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By Electronic Mail

June 3, 2011

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
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 (75 Fed. Reg. 63732 (October 18, 2010))

Dear Mr. Stawick:

New York Portfolio Clearing, LLC ("NYPC") appreciates the opportunity, afforded by the extended comment period,[1] to respond to the request by the Commodity Futures Trading Commission (the "Commission") for comments on proposed rules, issued pursuant to Section 726 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), relating to potential conflicts of interest in the governance of derivatives clearing organizations ("DCOs"), designated contract markets ("DCMs") and swap execution facilities (collectively, "registered entities").[2]

In its proposal, the Commission requested comment on the proposed definition of "public director." As discussed in greater detail below, we believe the proposed definition is unduly restrictive and could have the unintended effect of precluding individuals with the requisite skill and experience from serving on the boards of DCOs and other registered entities.

The Commission additionally requested comment on "whether both (i) structural governance requirements and (ii) limits on the ownership of voting equity and the exercise of voting power are necessary or appropriate to mitigate" such conflicts of interest.[3] While we recognize that

[1] Reopening and Extension of Comment Periods for Rulemakings Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 25274 (May 4, 2011).

[2] NYPC, which is registered with the Commission as a DCO, is owned equally by NYSE Euronext ("NYX") and The Depository Trust & Clearing Corporation ("DTCC"). NYPC clears U.S. dollar-denominated interest rate futures contracts and cross-margins eligible positions against U.S. Treasury and other fixed income securities and repurchase agreements cleared by DTCC's subsidiary, the Fixed Income Clearing Corporation.

[3] 75 Fed. Reg. 63732, 63737 (October 18, 2010).

mitigating potential conflicts of interest in the governance of regulated entities is an important objective of Section 726, we believe that rules promoting strong and effective governance standards will be more effective than arbitrary ownership limitations in effectuating the goals of Dodd-Frank.

The Proposed "Public Director" Definition is Unduly Restrictive.

The Commission's proposal would require that at least 35% of the members of the board of directors of a DCO or other registered entity be "public directors." The Commission's proposal would similarly establish a 35% public director requirement for a DCO's Risk Management Committee and a 51% requirement for the Nominating Committee. The characterization of an individual as a "public director," therefore, is critical to the effective implementation of Section 726 of Dodd-Frank.

We recognize the importance of including public directors on the board and committees of a registered entity and can affirm that public directors have provided an independent and valuable perspective to the deliberations of our Board and Committees. At the same time, we are concerned that the Commission's proposal, which would condition status as a "public director" upon the individual in question not having a "material relationship" with the registered entity, could have the effect of precluding talented individuals from serving on our Board and Committees.

In particular, the term "material relationship" is proposed to be defined by reference to anything "that reasonably could affect the independent judgment or decision-making of the director," followed by a list of conditions that would conclusively be deemed to constitute a "material relationship." We agree, in principle, that it would be inappropriate to characterize a director of a DCO as a "public director" if that person had a relationship with the DCO that could reasonably be expected to affect his or her independent judgment or decision-making as a member of the DCO's board or committees. At the same time, we are concerned that the portions of the proposed regulation that elaborate upon this general guidance are in some cases overbroad and, as such, could have the effect of excluding highly talented individuals from serving on our Board and Committees.

As an example, proposed regulation 1.3(ccc)(1)(ii) would preclude anyone who is employed by a clearing member from being classified as a "public director." We respectfully submit that such a restriction is inappropriate when it is applied to a registered entity, such as NYPC, that is majority owned by entities that are not members of or participants in the registered entity.[4]

[4] In this regard, it is useful to bear in mind that the "interested" directors on a registered entity's board or committees frequently have divergent views on a given subject, and that robust governance requirements that take into account the different interests of interested parties effectively serve the goal of addressing directors' conflicts of interest. The proposed definition, which focuses exclusively on public directors, does not take into account the possibility that there may also be differences among board members who are not entirely disinterested but who nonetheless may reflect diverse points of view on the board and committee of a registered entity.

Similarly, proposed regulation 1.3(ccc)(1)(iv) would preclude an employee of a law, accounting or consulting firm from serving as a public director if that firm receives $100,000/year in professional service fees from a registered entity, its affiliates, members or clearing members of the registered entity *and their respective affiliates*. Proposed regulation 1.3(ccc)(1)(v) would take this a step further, and eliminate the $100,000 threshold altogether for persons serving on a DCO's Risk Management Committee.

