

**THE OPTIONS CLEARING CORPORATION**

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April 26, 2011

**Via Electronic Mail**

Ms. Elizabeth A. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549-1090  
[rule-comments@sec.gov](mailto:rule-comments@sec.gov)

**Re: 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 Ms. Murphy:

This letter is submitted by The Options Clearing Corporation (“OCC”) in response to the Commission’s recent release<sup>1</sup> reopening the comment period on its previous release (the “Release”)<sup>2</sup> requesting comment on proposed rules (the “Proposed Regulation MC Rules”) mitigating conflicts of interest at registered securities clearing agencies that clear security-based swaps (“Security-Based Swap Clearing Agencies”), security-based swap execution facilities, and national securities exchanges that list security-based swaps for trading.<sup>3</sup> The Commission has reopened the comment period on the Proposed Regulation MC Rules to allow interested parties to comment in light of a subsequent proposal on “clearing agency standards for operations and governance” (the “Proposed Clearing Agency Standards”).<sup>4</sup> The Proposed Clearing Agency Standards also include provisions designed to address conflicts of interest at Security-Based Swap Clearing Agencies. Our comments are limited to those aspects of the Proposed Regulation MC Rules that affect clearing agencies. We submitted a comment letter in response to the

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<sup>1</sup> 76 FR 12645 (March 8, 2011).

<sup>2</sup> 75 FR 65882 (October 26, 2010).

<sup>3</sup> The Proposed Regulation MC Rules are being promulgated pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203.

<sup>4</sup> 76 FR 14472 (March 16, 2011).

Proposed Regulation MC Rules on November 22, 2010 (the “Initial SEC Comment Letter”), a copy of which is attached.

## The Proposed Clearing Agency Rules

### *Governance and Conflicts*

Proposed rule 17Ad-22(d)(8) under the Proposed Clearing Agency Rules would require each clearing agency to “[h]ave governance arrangements that are clear and transparent to fulfill the public interest requirements in section 17A of the [Exchange] Act applicable to clearing agencies, to support the objectives of owners and participants, and to promote the effectiveness of the clearing agency’s risk management procedures.” Furthermore, Proposed Rule 17Ad-25 would require “[e]ach clearing agency [to] establish, implement, maintain and enforce written policies and procedures reasonably designed to identify and address existing or potential conflicts of interest.” These policies and procedures would be required to “be reasonably designed to minimize conflicts of interest in decision making by the clearing agency.” We believe Proposed rule 17Ad-22(d)(8) is reasonable and should be an effective tool to allow the Commission to effectively mitigate clearing agency conflicts of interest. The simplicity and flexibility of this proposed rule stands in stark contrast to the highly prescriptive Proposed Regulation MC Rules, and we believe should be adopted *instead of* those rules.

As proposed, the Commission will have many different tools at its disposal to address the mitigation of conflicts of interest in the governance of clearing agencies, including governance standards, ownership limitations, requirements for fair and open access, the Commission’s own rule approval process, and the Commission’s oversight of clearing agencies generally. Clearing agencies need to have flexibility to deal with the very different potential conflicts of interest that arise as a result of their different ownership structures, memberships, clearing functions and other circumstances. We refer the Commission to our Initial SEC Comment Letter, which sets forth our objections to many of the Proposed Regulation MC Rules.

### *Standards for Board or Board Committee Members*

Proposed Rule 17Ad-26 includes governance and board composition requirements that we believe are flexible and reasonable and that will be effective in combating clearing agency conflicts of interest. In the Proposed Clearing Agency Rules, the Commission invited comment on possible more detailed proposals for Commission oversight of clearing agency boards and board committees. Our Initial SEC Comment Letter includes a proposed “fair representation” model for clearing agency board composition that we believe effectively addresses the potential conflicts of interests faced by OCC, and we believe that such a structure could be an effective alternative for other clearing agencies as well.

Conclusion

OCC appreciates the opportunity to comment on the Proposed Rules. We would be pleased to provide the Commission with any additional information or analysis that might be useful in determining the final form of the Proposed Rules.

Sincerely,

A handwritten signature in dark ink, appearing to read 'Wayne P. Luthringshausen', written over a horizontal line.

