

Via Electronic Submission

October 11, 2022

Mr. Christopher Kirkpatrick
Secretary of the Commission
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Governance Requirements for Derivatives Clearing Organizations
RIN 3038-AF15

Dear Secretary Kirkpatrick,

I appreciate the opportunity to comment on the Commodity Futures Trading Commission’s (“Commission” or “CFTC”) proposed rules on “Governance Requirements for Derivatives Clearing Organizations” (“Proposal”).¹ In my scholarship, I have analyzed the implications of different ownership models on clearinghouses’ risk profile;² I have looked at governance and financial mechanisms to more effectively align the economic interests and incentives of clearinghouses’ owners to those of their participants;³ and, more generally, I have studied the growing domestic and international regulation and role played by financial market infrastructures in the aftermath of the 2008 financial crisis.⁴ I welcome the chance to share my findings and views with the Commission, and

¹ Commodity Futures Trading Commission, Proposed Rule, *Governance Requirements for Derivatives Clearing Organizations*, 87 Fed. Reg. 49559 (Aug. 11, 2022) [CFTC Proposal].

The views and opinions expressed in this letter are solely the author’s and not those of George Mason University Antonin Scalia Law School.

² See Paolo Saguato, *The Ownership of Clearinghouses: When Skin in the Game is Not Enough: The remutualization of Clearinghouses*, 34 YALE J. ON REG. 601, 633-34 (2017), available at <https://digitalcommons.law.yale.edu/yjreg/vol34/iss2/5/> [hereinafter *The Ownership of Clearinghouses*].

³ See Paolo Saguato, *Financial Regulation, Corporate Governance, and the Hidden Costs of Clearinghouses*, 82 OHIO ST. L. J. 1071 (2021), available at <https://kb.osu.edu/handle/1811/101242> [hereinafter *The Hidden Costs of Clearinghouses*]; Paolo Saguato, *The Unfinished Business of Regulating Clearinghouses*, COLUM. BUS. L. REV. 449 (2020) <https://journals.library.columbia.edu/index.php/CBLR/article/view/7219> [hereinafter *The Unfinished Business*].

⁴ FINANCIAL MARKET INFRASTRUCTURE – LAW AND REGULATION (Jens-Hinrich Binder and Paolo Saguato eds., 2022).

I remain available to further discuss them with the Commission.

The Commission's Proposal is an important step in enhancing robust and participative governance arrangements for derivatives clearing organizations ("DCOs") and moves in the direction of addressing the incentives structure of DCOs' owners and participants, with the ultimate goal of fostering accountability, transparency, and resilience in DCOs. This letter endorses the Commission's effort to create a regulatory environment that pushes DCOs "to establish governance arrangements that are transparent, fulfill public interest requirements, and permit the consideration of the view of owners and participants."⁵ At the same time, this letter challenges the Commission to do more to address the misalignment of incentives between DCOs and their clearing members, particularly in those instances where DCOs are subsidiaries or business units of publicly-traded corporations, or, more broadly, for-profit enterprises.⁶ While no one disputes the important role that DCOs play in today's marketplace and their stable operations in recent times of high volatility, it only takes one severe incident or crisis to erode the confidence in such infrastructures. It behooves the Commission, therefore, to address potential market failures that undermine DCOs' governance and economic structure via reasonable market-based reforms that leverage properly aligned incentives and support the creation of a regulatory environment that creates a level playing field for DCOs' owners and participants to contract around optimal governance arrangements and capital framework. In this spirit and commending the Commission's rule-making initiative and the foundation work of the Market Risk Advisory Committee ("MRAC"),⁷ this letter urges the Commission to:

1. engage in a more comprehensive study of how different ownership models and organizational arrangements across DCOs allocate incentives between owners and participants, and how they reflect and impact risk management practices and capital structure;
2. effectively evaluate and address the misaligned incentives between DCOs' owners and their participants and implement effective and targeted reforms for the current regulatory architecture of DCOs' governance, risk management, and capital framework to address the market failure and agency costs that might spill from the "member-participant divide" and the "separation of risk and control."⁸

As I discussed in my writing, a DCO that has demutualized its ownership structure but still mutualizes the risk it faces among its participants,⁹ faces potential misaligned incentives between market participants. In this demutualized model, the participants are not owners, yet they are, in practice, the ultimate risk bearers of the business despite having no formal governance rights over the clearing business; and the DCO's owners, in contrast, retain all governance rights, yet have limited financial skin in the game. Promptly addressing these misaligned incentives is essential to supporting robust and accountable financial infrastructure and ultimately ensuring financial stability.