In addition to the impracticality of measuring the professional fees that have been paid in the preceding twelve months by a registered entity's member firms and member firms' affiliates (a single clearing member can itself have dozens of affiliates in the U.S. and overseas), we believe it is inappropriate to disqualify someone from service on a board merely because he or she advises the members of the registered entity, or a member's affiliate (as opposed to the registered entity itself or the registered entity's affiliates). In such a case, any potential conflict of interest is not only much more attenuated, it is also already addressed by the Commission's conflict of interest rules and internal governance procedures of the registered entity.[5] Furthermore, the proposed restrictions do not distinguish between the situation where a director is directly advising the registered entity or its respective affiliates from the situation in which a director is merely affiliated with a professional services firm, but does not himself or herself provide services to the registered entity or its affiliates.

As a practical matter, the application of these litmus tests would have the effect of making it difficult to recruit individuals who have the knowledge, skill and experience that would allow them to offer valuable insights and the ability to express views that differ from those of management and other members of the DCO's board or committee. It is precisely this specialized expertise, particularly risk management skills, that makes individuals with this type of background valuable additions to the board and committees of a DCO. Ironically, the bright-line tests that have been proposed by the Commission may result in the appointment of public directors to DCO boards who lack market or risk experience, forcing these directors to overly rely on the guidance and recommendations of management and interested directors and eliminating a proper check on board decision-making, which works against the goal that the Commission is aiming to achieve.

In contrast to these "bright-line" tests, we would respectfully urge the Commission to implement materiality standards similar to those set forth in the Commission's 2009 guidance regarding current DCM Core Principle 15 (Conflicts of Interest) and provide direction as to what factors should be taken into account in determining when a relationship should be considered "material" in evaluating the independence of a potential director.[6] The guidance that has been provided by the Commission on this subject was the result of a careful and well-thought-out

[5] *See, e.g.*, Commission Regulation 1.69; NYPC Rule 205.

[6] *See* 74 Fed. Reg. 18982 (April 27, 2009).

evaluation of DCM governance and conflicts of interest and could, we respectfully submit, be readily applied to other registered entities.[7]

We recognize that the Commission may be reluctant, given the other demands upon its resources, to undertake a comparable examination of these principles as they apply to DCOs. We nonetheless respectfully submit that section 726(b) of Dodd-Frank requires that the Commission first evaluate the consequences of any rules that it may adopt to mitigate conflicts of interest before putting any such rules into place.

Thus, while we agree with the Commission that it is important to provide for participation by public directors on the boards and committees of registered entities, we would ask that the Commission also bear in mind that DCOs are being asked to take on new and extraordinary responsibilities under Dodd-Frank. We therefore respectfully urge the Commission to afford DCOs—and, in particular, NYPC and other newly formed DCOs—the flexibility to draw upon the skill and experience of industry professionals who have a sophisticated understanding of the special attributes of clearinghouses, without application of the rigid and potentially disqualifying tests that would be required by proposed regulations 1.3(ccc)(1)(ii), (iv) and (v).

Accordingly, we urge the Commission to define the term "public director" as it applies to DCOs generally—or, at a minimum, newly formed DCOs, such as NYPC—in broad terms of general application, such as the test that is contained in the introductory paragraph of proposed regulation 1.3(ccc)(1). Doing so would allow DCOs—which remain subject to an obligation to minimize conflicts of interest under DCO Core Principle P—to exercise their own independent judgment, subject to Commission oversight, as to how the material relationship test contained in proposed regulation 1.3(ccc)(1) should be applied, without unnecessarily constraining their ability to attract and retain the best-qualified candidates to serve on their boards and committees.

New and Recently Formed Registered Entities Should be Allowed to Employ Other Structural Safeguards as an Alternative to Strict Public Director Percentage Requirements.

We also are concerned about the effect the strict public director percentage requirements will have on registered entities, especially on start-up organizations like NYPC. Independent directors with the experience, expertise and willingness to successfully lead a new entrant are already scarce and are very much in demand. Application of the 35% Board requirement and the 51% Nominating Committee requirement, therefore, could have the effect of precluding talented individuals who are not public directors from serving on boards and committees (their inclusion would require the registered entity to add still more public directors) and diluting the

[7] *See* 72 Fed. Reg. 6936 (February 14, 2007) (adoption of "acceptable practices" for DCM Core Principle 15, subject to two-year phase-in); 72 Fed. Reg. 14051 (March 26, 2007) (proposed "clarification" of public director definition); 72 Fed. Reg. 65658 (November 23, 2007) (indefinite stay of implementation of acceptable practices guidance pending adoption of "public director" definition); 74 Fed. Reg. 3475 (Jan. 21, 2009) (proposed re-definition of "public director"); 74 Fed. Reg. 18982 (April 27, 2009) (adoption of final rule defining the term "public director" for purposes of DCM Core Principle 15).

know-how and skill that is currently represented on the boards and committees of registered entities. This concern is particularly acute for new and innovative organizations, such as NYPC, whose very existence enhances competition but who must compete with larger, well-established entities to attract talented individuals to their boards. We therefore respectfully urge the Commission to allow new and recently formed registered entities to propose, pursuant to the procedures in Commission Regulations 40.5 and 40.6, alternatives to the strict percentage requirements contemplated by the proposed rules, such as requiring the support of a majority of the public directors (in addition to a majority of the board as a whole) for the approval of certain types of matters.

