



March 15, 2011

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

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington DC 20549-1090

Re: CFTC 17CFR Parts 1, 37, 38, 39, 40 RIN 3038-AD01. Governance Requirements for Derivative Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities; Additional Requirements Regarding the Mitigation of Conflicts of Interest; and SEC 17CFR Part 242 RIN 3235-AK74 File No. S7-27-10. 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.

Dear Sir/Madam Secretaries,

This letter updates our November 2010 public submission statement as certain information such as additional relevant proposals, comment letters, conference and roundtable information were not available at the time of its publication.

The SDMA largely supports Title VII of the Dodd-Frank Act and commends the extensive hours of due diligence and follow-through by both chambers of Congress, regulators and staff to make the legislation an effective document.

The SDMA is a non-profit financial markets trade group formed in January 2010 of United States and internationally based broker-dealers, investment banks, futures commission merchants and asset managers participating in all segments of the exchange-traded and over-the-counter derivatives and securities markets.

I. Introduction

Voting power and governance of Central Counterparty Clearing Houses (“CCPs”) for OTC Derivatives are too restrictive and must have balanced and fair representation. The SDMA believes the Mitigation of Conflicts of Interest sections of Title VII of the Dodd-Frank Act are critical to the success of clearing, especially with respect to:

- 1) Market Participants: Increased competition in execution and clearing;
- 2) Cleared Products: Increased number of clearable types of swaps and derivatives; and
- 3) Clearing Member & Participant Requirements: Objective, transparent and non-arbitrary initial and ongoing qualifications.

The Dodd-Frank Act (“DFA”) creates a new comprehensive regulatory framework for interest rate and security-based swaps in which CCPs play a key role. The DFA amends the Commodity Exchange Act (“CEA”) and the Securities Exchange Act of 1934 to require mandatory clearing of interest rate and security-based swaps, respectively, which provide that it shall be unlawful for any person to trade an interest-rate swap or security-based swap unless that person submits such swap for clearing to a CCP, if those swaps are required to be cleared.

Under no circumstance should CCPs be permitted to undermine the goals of DFA. Because CCPs and their Risk Management Committees have been given broad power to determine what will be cleared and who will be permitted to clear, the CCP must be required to fulfill this role through fair dealing, open access to membership, transparency in governance and nondiscriminatory behavior.

CCPs are private entities that have a fiduciary duty to enhance their shareholder’s value. More importantly, CCPs serve a broader public role as the gatekeepers to clearing as they determine what is cleared, margin requirements and who may participate in the clearing house. Since their inception clearing houses have played a vital role in the market by managing the default risk of counterparties and spreading that risk across its members. This system is most effective when the group of clearing members is large and non-correlated, and conversely, least effective when the group is small and correlated. Where there is a small number of correlated members the default of a member has a greater chance of causing the default to spread to other clearing members. By creating barriers to membership to protect entrenched interests and limiting membership to a small correlated group, CCPs are increasing systemic risk.

As discussed below, the SDMA supports the CFTC and SEC proposals because they address the need for objective standards, open access, and transparency in the OTC derivatives markets. We believe they are consistent with the core principles of the DFA to help ensure the successful addition of execution-only broker/dealers, qualified clearing members and participants who will increase liquidity and diversify systemic risks.

II. Clearing Houses (CCPs): CFTC Regulated Derivatives Clearing Organizations (Interest Rate Swaps & Broad-Based Credit Indices) and SEC Regulated Security-Based Swap Clearing Agencies (Single Name Credit Default Swaps)

The following sections list the regulatory proposals as procured from the Federal Register in table format followed by the SDMA’s recommendations with the main focus on CCPs as they importantly represent the central nexus of access in the cleared OTC derivatives marketplace.

A. Clearing House (CCP) Voting Power: Direct & Indirect Limitation on Voting Equity Ownership & Exercise of Voting Rights

Regulatory Proposals	Individual Aggregate	Collective Aggregate
<p>CFTC First Alternative</p>	<p>20% max by clearing member and/or enumerated entity and its related persons</p>	<p>40% collective max by all clearing members and/or enumerated entities and its related persons</p>

CFTC Second Alternative	5% max by clearing member and/or enumerated entity & its related persons	None proposed because of 5% cap in the individual aggregate
SEC Voting Interest Alternative	20% max by clearing agency participant and its related persons.	40% collective max by all clearing agency participants and its related persons.
SEC Governance Focus Alternative	5% max by clearing agency participant & its related persons	None proposed because of the 5% cap in the individual aggregate

Recommendation: The SDMA supports the CFTC’s First Alternative proposal that limits voting power to a 40% collective aggregate maximum by all clearing members and/or enumerated entities and their related persons.

