, however, the Firms strongly oppose more intrusive ownership or governance restrictions.[13]

## DISCUSSION

### I. Restrictions on Ownership

The Proposed Rules provide for individual and aggregate numerical limitations on the voting equity in clearinghouses that may be owned by clearinghouse participants and certain other market participants. Specifically, a clearinghouse would be subject to one of two

---

[12] See Financial Stability Board, Implementing OTC Derivatives Market Reforms (Oct. 25, 2010) at page 32.

[13] In raising these concerns, the Firms have sought to highlight those issues that are most consequential and for which there is a consensus among the Firms that the Commissions must address in order to avoid serious unintended consequences. In addition to the issues discussed in this letter, there are also a number of practical or technical issues – such as ensuring consistency between the Rules of the two Commissions – that the Commissions should consider. In addition, some or all of the Firms may also support the positions taken in other letters submitted on the Proposed Rules with respect to issues not raised in this letter.

regimes: under the first, clearing members would be subject to an individual ownership limit of 20% and an aggregate ownership limit of 40%;[14] under the second, clearing members would be subject to an individual limit of 5% and no aggregate limit. In addition, both Commissions have proposed a 20% individual limit on exchanges and execution facilities that may be owned by any member or participant. The Firms do not regard there to be empirical evidence supporting these limits and, while the Firms are not strongly opposed to a 20% individual limit on ownership of clearinghouses and exchanges consistent with the limit currently imposed on securities exchanges, the Firms are very concerned that the 40% aggregate ownership limit on clearinghouses and the 20% individual limit on execution facilities would adversely affect the swap market and its participants.

A. Aggregate Ownership Limits

The Firms believe that the proposed 40% limit on the aggregate voting equity interest in a clearinghouse is inconsistent with Congressional intent and, as noted by the European Commission in rejecting analogous limitations on ownership of clearinghouses, would have undesirable market consequences.[15] Dodd-Frank provides the Commissions with other, more flexible and more tailored tools to address the potential for conflicts of interest to interfere with statutory objectives. For example, the Commissions have authority to conduct their own reviews of swaps and impose a mandatory clearing requirement – whether or not the relevant swap is listed for clearing – and to oversee compliance with open access requirements and other core principles. In light of the foregoing, we strongly urge the Commissions to reconsider the proposed limits on aggregate ownership of clearinghouses.[16]

*1. Congress Did Not Authorize an Aggregate Limit*

Although a limit on aggregate ownership was included in both the House bill and in the House conference proffer,[17] Congress expressly rejected those provisions and enacted

---

[14] Under the CFTC Proposal, the 40% aggregate limit would apply to enumerated entities, regardless of whether they are clearing members.

[15] Proposal for a Regulation of the European Parliament and of the Council on OTC Derivatives, Counterparties, and Trade Repositories, 2010/0250 (COD), at page 10 (Other "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* . . . ).") (emphasis added).

[16] The Commissions should also eliminate the proposed alternative 5% limit on individual member ownership, which would no longer be necessary.

[17] See H.R. 4173, 111th Congress, § 3306 (as engrossed in House) and H.R. 4173, 111th Congress, § 754 (in House proffer).

Dodd-Frank *without* any such limit. The enacted Dodd-Frank conflicts provisions *permit*, but do *not require*, the imposition of numerical limits on ownership.[18] However, the wording of these provisions clearly indicates that Congress intended that such limits should apply to enumerated entities on an individual, and not on an aggregate, basis. Sections 726(b) and 765(b), for example, provide that:

> The Commissions "shall adopt rules which *may* include numerical limits on the control of, or the voting rights with respect to, any [Covered Facility], by *a* bank holding company . . . , *a* nonbank financial company . . . , *an* affiliate of such a bank holding company or nonbank financial company, *a* [swap/security-based swap] dealer, major [swap/security-based swap] participant, or associated *person* of a [swap/security-based swap] dealer or major [swap/security-based swap] participant" (emphases added).
>
> Sections 726(c) and 765(c) go further, specifically providing that:
>
> "[T]he [Commission] shall consider any conflicts of interest arising from the amount of equity owned *by a single* investor . . ." (emphasis added).

Accordingly, Dodd-Frank has not authorized the Commissions to impose *any* aggregate voting equity limit.