Ownership Limits Are Not Necessary or Appropriate to Mitigate Conflicts of Interest.

The Commission has observed that its proposed "structural governance requirements," including the requirement for significant levels of participation by public directors on the boards and key committees of a registered entity, can be expected to mitigate conflicts of interest by "introducing a perspective independent of competitive, commercial, or industry considerations to the deliberations" of a registered entity's board of directors and committees.[8] In fact, the Commission has consistently taken the position that governance measures are sufficient to address conflicts of interest: "In publishing the 2009 amendments [to the DCM Core Principle 15 guidance relating to public directors], the Commission asserted its continued commitment to 'the fundamental philosophy underpinning the acceptable practices for Core Principle 15: potential conflicts of interest in self-regulation by for-profit and publicly-traded DCMs can be addressed successfully through appropriate measures embedded in DCMs' governance structures.'"[9]

NYPC agrees, and believes that implementation of the governance measures that have been proposed by the Commission would increase the range of viewpoints involved in the governance and administration of DCOs.[10] More importantly, NYPC believes that the adoption of effective structural governance requirements of the type that have been proposed by the Commission make it unnecessary for the Commission additionally to restrict the ability of

[8] 75 Fed. Reg. at 63738.

[9] 74 Fed. Reg. 18982, 18984 (Apr. 27, 2009), *quoting* 74 Fed. Reg. 3475, 3476–77 (Jan. 21, 2009). Although Dodd-Frank re-designated this as new Core Principle 16, Congress "left the actual language of the principle substantively unchanged." 75 Fed. Reg. at 63733 n.11

[10] As the Commission is aware, the European Commission rejected a system that would have implemented ownership limits, finding that governance measures are "more effective in addressing any potential conflicts of interest that may limit the capacity of CCPs [central counterparties] to clear," noting that ownership limitations "may have undesirable consequence on market structures," particularly as applied to exchanges that own a CCP. Proposal for a Regulation of the European Parliament and of the Council on OTC Derivatives, Central Counterparties and Trade Repositories, § 4.3.4., COM (2010) 484/5 (Sept. 15, 2010), *available at* http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20100915_proposal_en.pdf.

clearing members to have a significant ownership interest in the DCOs in which they participate.[11]

NYPC is especially concerned that the proposed ownership limits could force DCOs that are not part of broadly held, publicly traded companies to dilute the ownership interest of their clearing members in order to come into compliance with the ownership restrictions and, in the process, deprive such DCOs of the perspectives, skills and knowledge that are contributed by members of the board of directors who are themselves employed by clearing members, whose margin and guaranty fund deposits are at risk if a DCO is not managed and overseen by professionals with extensive experience in the management of risk. Unlike venture capital and private equity fund investors who might invest in a DCO to the extent that clearing members cannot do so, the member-owners of a DCO are focused on managing and mitigating the DCO's risk, as opposed to its return on equity.

Finally, we believe the imposition of strict ownership caps would be inconsistent with Congressional intent with respect to the mitigation of conflicts of interest under Dodd-Frank, as evidenced by the fact that Congress explicitly rejected the "Lynch amendment," which would have imposed absolute limits, and instead enacted Dodd-Frank without ownership restrictions. Indeed, Section 726 instead permits the Commission to adopt rules that would impose ownership limitations *only* if the Commission first conducts a review and determines "that such rules are necessary or appropriate to improve the governance of, or to mitigate systemic risk, promote competition, or mitigate conflicts of interest in connection with a swap dealer or major swap participant's conduct of business with, a derivatives clearing organization, contract market, or swap execution facility that clears or posts swaps or makes swaps available for trading and in which such swap dealer or major swap participant has a material debt or equity investment." We do not believe sufficient evidence has been presented to justify a determination that ownership limitations are necessary or appropriate.

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[11] Although NYPC is currently owned in equal shares by DTCC and NYX, clearing members may in the future have an ownership interest in NYPC.

NYPC appreciates the opportunity to submit these comments in connection with the proposed governance and ownership rules for registered entities. If the Commission has any questions concerning the matters discussed in this letter, please contact the undersigned (at 212-855-5210 or wlukken@nypclear.com) or Laura C. Klimpel, NYPC's Chief Compliance Officer and Counsel (at 212-855-5230 or lklimpel@nypclear.com).

Very truly yours,

Walter Lukken
Chief Executive Officer

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

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