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

March 7, 2011

Via Electronic Submission: http://comments.cftc.gov

David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: RIN No. 3038-AD01: Notice of Proposed Rulemaking on Governance Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities; Additional Requirements Regarding the Mitigation of Conflicts of Interest

Dear Mr. Stawick:

Managed Funds Association ("**MFA**")[1] appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the "**Commission**") on its proposed rulemaking on "Governance Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities; Additional Requirements Regarding the Mitigation of Conflicts of Interest" (the "**Proposed Governance Rules**")[2] in connection with the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").[3] MFA supports the Commission's general approach to establish rules that may achieve better governance of, and mitigate conflicts of interest within, derivatives clearing organizations ("**DCOs**"), designated contract markets ("**DCMs**") and swap execution facilities ("**SEFs**"). We look forward to working closely with the Commission to promulgate final rules in this regard.

I. MFA Previously Submitted Comments on Proposed Conflicts Rules

On November 17, 2010, MFA submitted a comment letter to the Commission (the "**November Letter**") regarding its proposed rulemaking on "Requirements for Derivatives

[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.9 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

[2] 76 Fed. Reg. 722 (January 6, 2011) (the "**Governance NPRM**").

[3] Pub. L. 111-203, 124 Stat. 1376 (2010).

Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest" (the "**Proposed Conflicts Rules**").[4] The Proposed Governance Rules are intended to complement the Proposed Conflicts Rules to accomplish the Commission's goal "to reduce risk, increase transparency and promote market integrity within the financial system".[5] While we strongly support the measures set out in both these proposed rulemakings, we remain concerned that they fall short in certain key areas. Therefore, we would like to reiterate and expand on certain comments we previously submitted in response to the Proposed Conflicts Rule.[6]

In our November Letter, we strongly supported public director representation on each DCO, DCM and SEF's Board of Directors ("**Board**") and committees as well as customer representation on each DCO's risk management committee ("**RMC**"). We also requested that the Commission permit employees or officers of a DCO to be members of such DCO's RMC or similar governing body. In addition, we encouraged the Commission to impose requirements that affirmatively limit the representation of clearing members on Boards and committees to a percentage lower than a controlling majority. Finally, we made recommendations regarding the ownership and voting proposals to ensure that clearing members do not have sole control of DCOs or an overriding profit sharing motivation to support one DCO at the expense of another.[7]

II. The Proposed Governance Rules

MFA is very supportive of the core principles and disclosure requirements set forth in the Proposed Governance Rules because we believe these rules are helpful in achieving fair and open access to clearing and electronic execution. We strongly support making clearing opportunities available for derivative instruments and believe that competition among clearing venues can encourage clearing and reduce costs. We are concerned that, in the absence of a balanced governance system for DCOs, along the lines suggested in this letter, enumerated

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[4] 75 FR 63732 (October 18, 2010) (the "**Conflicts NPRM**").

[5] *Id.* at 63732.

[6] On November 26, 2011, MFA also submitted comments to the Securities Exchange Commission ("**SEC**") regarding its proposed rule on Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies ("**SBSCA**s"), Security-Based Swap Execution Facilities ("**SB SEFs**"), and National Securities Exchanges with Respect to Security-Based Swaps ("**SBS Exchanges**") under Regulation MC (75 Fed. Reg. 65882 (October 26, 2010)). In its comment letter, MFA advocated that the SEC mandate that SBSCA, SBS Exchanges and SB SEF Boards, RMCs and regulatory oversight committees include non-dealer, customer representatives. As a related point, we suggested that the SEC impose requirements that affirmatively limit the representation of clearing members on Boards and committees to a percentage that is less than what would constitute control under the applicable corporate constitutive documents. With respect to the voting and ownership limitations of SBSCAs, we supported the proposed "Voting Interest Focus Alternative" for limiting ownership of voting equity and the exercise of voting rights at SBSCAs because the proposed "Governance Focus Alternative" did not include an aggregate limit on ownership or voting control.

[7] We supported the Commission's proposed "First Alternative" for limiting ownership of voting equity and the exercise of voting rights within DCOs, which included both a single-member limit and an aggregate limit, consistent with the Commission's goal of "introducing a perspective independent of competitive, commercial, or industry considerations to the deliberations of governing bodies". *See* Conflicts NPRM at 63742.

entities ("**Enumerated Entities**")[8] may dominate DCO governance and hinder market participants' access to clearing.

Below we respectfully provide certain recommendations on the Proposed Governance Rules (many of which we also provided in the November Letter with regard to the Proposed Conflicts Rules) that we hope will assist the Commission with adopting final rules that strike the optimal balance between safe risk management and comparative efficiency.