⁵ See CFTC Proposal, *supra* note 1, at 49560.

⁶ See Saguato, *The Hidden Costs*, *supra* note 3, at 1098-1108.

⁷ See e.g., CFTC Market Risk Advisory Committee, CCP Risk and Governance Subcommittee, *Recommendations on CCP Governance and Summary of Subcommittee Constituent Perspectives* (Feb. 23, 2021), available at https://www.cftc.gov/media/5701/MRAC_CRGSubcommittee-RecommendationsOnCCPGovernance022321/download; CFTC Market Risk Advisory Committee, CCP Risk and Governance Subcommittee, *DCO Capital and Skin in the Game Discussion Paper* (July 13, 2021); available at https://www.cftc.gov/media/6181/MRAC_CRGCapitalSITGFinalPaper071321/download;

⁸ See Saguato, *The Hidden Costs*, *supra* note 3, at 1098-1108.

⁹ See Saguato, *The Ownership of Clearinghouses*, *supra* note 2, at 640-653 (discussing the costs and benefits of different ownership models).

The Commission's Proposal moves in the direction of creating more participative mechanisms in the governance of DCOs, and I welcome the proposed provisions that support governance arrangements that incorporate processes and policies that include inputs and direct engagements from market participants on matters relate to risk management. However, the Proposal could and should go further to align asymmetric interests and enhance resiliency. The Commission should continue in its mission to strengthen and support our national derivatives markets. To that end, and embracing the Proposal's perspective on granting more "voice" to participants in the governance of DCOs, I respectfully urge a more comprehensive reassessment of the existing regulatory framework for clearinghouses' financial resilience as well as their recovery and resolution regime. In doing so, the Commission should be cognizant that the current market structure has been substantially influenced by the presence of the legislative clearing mandate for standardized swaps that affects the market dynamics between DCOs and their participants. For this reason, the Commission should be cautious about having solely a principles based delegation of DCOs in the self-regulatory organization ("SRO") role to set their optimal arrangements. Finally, governance reforms alone, while they can result in more transparent and participative arrangements, cannot on their own enhance clearinghouses' financial resilience and ultimately support financial stability.¹⁰

This letter provides additional comments on two aspects of the Proposal: (i) risk management committee(s) and market participants risk advisory working groups; (ii) fitness standards for risk management committee members.

- (i) Risk management committee(s) and market participants risk advisory working groups §39.24 (b)(11), (12)

The proposed amendments to the current governance regime for DCOs, which formalize the role of the risk management committee(s) ("RMC") and create novel market participants risk advisory working groups ("RWG"), are welcome. I strongly support the creation of governance arrangements that facilitate engagement and input from market participants not just to implement the DCO Governance fitness standards, but also as a way to move towards re-aligning the incentives of participants and owners that ultimately support the resilience of DCOs. Furthermore, I agree with the Commission's approach in setting a broad authority perimeter for the RMC to encompass "all matters that could materially affects the risk profile of the" DCO. In addition, I find the dual level risk committee structure to be theoretically ideal as it would create two distinct *fora* to better incorporate inputs from the many constituencies of a DCO. However, I encourage the Commission to further explore the idea of embracing more prescriptive language and requiring not simply the creation of the RMC as an advisory committees to the Board of Directors, which includes representatives of clearing members and customers of the clearing members, but also requiring DCOs to have a board-level risk committee that is composed of a majority of independent directors – i.e. directors with no material relationships with the DCO, its affiliates, and its controlling shareholder(s) – that is responsible for oversight of the DCO's risk management. In addition, I strongly encourage the Commission to evaluate the merit of strengthening the decision-making process for risk management related matters. For instance, "the Commission notes that while it believes that codifying an RMC consultation requirements will significantly enhance overall DCO risk management, a DCO's board of directors has the ultimate responsibility to make major decisions with respect to the DCO."¹¹ Notwithstanding

¹⁰ See Saguato, *The Hidden Costs*, *supra* note 3, at 1132-1139 (offering policy option to align clearinghouse shareholders and members incentives in the firm capital structure, and in recovery and resolution proceedings).