Wayne P. Luthringshausen  
Chairman and  
Chief Executive Officer

Encl.: OCC Comment Letter, dated November 22, 2010 on Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies Under Regulation MC (S7-27-10)

cc: Mary L. Schapiro  
Chairman  
Securities and Exchange Commission

Kathleen L. Casey  
Commissioner

Elisse B. Walter  
Commissioner

Luis A. Aguilar  
Commissioner

Troy A. Paredes  
Commissioner

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November 22, 2010

**Via Electronic Mail**

Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F St., N.E.  
Washington, D.C. 20549-1090  
[rule-comments@SEC.gov](mailto:rule-comments@SEC.gov)

**Re: S7-27-10 Ownership Limitations and Governance Requirements for  
Security-Based Swap Clearing Agencies Under Regulation MC**

Dear Ms. Murphy:

This letter is submitted by The Options Clearing Corporation ("OCC") in response to the Commission's recent release (the "Release")<sup>1</sup> requesting comment on its proposed rules (the "Proposed Rules") for mitigating conflicts of interest at registered securities clearing agencies that clear security-based swaps ("Security-Based Swap Clearing Agencies"), security-based swap execution facilities, and national securities exchanges that list security-based swaps for trading. The Commission is promulgating the Proposed Rules, which are proposed to be incorporated in a new Regulation MC, in response to the mandate of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").<sup>2</sup>

Our comments are limited to those aspects of the Proposed Rules that affect Security-Based Swap Clearing Agencies. We recognize that the Proposed Rules are similar to conflict of interest rules recently proposed by the Commodity Futures Trading Commission ("CFTC"),<sup>3</sup> and we applaud the efforts of the two agencies to coordinate their rulemaking activities in this area. In addition to being a securities clearing agency subject to Section 17A of the Securities Exchange Act of 1934 (the "Exchange Act"), OCC is a derivatives clearing organization ("DCO") registered as such under the Commodity Exchange Act (the "CEA"). OCC

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<sup>1</sup> 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, 75 FR 65882 (October 26, 2010).

<sup>2</sup> Public Law 111-203.

<sup>3</sup> See Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 FR 63732 (October 18, 2010).

would therefore potentially be subject to the CFTC's proposed conflict of interest rules. Accordingly, on November 17, 2010 we submitted a comment letter to the CFTC that was substantially similar to this comment letter (the "CFTC Comment Letter"). A copy of that letter is attached as Appendix II to this letter.

### Executive Summary

OCC employs a not-for-profit, market utility model through which it acts as the clearing organization for multiple exchanges. OCC's business model has been widely praised as representing an ideal for the industry. OCC provides its clearing members with efficient, low-cost clearing services and superior risk management, thereby benefitting customers and the public. OCC's governance structure was carefully designed with the participation of the Commission to provide fair representation to clearing members. OCC rules require that its "Member Directors" be representative of OCC's overall membership, which includes large and small firms, thus assuring that the largest firms (including those that are the largest dealers in OTC derivatives) do not control OCC's Board of Directors.

While we support the goals of the Commission's Proposed Rules and believe that the Release correctly identifies potential conflicts of interest, we believe that neither of the Commission's proposed alternative governance structures—the Voting Interest Focus Alternative (referred to herein as "Alternative I") or the Governance Focus Alternative ("Alternative II")—is appropriate to a clearing agency such as OCC that acts as a market utility. OCC believes, for the reasons discussed below, that its present governance structure is generally effective in addressing the potential conflicts of interest that are identified in the Commission's Release. Although OCC does not presently clear security-based swaps, OCC anticipates that it is likely to do so in the future and will therefore likely become subject to the Commission's Proposed Rules. However, as noted in our CFTC Comment Letter, OCC has no present plans to clear CFTC-regulated swaps and does not believe it should be subject to the CFTC's conflict of interest rules.<sup>4</sup> Because OCC has concerns with respect to the proposals of both agencies as to their potential adverse consequences for OCC and other clearing organizations that might adopt a similar market utility model for providing clearing services, we have developed a "fair representation" alternative that we believe would be a more appropriate and effective means for such clearing organizations to address the types of conflicts identified in the Release. We urge both agencies to provide for such an alternative.

As discussed in more detail below, we believe that the Proposed Rules as drafted are too prescriptive, are incompatible with a fair representation model, and are likely to lead to significant unintended consequences. Among our specific concerns are the following:

- The requirement that independent directors must comprise either 35% (Alternative I) or 51% (Alternative II) of the board would result in a dilution of representation of clearing members, who are the constituents with the greatest interest in maintaining a market-utility model. Dilution of their interest will likely have adverse consequences for such a model.

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<sup>4</sup> Unlike the SEC's Proposed Rules, the CFTC's proposed rules would be applicable to all DCOs, whether or not they clear swaps. We believe that in making this proposal, the CFTC has overstepped the mandate of Dodd-Frank. As OCC does not propose to clear swaps and since less than 1% of its clearing activity involves products within the jurisdiction of the CFTC, OCC has strongly urged that it not be made subject to the CFTC's proposed rules.

Notwithstanding the foregoing, OCC believes that independent directors make an important contribution to the board of a clearing organization, and suggests that a standard of as much as 20% would be consistent with a fair representation model.