A. Customer Representation on DCOs' Boards and RMCs[9]

In the Governance NPRM, the Commission requests comments on the alternative proposals for requiring customer representation on one or more of a DCO's Board, RMC, RMC Subcommittee or other committee (collectively, "**DCO Governing Bodies**").[10] MFA recognizes that the success of clearing will depend on the structure, governance and financial soundness of DCOs. DCO governance is integral to fostering competition and determining the costs charged to customers by DCOs and indirectly the further costs charged by clearing members to their customers for cleared products. Thus, customers have a vested interest in safe and sound governance mechanisms that will encourage fair pricing of both products that are not subject to mandatory clearing but which may be clearable as well as products that are required to be cleared.

As a result, we favor an affirmative mandate in the Proposed Governance Rule that all DCO Governing Bodies must include non-dealer, customer representatives.[11] Since customers represent a substantial portion of the trading volume of each over-the-counter derivatives class, customers are important stakeholders and should have their views reflected in the critical decisions of these bodies. We are concerned that without such a mandate and without the mandate applying to each DCO Governing Body, DCOs may not adequately take into account the views of all market participants. Thus, in our view, measures that require customer representation will foster transparency and confidence in DCOs and greater parity in their governance structure.

If the Commission were to require customer representation on only one DCO Governing Body, we would prefer to have customer representation on a DCO's RMC because that is where

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[8] ''Enumerated entities'' are those entities listed in Section 726(a) of the Dodd-Frank Act and include: (i) Bank holding companies with over $50,000,000,000 in total consolidated assets; (ii) a nonbank financial company supervised by the Board of Governors of the Federal Reserve System; (iii) an affiliate of (i) or (ii); (iv) a swap dealer; (v) a major swap participant; or (vi) an associated person of (iv) or (v).

[9] The focus of this letter is on RMCs of DCOs. However, we believe that the Boards and Regulatory Oversight Committees of DCMs and SEFs should also be composed of a diverse group of market participants, with no group constituting a controlling majority.

[10] Section 726 of the Dodd-Frank Act; Governance NPRM at 729.

[11] Proposed Rule 39.13(g)(3)(i) defines "customer" as any customer of a clearing member, including, without limitation, commodity customers, foreign futures or foreign options customers, and any customer entering into a cleared swap.

we are concerned Enumerated Entities' "economic incentives to minimize the number of swap contracts subject to mandatory clearing and trading"[12] could constrain access to and utilization of clearing facilities and would potentially have the greatest influence. As the Commission recognized in the Conflicts NPRM, "it is important to mitigate potential conflicts of interest that may prevent clearable swap contracts from becoming subject to mandatory clearing".[13] Specifically, the Conflicts NPRM charges the RMC with determining products eligible for clearing, setting standards and requirements for initial and continuing clearing membership eligibility, and advising DCO Boards on risk model and default procedures,[14]each of which is a decision that has a profound effect on market structure.[15] Customer involvement in these decisions would increase the transparency and balance of the decision-making process, helping to mitigate potential conflicts of interest inherent in the involvement of Enumerated Entities and improve the prospects for resolving such conflicts.[16] In addition, because of the highly technical nature of decisions relating to market structure, it is not only advisable but also necessary that customers contribute their expertise to the making of these determinations.

B. Balanced RMC Composition

Like many other market participants, MFA is concerned "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."[17] Therefore, we are concerned that the Proposed Governance Rules do not include any restrictions on the percentage representation of clearing members on RMCs or otherwise limit clearing members from having a controlling majority on an RMC.[18] We reiterate our conviction, set out in greater detail in the November Letter, that to completely effectuate fair representation and balanced governance, the Commission should impose requirements that affirmatively limit the representation of Enumerated Entities on RMCs to a percentage lower

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[12] Governance NPRM at 724; Conflicts NPRM at 63734.

[13] Conflicts NPRM at 63736.

[14] *Id.* at 63750.

[15] There are many decisions under the purview of RMCs, some of which are highly technical, that have a material impact on market structure and that are unlikely to fall within the scope of Board decision-making. See Appendix A to the November Letter, which provides a partial list of material features of swaps clearing and execution that are subject to decision by the Boards and committees of DCOs, DCMs and SEFs, and therefore, are areas of potential conflict of interest in decision-making.

[16] *See* November Letter at 6, where MFA provides a partial list of material features of swaps clearing and execution that are subject to decision by the Boards and committees of DCOs, DCMs and SEFs, the outcomes of which could have a significant impact on access, clearing, execution, transparency and competition, as well as on the cost and liquidity of cleared swaps. *See also* Section B below.

[17] Governance NPRM at 724; Conflicts NPRM at 63734.

[18] Proposed Governance Rule 39.13(g)(3)(i) includes the same requirements as the Proposed Conflicts Rules (*i.e.*, it continues to provide that each DCO have an RMC with at least 35% public directors and 10% customer representatives).

than what would constitute control of the RMC under the DCO's corporate constitutive documents.