¹¹ See 17 C.F.R. § 39.24(a)(2) through (3).

this statement, I believe the Commission should consider requiring any DCOs to promptly report to the Commission any decisions where the board decides *not* to follow the advice of the RMC (or more critically a board-level risk committee) and to provide a comprehensive explanation for that decision.¹²

On the matter of board composition and independent directors, I encourage the Commission to explore the opportunity to align its novel governance requirements for DCOs with the SEC's novel proposed rule on clearing agencies (CAs) and also consider the current regulatory framework set in the European Union for central counterparties ("CCPs") in the European Financial Market Infrastructure Regulation ("EMIR") and its implementing delegated and technical regulations when developing any future rulemakings.

More technically, the Commission asked for comments on the rotation requirements for members of the RMC. Members of the RMC should not be subject to fixed term rotations, but each DCO should have the authority to set the membership terms and limits. However, a possible alternative could be structuring the RMC as staggered committee, with member being elected or appointed in different years. DCOs would benefit in having RMC's members with longer terms who can contribute and develop institutional knowledge of the firm and that have the incentive to invest time and resources in their important role. DCOs could be delegated the authority to set the terms for the members of the RMC and the RWG, to set the criteria for a fair representation of members and end-users on the committee taking into account the financial exposure that members have to the DCOs.

(ii) *Fitness standards for risk management committee(s) members §39.24 (c)*

I support the Commission's proposal to require a DCO to establish and enforce appropriate fitness standards for the members of the risk management committee(s). This would ensure that committee(s) members have the skills and incentives to support the operations of the DCO.

While outside the scope of the current proposed rule, yet in the spirit of harmonizing the DCOs regulatory framework with the new proposed SEC's regime for clearing agencies, I encourage the Commission to evaluate the merit of including, in addition to the "fitness standards" for members, directors of a DCO or for one or more of its committees, an "independence" requirement; in other words, a requirement that the majority of the directors of a DCO are not affiliated with the DCO and its owner(s). Implementing such a recommendation would result in a novel § 39.24 (d) that would embrace a definition of "independence" that would at least encompass all those people who do not have a material relationship with the registered DCO, or an affiliate of the registered DCO, or who is a director, or employee of the controlling shareholder of the DCO. In addition, § 39.26 would need to be amended to require that the governing board and board level committee of DCOs should be composed of a majority of independent directors.

This recommendation to the Commission to broaden the regulatory initiatives on the governance of DCOs is justified by the misaligned incentives between (1) DCOs and their owners and (2) participants. Participants provide clearinghouses with loss absorbing financial resources (i.e. margin and guaranty fund contributions) and are contractually bound to support the clearing business with additional contributions (i.e. assessment contributions) if the pre-funded resources were not sufficient to absorb the losses of the default of one or more of the clearing members. DCOs and their owners, meanwhile, have limited levels of financial resources committed to the resilience of the firm. This unbalanced capital structure does contribute to moral hazard in decision making by DCOs. And

¹² See Regulation 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC Derivatives, Central Counterparties and Trade Repositories (EMIR), 2012 O.J. (L 201) 1, 70, Article 28 – Risk Committee; see Sagunto, *The Hidden Costs*, *supra* note 3, at 1131.

these misaligned incentives can be even further exacerbated by the existing potential tension between the public policy role bestowed on clearinghouses as systemic risk buffers and the for-profit nature of the financial conglomerates to which some DCOs belong. Specifically: on one side, they have been entrusted to act as risk managers and they nurture a risk management culture, but on the other side, being for profit corporations, they need to generate profits for their shareholders by taking on some forms of risks.

Despite the good practices and performance of existing DCOs, which have proven being critical and reliable infrastructures for the derivatives markets, I encourage the Commission and its Market Risk Advisory Committee, DCOs, and market participants to continue with their efforts to support efficient, resilient, and accountable derivatives markets that function as an engine for the economy.

Thank you for the opportunity to comment on this important Proposal. If the Commission or staff have any questions and are interested in further discussing these issues, please do not hesitate to contact me at psaguato@gmu.edu. I look forward to continuing a dialogue with the Commission on derivatives clearing organizations and our nation's derivatives markets more broadly.

Sincerely,



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