- Conflicts of interest can be effectively controlled by requiring that directors representing clearing members be representative of a diverse group of large and small firms and different types of business models.
- The Commission's proposed composition requirements for committees, including risk committees, that have the authority to act on behalf of the board are too broad and should be more narrowly focused on mitigation of the most significant potential conflicts that have been identified. A risk committee, for example, should not be required to have either 35% or 51% independent directors, who are unlikely to have the necessary practical experience or the availability or involvement to deal effectively with crises. We support the CFTC's proposed alternative of allowing a clearing organization to apply the composition requirements only to a subcommittee of the risk committee that would make decisions as to whether or not to clear particular products, set membership standards and approve membership applications. This approach is, in our view, workable with the suggested reduction of the independent director requirement to 20% in the case of the fair representation alternative (although so long as the requirement applies only to a subcommittee with the limited functions identified, a higher percentage requirement could be workable).
- We do not believe that it is necessary or desirable to limit the percentage of ownership or voting rights that clearing members may have in a Security-Based Swap Clearing Agency if the clearing agency has governance standards meeting the requirements of an appropriate fair representation model. The imposition of such a limitation could be adverse to a nonprofit market utility clearing model because clearing members and participating exchanges are the only parties likely to invest in such a clearing organization. Limiting ownership by members could make such models very difficult to establish and maintain. OCC's experience demonstrates that it is possible to adopt and maintain a governance structure where stockholders are represented but the board is not controlled by them.

We have described below, and summarized in Appendix I to this letter, requirements that could be added to the Proposed Rules as an alternative available to Security-Based Swap Clearing Agencies that are operated on a not-for-profit, market utility model. While requiring OCC to add some additional independent directors, adoption of these standards would allow OCC to comply while maintaining the basic governance structure that has served it well throughout its history. Such an alternative would also allow other clearing organizations to be created on the same model.

### Discussion

We believe the Commission has correctly identified the three areas of decision-making in which a conflict of interest of participants who exercise undue control or influence over a Security-Based Swap Clearing Agency could adversely affect the clearing agency: (1) decisions regarding access to the clearing agency, either through direct participation or indirect access

through correspondent clearing arrangements, (2) decisions regarding the products eligible for clearing, and (3) decisions regarding the amount of margin or guaranty fund contributions required to be made by participants in the clearing agency.<sup>5</sup> While we support the Commission's determination to carry out the mandate of Dodd-Frank by addressing these important issues, we are concerned that the Proposed Rules are overly prescriptive and could have significant unintended consequences for the market-utility model of providing clearing services. We applaud the Commission for limiting its Proposed Rules to those clearing agencies that actually clear security-based swaps. The CFTC has proposed that its corresponding rules addressing conflicts of interests with respect to DCOs should apply to all DCOs without regard to whether they clear swaps, which is a view we opposed in our CFTC Comment Letter. We believe that the CFTC's proposed approach overreaches its statutory mandate under Dodd-Frank and that the Commission's approach is both more appropriate and more consistent with Dodd-Frank's mandate. Nevertheless, we respectfully request that the Commission consider adopting a "fair representation" model in coordination with the CFTC. We made the same request of the CFTC in our CFTC Comment Letter.

Note that although OCC is planning to clear OTC options based on broad-based security indices, such instruments are excluded from the definitions of "swap" and "security-based swap" under Dodd-Frank because they are subject to the Exchange Act and the Securities Act of 1933, as amended.<sup>6</sup> The Commission's Proposed Rules would not capture such clearing activities, however, OCC anticipates that at some point in the near future it will seek to clear security-based swaps and therefore will be considered a Security-Based Swap Clearing Agency within the meaning of the Proposed Rules.

#### OCC Background Information

Founded in 1973, OCC is currently the world's largest clearing organization for financial derivatives. OCC is the only clearing organization that is registered with the Commission as a securities clearing agency pursuant to Section 17A of the Securities Exchange Act of 1934 (the "Exchange Act") and with the CFTC as a DCO under Section 5b of the CEA. OCC clears securities options, security futures and other securities contracts subject to the Commission's jurisdiction, and commodity futures and commodity options subject to the CFTC's jurisdiction. OCC clears derivatives for all nine U.S. securities options exchanges and five futures exchanges.<sup>7</sup> It has operated safely and effectively for over 35 years, including through the market crises in 1987 and 2008, mitigating systemic risk associated with derivatives trading.

OCC has always been operated as a non-profit market utility. Each year OCC returns to its clearing members the excess of clearing fees received over its operating costs plus an amount reasonably required to be retained as additional capital to support its clearing activities. Identical contracts traded on more than one OCC-cleared exchange are fungible in clearing member

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<sup>5</sup> 75 FR 65885.

<sup>6</sup> See CEA § 1a(47)(B)(iii) (as amended by § 721(a)(21) of Dodd-Frank), effective July 15, 2011.