MFA also believes that employees and officers of a DCO should have representation on RMCs or other similar governing bodies. The interests of a DCO's employees and officers are generally aligned with such DCO's interests because employees and officers are motivated to expand the scope of DCO products and services, offer optimal capital, margin and cost management, and maintain DCO risk management boundaries that prevent losses to the DCO, its members and the markets. DCO management also brings much needed high-quality risk management and market expertise to any RMC decision-making process. Therefore, MFA urges the Commission to adopt provisions that expressly allow DCO management to participate on RMCs or other similar DCO governing bodies.

We think it appropriate for a DCO Board to review and re-examine for conflicts of interest any decision that the RMC approves, including decisions approved despite significant dissent from RMC members. Where such review reveals an underlying conflict of interest, we believe that the Board, consistent with general corporate governance principles, should be able to overturn the RMC's decision. We would recommend that the Commission allow any dissenting RMC member to initiate the appeal or review process, if it could reasonably show that there was an underlying conflict of interest or that the RMC did not undertake an appropriate process to avoid a conflict of interest. For example, with respect to an RMC's decision to set exclusionary membership criteria, the Board would be obliged to review it by determining whether the RMC made its decision based on objective, risk-based criteria, rather than through a majority vote of RMC members with unresolved conflicts of interest. This right to appeal will help provide essential balance and is particularly important in the event that there is no express requirement that the Board must have customer representation. At the same time, we think it should be sufficient for this right to appeal to apply only to decisions that meet this burden of proof, in order to balance the need to have a material constraint on decisions informed by conflicts of interest with the need to prevent excessive appeals from delaying the functioning of and decision-making by the RMC or Board.[19]

C. Delegation of Decision-Making from the RMC to an RMC Subcommittee

The Proposed Governance Rules permit an RMC to delegate certain decisions about whether a product is capable of being cleared and whether particular entities are capable of performing such clearing to an RMC Subcommittee.[20] Those rules also allow the Board to reject

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[19] *See* Section C, fn. 21, for MFA's views on further review of conflicted decisions by the Commission.

[20] To encourage greater clearing member participation on its RMC, a DCO may cause its RMC to delegate to an RMC Subcommittee decisions about whether a product is capable of being cleared and whether particular entities are capable of performing such clearing. In addition, the Proposed Governance Rules also specify that the RMC Subcommittee must report to the RMC, which in turn, must report to the DCO's Board. Where the Board rejects a recommendation of the RMC or RMC Subcommittee, the DCO must submit a report to the Commission, which can then evaluate whether the rejection or supersession of such a recommendation originated from a conflict of interest. *See* Proposed Rule 39.25(b); Governance NPRM at 725.

a recommendation of the RMC or the RMC Subcommittee and provide the Commission, upon submission of a report by the DCO, with ultimate authority to evaluate the rejection to identify potential conflicts of interest.[21] If the Commission requires customer participation and balanced governance on each DCO Governing Body, this process may function as an appropriate system of checks and balances. However, in the absence of these safeguards, we are concerned that permitting an RMC to delegate any decisions affecting market structure to an RMC Subcommittee could lead to many scenarios where customers and independent representatives are effectively excluded from critical decisions. This possibility is of particular concern where Enumerated Entities have majority control of the RMC. To help mitigate this potential problem, we recommend that the proposed percentage of customer representation on any RMC Subcommittee be the same as on the RMC.

Furthermore, we recommend that the Commission require DCOs to implement procedures that mandate a full review by an RMC of an RMC Subcommittee's decisions that are material to market structure, which would ensure necessary input by a diverse group of affected market participants and guarantee appropriate transparency. We also recommend that, where such RMC review leads to the rejection of an RMC Subcommittee's recommendation, the DCO report that divergence of views to the Commission.

As a related point, we support the Proposed Governance Rules' requirement that DCOs must institute a regulatory program to monitor and disclose actual and potential conflicts of interest.[22] However, we reiterate that monitoring and disclosing conflicts is not enough. Since clearing for liquid swaps is expected to be mandatory for a significant portion of the traded volume in any given asset class and because DCO consolidation is a real possibility, customers will not have the ability to opt out of a conflicted decision on market structure, even where they believe that such decision does not adequately represent their views. As a consequence, it is important that DCO governance procedures seek to address conflicts of interest as they arise, rather than providing solely for monitoring and disclosure of those conflicts to the Commission after a DCO Governing Body has already made important market structure decisions. Accordingly, we request that the Commission implement the suggestions outlined in this letter regarding customer representation on all DCO Governing Bodies.

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[21] *Id.*

[22] Proposed Rule 40.9(e).

MFA thanks the Commission for the opportunity to provide comments on the Proposed Governance Rules. Please do not hesitate to contact Carlotta King or the undersigned at (202) 730-2600 with any questions the Commission or its staff might have regarding this letter.

Respectfully submitted,

/s/ Stuart J. Kaswell

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

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

The Hon. Mary Schapiro, SEC Chairman
The Hon. Kathleen L. Casey, SEC Commissioner
The Hon. Elisse B. Walter, SEC Commissioner
The Hon. Luis A. Aguilar, SEC Commissioner
The Hon. Troy A. Paredes, SEC Commissioner