*2. An Aggregate Limit May Exacerbate Systemic Risk*

The proposed limit on aggregate ownership is likely to introduce unintentional but serious distortions to the development and management of clearinghouses by concentrating ownership (and, consequently, governance rights) in non-member-owners who do not share member-owners' expertise in risk management or share the same incentives to manage risk. As the CFTC itself acknowledges, the ordinary risk management protocol of clearinghouses fosters among member-owners strong economic incentives to (i) ensure a broad membership that is capable of meeting the financial integrity standards required of clearinghouses; (ii) take a conservative approach to risk management; and (iii) provide a diversified set of cleared products.[19]

In contrast, non-member-owners do not share such incentives. In fact, non-member-owners would potentially be encouraged to assume greater risk because the risk

---

[18] Dodd-Frank, §§ 726(a) and 765(a).

[19] CFTC Proposal at 63734.

waterfall structure of clearinghouses effectively subordinates clearing members to non-member-owners with respect to default risk.[20] Indeed, under certain structures, non-member-owners may have no risk exposure to default. A limit on aggregate ownership would diminish the decision-making authority of those who have the greatest exposure and who are most likely to act in a risk-averse and conservative manner – clearing members – and, instead, cede control to those who do not have "skin in the game." As a corollary, non-member-owners have clear economic incentives to allocate or concentrate losses associated with low probability events to clearing members, an incentive that could well exacerbate the transmission of systemic risk through financial institutions in the event of a financial crisis. Such a result is patently at odds with the risk mitigation objectives of Dodd-Frank generally and sections 726 and 765 in particular and would create a conflict of interest between the majority non-member-owners on the one hand and clearing-member-owners on the other of substantially greater concern than the potential conflicts the Proposed Rules are intended to address.

*3. An Aggregate Limit Would Curtail Competition*

Furthermore, as noted by Commissioners Sommers and O'Malia, a limit on aggregate ownership would discourage new entrants and curtail competition.[21] Experience demonstrates that clearing members and enumerated entities are the most likely sources of capital for new clearinghouses. It is unrealistic to expect investors to assume the economic risk of capitalizing new entities if they are denied the basic governance rights that are necessary to protect their legitimate commercial interests (such as intellectual property, technology solutions, technology providers, organization of operations, revenue policy, market structure and the like), quite apart from risk of loss and access issues.

Decreased competition and impediments to innovation would naturally concentrate the systemic risk incident to clearing operations and also, as a practical matter, require the Commissions to engage in closer oversight over otherwise purely commercial decisions in order to prevent incumbents from exercising market power in potentially disruptive or anticompetitive ways. For example, without the market discipline resulting from competition with structurally open clearinghouses, clearinghouses that operate vertically integrated exchanges or execution facilities would need to be overseen by the Commissions more closely in order to ensure that the conflicts of interest inherent in vertical integration do not result in subtle

---

[20] In most clearinghouse risk waterfall structures, the vast majority of losses that result from a clearing member's default (to the extent that those losses exceed the amount of margin posted by the defaulting member (including in most structures, margin posted by the defaulting member's customers to the extent there is a shortfall in the customer account giving rise to the insolvency of the clearing member)) are borne by the other clearing members through their contributions to the guaranty fund and additional guaranty fund assessments, if necessary.

[21] CFTC Proposal at 63752 – 53.

measures that undermine Dodd-Frank's requirements for open access and the promotion of competition.

B. Individual Ownership Limits

The Firms are not aware of any empirical evidence warranting the proposed 20% individual ownership limits on Covered Facilities. Nevertheless, the Firms would not be strongly opposed to applying those limits to clearinghouses and exchanges. Such a limit would be consistent with the informed limits currently imposed by SEC staff in the case of securities exchanges.

On the other hand, the Firms are deeply concerned that imposition of ownership limits on execution facilities would impede innovation and competition in the emerging marketplace for swap execution and would frustrate Congress' objective of promoting trading on execution facilities.[22] The development of successful non-exchange trading platforms has historically depended upon technological expertise and other contributions from market participants. Market participants would be disincented to make these contributions without the ability to participate in both the economic returns and management of these platforms. These disincentives would be especially acute in the case of start-ups with corollary impacts on competition and innovation by impeding successful market entry and entrenching incumbents.