This proposal allows for the inclusion of both clearing and non-clearing members and participants. Such a proposal would increase and diversify the number of non-correlated firms shouldering the risk and controlling access.

Current CCP voting structures are not representative of the market, lack transparency, limit access and can lead to poor decisions made on incomplete data. For example, if the Commissions adopted the 5% individual aggregate maximum, a mere 11 member majority (11 members x 5%) could exert a highly correlated controlling block of voting power.

B. Clearing House (CCP) Board of Directors and any Executive or Authoritative Arm Thereof

CFTC First and Second Alternatives	35% min Independent Directors with two total minimum being Independent Directors
SEC Voting Interest Alternative	35% min Independent Directors
SEC Governance Focus Alternative	51% min Independent Directors

Recommendation: The SDMA supports the SEC Governance Focus Alternative that is consistent with the core principles of the Act. It is well established in many industries that qualified and experienced independent directors play a valuable and important role in bringing integrity and fair market representation to the corporate organizational structure. Likewise within the CCP context, it is important that they remain truly representative of the marketplace and maintain neutrality amongst competing market interests.

Discussed below, to act efficiently as arbiter, material CCP committees should seek to include truly independent representation and properly reflect the market as a whole. CCP committees should be transparent and open up to include participation from independent dealers and clearing firms as well as buy-side participants and swap execution facilities (“SEFs”).

C. Clearing House (CCP) Risk Management Committee and Subcommittees

CFTC First and Second Alternatives	35% Independent Directors with sufficient clearing expertise, 10% Customers of clearing members
SEC Voting Interest Alternative	35% min Independent Directors
SEC Governance Focus Alternative	51% min Independent Directors

Recommendation: The SDMA supports a solution that has an independent Chair, a majority of independent directors, buy-side clients, SEFs and academic representation, as it would ensure more objectivity and greater probability of the success of central clearing.

The Risk Management Committee determines several important matters crucial to fair and open access such as:

- 1) Initial and Continuing Membership & Participant Criteria
- 2) Swap Eligibility for Clearing
- 3) Proper Risk Model and Default Procedures

To date, clearing members and participants have been exclusively enumerated entities that are too few in number and not representative of the cleared marketplace. Predictably, such participants have limited access to clearing at the expense of market integrity.

1. Historical Limited Access to Clearing

Initial and Continuing Membership & Participant Criteria are good examples of how access has been limited. These include:

- a. Exclusionary Capital Requirements: CCPs should not be permitted to place unreasonable capital requirements on members. Capital should be directly proportional to the risk a member introduces to the system.

We support the CFTC and SEC’s position that a clearing firm’s minimum capital be closer to \$50mm than to the \$1bn or \$5bn as presently required. For example, it is worth remembering that Lehman and Bear Stearns would have met the \$1bn threshold until the days of their failure.

- b. Arbitrary Sophistication Standards: Clearing member sophistication standards such as volume thresholds and the pre-existence of a swap portfolio as a condition of admission are unnecessary. For example, LCH Clearnet requires a firm to have a \$1 trillion swap book as a membership prerequisite. Consequently, it would be impossible for a firm to acquire a \$1 trillion swap book if it could not trade or clear the product in the first place.
- c. Default Management Process: Clearing members should not be required to operate swap dealer desks just so they can meet their actionable quote and auction pricing obligations in the default management process. Such

requirements can easily be met contractually through third party agreements with independent dealers. Moreover, as SEFs become more liquid, they will play a larger role in the transparent pricing of swap positions in the default management process.

- d. Artificial Linkage of Clearing & Execution: Broadly speaking, artificial constructs that link clearing to execution should be seen for what they are - transparent attempts to limit competition. Such linkages decrease market place liquidity by limiting the number of dealers to all but a few self-clearing participants. Such a construct also dangerously increases the market's systemic risk by restricting clearing member access to all but a few highly correlated players.
- e. Lack of 'Execution Blind' Access. Importantly, certain CCPs that are not truly representative of the market have even sought to limit the method by which trades are executed.

Recently, these CCPs have required that one side of an OTC swap be done only with the execution desk of one of its constituent clearing members. Such a restriction is clearly discriminatory, contrary to the express language of the Dodd Frank Act, and denies access to non self-clearing dealers and buy-side customers who wish to trade directly with themselves.