Moreover, experience from the securities markets – where analogous non-exchange trading platforms (alternative trading systems) are not subject to ownership limits and many platforms are sponsored by a market maker or other broker-dealer – demonstrates that ownership of trading platforms by market participants tends to lead to better trading services, increased competition and lower trading costs. To the extent that the Commissions are concerned that conflicts of interests arising from ownership of execution facilities by market participants might impair achievement of statutory objectives, then the Commissions should, as the SEC has done with alternative trading systems, address those issues through oversight of open access and other regulatory requirements.[23] That task will be made easier in the case of execution facilities in the swap markets than it is in the case of alternative trading systems in the securities markets because of the rule review process established under Dodd-Frank for such execution facilities.

---

[22] See, e.g., Dodd-Frank § 733 ("[t]he goal of this section is to promote the trading of swaps on swap execution facilities . . . ."). Increased ownership of execution facilities by market participants would, consistent with Congress' objective, promote trading on execution facilities by increasing the number and variety of execution facilities, resulting in more choices and lower costs for market participants.

[23] For instance, we would expect that the Commissions would require that an execution facility owned by some of its participants establish objective membership standards, non-discriminatory pricing and access to trading and data, and safeguards to ensure appropriate performance of its self-regulatory obligations.

## II. Structural Governance Requirements

### A. Boards of Directors

The CFTC Proposal would require that DCO, DCM and SEF boards include at least 35% (and no fewer than two) public directors. The SEC Proposal would also require 35% independent directors for SBSCAs that comply with the proposed 20% individual and 40% aggregate limits on member ownership, but would diverge from the CFTC Proposal by requiring the boards of SBSCAs that comply with the alternative 5% individual limit on member ownership, as well as those of all SBS Exchanges and SBSEFs, to have 51% independent directors. This divergence would effectively require clearinghouses, exchanges and execution facilities that clear or trade both swaps and security-based swaps to comply with the stricter SEC requirements.

The Firms believe that a uniform 35% standard, which has been effective in the futures market, should be adopted by both Commissions. Such an approach would ensure greater regulatory consistency across Covered Facilities. We are not aware of any convincing evidence that the public is advantaged by a requirement that the governance of an exchange or execution facility be controlled by public/independent directors who may or may not have, but in any event are less likely to have, the experience and expertise that is appropriate to advance the commercial objectives of the exchange or execution facility. While every exchange and execution facility has regulatory responsibilities for which it can be held accountable, in the final analysis, the greatest threat to an exchange or execution facility is lack of commercial success. Creating obstacles to governance by expert and entrepreneurial managers has the potential to introduce governance inefficiencies that indirectly impede effective competition.

### B. Committees

The Proposed Rules would impose heightened independence requirements on certain board committees of Covered Facilities: nominating committees would need to be at least 51% independent;[24] disciplinary panels would be required to include at least one public/independent director (as would any appellate body of a disciplinary panel); DCO risk management committees would need to include 35% public directors and 10% customer representatives; exchange and execution facility regulatory oversight committees would need to be 100% independent; and DCM and SEF membership and participation committees would need to be 35% independent.

---

[24] The CFTC Proposal further requires that the nominating committee be chaired by a public director. The SEC Proposal also contemplates a 100% independent director requirement for the nominating committee.

The Firms believe that the Commissions' proposed board committee composition requirements unnecessarily depart from existing practice. As Commissioner Chilton noted during the CFTC open meeting for the CFTC Proposal, these requirements, when coupled with the more stringent independence requirements proposed by the regulations, could result in a shortfall in the number of qualified persons willing and able to serve as public/independent directors, especially in highly technical areas such as DCO risk management committees. As a result, the proposal could also lead to the inclusion of less qualified individuals lacking in relevant expertise (at least in the case of expert committees, such as a risk management committee). In addition, the Proposed Rules may *increase* conflicts of interest as non-stakeholder independent/public directors are confronted with commercial decisions that do not directly implicate regulatory policy.

These concerns are particularly acute in the case of the CFTC's proposal to require that fully 35% of the members of DCO risk management be public directors. Risk management committees are typically responsible for a wide range of difficult, highly technical and highly consequential decisions, such as (i) evaluating the risk characteristics of new products for clearing; (ii) providing market expertise on the suitability of such products for clearing based on factors such as liquidity, standardization and complexity; and (iii) evaluating and providing risk assessment of proposals to modify margin methodology, eligible collateral rules and investment options as well as changes to the guaranty fund computation methodology. The Commissions should not discount the critical importance of the highly specialized expertise that is required to discharge these responsibilities effectively. While clearing members typically have expertise in the relevant areas and incentives to manage risk conservatively,[25] public directors may lack the necessary expertise or any incentives to acquire it and may, in some cases, even have conflicts of interest that lead them to make decisions that are not aligned with the Commissions' objective of mitigating systemic risk.[26]

A more effective approach would be to require that a clearinghouse establish policies and procedures designed to ensure that the views of a wide range of constituencies are

---

[25] For example, clearing members have incentives to set membership standards in a manner that balances the decreased risk associated with mutualizing losses across a greater number of clearing members against the increased risk associated with accepting clearing members that may not have the expertise or financial wherewithal necessary to participate in the default management of a defaulted clearing member's portfolio. Specifically, upon a clearing member default, in addition to bearing losses (through prior contributions to the clearinghouse's guaranty fund and subsequent assessments), clearing members resolve defaults by bidding on the portfolio of the defaulting clearing member. In order to perform this role, non-defaulting clearing members must have the appropriate expertise to price a complex portfolio of instruments accurately and the financial wherewithal to accept and manage the risk arising from that portfolio. Accordingly, it is vitally important for membership standards to ensure that clearing members have the expertise and resources necessary to perform this role.

[26] See, e.g., the discussion regarding the duties of public/independent directors, infra Section III.

adequately represented in the deliberations of its risk management committee. This objective could be accomplished, for example, through a representative advisory committee structure. Such an approach could also be replicated for other committees where it is important to have the views of particular constituencies taken into account. These measures, in combination with independence requirements at the board itself, should adequately ensure that diverse perspectives are taken into account in the management of Covered Facilities.

If the Commissions instead decide to impose rigid composition requirements on board committees, then those requirements should apply only to those decisions by committees or subcommittees that directly implicate specific regulatory policies. For example, if the Commissions were to require that clearinghouse risk management committees include minimum numbers of public/independent and customer representatives, the Firms would support the CFTC's proposal that those requirements would not apply to plenary decision-making by the risk management committee so long as a subcommittee that complied with relevant composition requirements had responsibility to approve or deny membership applications.[27] Similarly, a nominating committee should not be subject to composition requirements if it delegates authority to nominate public/independent directors to a subcommittee composed of the required number of public/independent requirements. It should be noted that decisions of board committees and subcommittees are subject to the plenary authority of the full board of directors, which would itself be subject to independence requirements.

## III. Public/Independent Directors

The Firms strongly encourage the Commissions to adopt consistent regulations in the Proposed Rules. As such, the Firms appreciate the Commissions' efforts to harmonize the definitions of public/independent directors. In keeping with this approach, the Firms believe that the CFTC should adopt the SEC's more context-sensitive 2% of gross revenues test for recipients of payments from registered entities. Furthermore, in order to ensure that there are sufficient numbers of qualified individuals to serve as public/independent directors, the Commissions may wish to make waivers available for directors with highly attenuated "per se" material relationships but who are otherwise qualified to serve.

An additional point that has gone largely unaddressed in the years since the Commissions began to impose independence requirements is the nature of the duty that is owed by a public/independent director. Directors of a corporation generally owe fiduciary duties of

---

[27] Determination of membership standards and products eligible for clearing, on the other hand, are core risk decisions for which clearing members are best suited, by virtue of both expertise and incentives, to act appropriately and conservatively. Moreover, because the Commissions exercise direct oversight of those determinations – through the rule certification or approval process and review of swaps for mandatory clearing, respectively – there is little reason to impose artificial restrictions on decision-making at the clearinghouse level.

care to the corporate entity and its shareholders. Decisions that are driven by duties to shareholders, however, will not necessarily be consistent with the objectives of the Commissions' rulemakings or the best interests of the public markets. Indeed, in many cases, and particularly in the case of clearing, there are inherent conflicts of interest that could produce highly undesirable results. The Commissions will have accomplished little if public/independent directors only have a duty to act in the best interests of shareholders. Accordingly, before imposing the board composition requirements contained in the Proposed Rules, the Commissions need to give consideration not only to the appropriate standards that should apply to decision-making by public/independent directors of an enterprise expected to manage successfully such a high concentration of the world's systemic risk, but also to the interaction of such standards with state corporate laws.