2. Key Issues of Representation and Undue Influence

a. Customer (Buy-Side) Representation

In reviewing Blackrock's November 15, 2010 letter to the CFTC regarding CCP governance and voting power and more specifically in reference to the default fund, the SDMA agrees with and finds justification for increased buy-side representation on the Risk Management Committee from the following excerpt:

"Under the current central counterparty clearing house ("CCP") structure, when a futures commission merchant defaults, client collateral funds are depleted before the CCP's default fund is tapped."

In other words, buy-side clients essentially are first-loss equity holders while clearing firms assume less risk by effectively being in the tranche above them in the model's waterfall. Consequently, appropriate buy-side representation is mandatory.

b. Credit Default Swap Clearing House (CCP) Influence

Examples of Risk Management Committee power in the credit default swap market are evident in the amount of cleared transaction volume that has gone exclusively through the Intercontinental Exchange (ICE). As of March 11, 2011, ICE has cleared over \$14 trillion CDS contracts vs. the CME's total of \$236mm CDS contracts, a staggering ratio of approximately 60,000 to 1, even though both were mandated for central clearing in March 2009 and have the same Risk

Management Committee members. The major difference is an economic one. The arrangement is that ICE takes half of the profits of the CCP itself and the other half is split by the nine founding banks. CME has no such arrangements and is subject to trading caps by the very same banks that reap profits at ICE.

Additionally, this construct creates a competitive advantage for the founding banks over new members to ICE as well to all the members of the CME. It also provides them with a significant cost advantage by allowing the founders essentially to subsidize their businesses with the fees of other members who don't hold the same position.

If we are to promote increased competition at the CCPs, especially within the Risk Management Committees, then appropriate checks and balances must be in place. Furthermore, this data reflects exactly what the CFTC and SEC are trying to avoid, namely a small number of participants exercising undue influence over a CCP. In this case, a small number of Risk Management Committee members are actually exerting tremendous influence over at least two CCPs.

c. Composition Requirements and Reporting

Regarding composition requirements and reporting as well as gaming the rules surrounding open access, membership and the acceptance/rejection of products for clearing, the SDMA believes the Commission's final rules should include that:

- i. any Risk Management Subcommittee composition be identical to the Risk Management Committee makeup and vice versa;
- ii. any Risk Management Subcommittee recommendation that is rejected or superseded by the Risk Management Committee has to be reported to the CFTC and/or SEC, as appropriate;
- iii. any recommendation by the Risk Management Committee or any Subcommittee of the Board that is rejected or superseded by the Board has to be reported to the CFTC and/or SEC, as appropriate; and
- iv. procedures need to be written and enforced accordingly regarding the above listed items.

D. Clearing House (CCP) Nominating Committee

CFTC First and Second Alternatives	51% min Independent Directors with an Independent Chair
SEC Voting Interest Alternative	51% Independent Directors
SEC Governance Focus Alternative	100% Independent Directors

Recommendation: The Nominating Committee identifies individuals qualified to serve on the Board of Directors and administers a process for nomination to the Board. The SDMA supports the CFTC First and Second Alternative proposals that would also include the buy-side, SEFs and academics. Making it a majority independent committee with an

Independent Chair and legitimate industry representation protects the integrity of the decision process by striking a balance between the inputs and concerns of all parties.

E. Clearing House (CCP) Disciplinary Panel

CFTC First and Second Alternatives	Minimum one Independent Director with an Independent Chair
SEC Voting Interest & Governance Focus Alternatives	Balanced with one Independent Director

Recommendation: The Disciplinary Panel's responsibilities are to conduct hearings, render decisions and impose sanctions on disciplinary matters. The SDMA supports the SEC Voting Interest and Governance Focus Alternative proposals that would also include other market participants such as the buy-side, SEFs and academics. This would insure proper procedures would be followed before and after a decision is rendered to keep the market and organizational integrity of the CCP intact.

III. Conclusion

Any waiver of voting power limits as mentioned in the Federal Register once adopted is not recommended unless it can be proven that without them the following has been improved: 1) governance, 2) systemic risk mitigation, 3) competitive fair and open access as evidenced by more executing-only broker/dealers and qualified clearing firms, and 4) more products eligible for clearing.

The SDMA's recommendations set forth in this letter point to the necessity for the CFTC and SEC to jointly issue rules and regulations for CCPs, DCMs, SEFs and Exchanges. Anything less will cause confusion and create loopholes; especially when trying to harmonize with international regulatory bodies.

We appreciate the opportunity to comment on these important issues and look forward to working with the Commissions to implement the Dodd-Frank Act and its subsequent rules and regulations. If you have any questions or need additional information please contact the Swaps & Derivatives Market Association at mhisler@thesdma.com or visit our website at www.thesdma.org

Sincerely,



Mike Hisler
Co-Founder
The Swaps & Derivatives Market Association