## IV. Scope

Dodd-Frank's conflicts provisions are limited in the scope of the authority granted to the Commissions: the Commissions may promulgate ownership and governance restrictions *only* on clearinghouses, exchanges and execution facilities that clear swaps or that post swaps or make swaps available for trading.[28] Nothing in Dodd-Frank authorizes the Commissions to impose such restrictions on other entities.

However, the CFTC Proposal extends beyond this statutory authority by applying governance restrictions to any parent "operating" a DCO, DCM or SEF.[29] Although the Firms agree that it is appropriate to look through to parent entities for purposes of determining whether an individual firm exceeds its individual ownership limit, the Firms believe that, if board governance requirements are satisfied at the operating level, it is neither necessary nor appropriate to impose such requirements separately at the parent level. Moreover, Dodd-Frank does not provide the Commissions with the authority to so extend governance requirements. Additionally, the imposition of governance restrictions to other regulated entities or to non-U.S. publicly-listed parent companies might result in conflicts with existing policy judgments by other regulators or other sovereign countries about appropriate corporate governance arrangements.

The Commissions can fully accomplish their appropriate objectives in the context of holding companies by specifying that the individual voting equity limits apply to <u>direct or indirect</u> interests in a Covered Facility.

---

[28] Dodd-Frank §§ 726(a) and 765(a).

[29] The Firms also note that the CFTC Proposal would apply not only to DCOs and DCMs that clear or list swaps, but also to DCOs and DCMs that clear or list only futures and commodity options. The Firms are not aware of any provision under Dodd-Frank or the CEA that authorizes this extension of governance restrictions.

**CONCLUSION**

The Firms agree with the statutory goal of limiting the undesirable effects of conflicts of interest and therefore broadly support the objectives of the Commissions' efforts. However, the Firms believe that rules to address conflicts of interest must be narrowly crafted so as to address specific identified risks and impose minimal costs and burdens. The imposition of costs and burdens, especially those that create other conflicts and potentially greater risks, must be supported by substantial empirical evidence that they are outweighed by the benefits to be produced.

Limitations similar to the 20% voting equity ownership restriction on clearinghouses and exchanges and 35% board composition requirement, together with the Commissions' oversight and regulatory authority, have proved workable in the futures and securities markets without resulting in unintended adverse consequences.

However, absent demonstrated need, the Firms strongly oppose more intrusive ownership or governance restrictions that potentially carry serious unintended consequences. Moreover, the Commissions have more than adequate tools under Dodd-Frank and applicable core principles to ensure that decision-making bodies at Covered Facilities do not adopt rules on access or listing or make self-regulatory decisions that would contravene or interfere with Dodd-Frank's statutory mandates and objectives.[30] The Firms respectfully suggest that, rather than imposing potentially distorting restrictions on the clearing and execution structures of swap markets before such structures develop more fully, the Commissions should rely on their existing tools to oversee governance issues and decision-making of Covered Facilities with regulatory implications. If the Commissions were to determine in the future that decision-making bodies at Covered Facilities were, as a result of their governance structure, adopting rules on access or listing or making self-regulatory decisions that are inconsistent with Dodd-Frank's objectives, any warranted regulatory action could then be taken in an appropriately calibrated manner.

* * *

[30] Specifically, under Dodd-Frank, the Commissions have authority to initiate their own reviews of swaps that should be subject to mandatory clearing, oversee the rule certification and approval process of Covered Facilities and require Covered Facilities to comply with open access requirements and core principles.

The Firms appreciate the opportunity to comment on the conflicts of interest provisions of Dodd-Frank. We would be pleased to provide further information or assistance at the request of the Commissions or their staffs. Please do not hesitate to contact Edward J. Rosen (212 225 2820) of Cleary Gottlieb Steen & Hamilton LLP, outside counsel to the Firms, if you should have any questions with regard to the foregoing.

Respectfully submitted,

Edward J. Rosen, for

Bank of America Merrill Lynch
Barclays Capital
BNP Paribas
Citi
Credit Agricole Corporate and Investment Bank
Credit Suisse Securities (USA)
Deutsche Bank AG
HSBC
Morgan Stanley
Nomura Securities International, Inc.
PNC Bank, National Association
UBS Securities LLC
Wells Fargo & Company