<sup>7</sup> The participating options exchanges are BATS Options Exchange, C2 Options Exchange, Inc., Chicago Board Options Exchange, Inc., International Securities Exchange, NASDAQ OMX BX, Inc., NASDAQ OMX PHLX, Nasdaq Options Market, NYSE Amex Options, and NYSE Arca Options. OCC clears futures products traded on CBOE Futures Exchange, NYSE Liffe U.S., NASDAQ OMX Futures Exchange and ELX Futures, as well as security futures contracts traded on OneChicago.

accounts at OCC. This model fosters competition among execution venues while minimizing clearing costs. Price competition among execution venues and low clearing costs, in turn, lower the cost of trading for public customers. OCC believes that its clearing fees—averaging 1.8 cents per trade side—are the lowest of any derivatives clearinghouse in the world.

### OCC's Ownership and Governance Structure

OCC is owned equally by five options exchanges<sup>8</sup> and currently has approximately 120 clearing members. OCC's Board of Directors has 16 members consisting of nine clearing member directors ("Member Directors"), five directors nominated by the stockholder exchanges ("Exchange Directors"), one director who is not affiliated with any national securities exchange, national securities association, or broker or dealer in securities (the "Public Director") and the Chairman of OCC (the "Management Director"). While the Member Directors control the Board (with 9 of 16 seats), OCC rules require that Member Directors be representative of OCC's overall membership, which includes large and small firms, thus assuring that the largest firms (including those that are the largest dealers in OTC derivatives) do not control the Board.

Directors are ineligible to serve on OCC's Nominating Committee, which nominates both Member Directors and members of the next year's Nominating Committee, and no person associated with the same firm as a member of the Nominating Committee may be nominated as a Member Director or a member of the next year's Nominating Committee.

OCC's Membership/Risk Committee is composed of the Management Director, the Public Director, and five Member Directors. This committee manages the risk of the clearinghouse, including making decisions on clearing membership. All clearing members must meet certain requirements regarding financial responsibility, operational capability, and experience and competence. Each clearing member must have an initial net capital of \$2,500,000 prior to being admitted, and in order to have contracts cleared, members must maintain a minimum of \$2,000,000 net capital, with increasing margin requirements for positions not adequately supported by capital. The committee's composition guarantees that the directors making critical risk management decisions not only have the required expertise to do so, but also that the committee is composed of members with a financial stake in the decisions made. The quality of OCC's risk management is reflected in the fact that OCC was the first clearing organization to receive a AAA credit rating from Standard and Poor's, which recently noted that OCC's financial safeguards functioned particularly well during the times of extreme market volatility in 2008 and 2009.<sup>9</sup>

OCC's carefully designed governance structure has allowed OCC to operate as a market utility, providing low cost clearing services to its members, while maintaining open access to members that meet OCC's membership requirements but ensuring that margin levels are set at appropriate levels to manage risk in a cost-effective manner.

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<sup>8</sup> Two of OCC's stockholder exchanges—NYSE Amex Options and NYSE Arca Options—are under common ownership.

<sup>9</sup> Standard and Poor's, *Full Analysis, Options Clearing Corporation* (March 12, 2010).



### OCC's Concerns with Proposed Board and Committee Composition Requirements

As noted above, OCC believes the proposed governance rules are too specific and prescriptive to be appropriate in all cases, and they are not appropriate in OCC's case. We have identified below the specific aspects of the Proposed Rules that we find to be ill suited to a fair representation model.

Public Directors. Where, as in OCC's case, a clearinghouse operated as a market utility provides significant board representation for stakeholders other than clearing members, adding sufficient numbers of independent directors to meet the Commission's proposed 35% standard can unduly dilute clearing member influence on the board. This can in turn threaten the market utility model. Member directors have the strongest interest in the preservation of the market utility model because they represent clearing members who not only bear the financial burden of systemic risk management, but also directly benefit from low cost clearing services and appropriate margin levels. Preservation of OCC's market utility model depends on maintaining the appropriate balance among OCC's various constituencies. As you are no doubt aware, OCC's governance structure was carefully constructed with the active participation of the Commission to balance competing interests among large and small clearing members, clearing members representing different business models, and the stockholder exchanges (which compete with each other). Increasing the independent director requirement means that both small and large clearing firms would have a diminished role.

OCC recognizes that independent directors can play a constructive role on a clearing organization's board of directors. There are talented and knowledgeable candidates available to serve this function, and they generally provide a perspective independent of the self-interest of any particular constituency. However, independent directors—regardless of how experienced and knowledgeable they may be—are not a magic bullet to cure all conflict of interest issues. While independent directors are useful, they should not have so large a presence on a board that fair representation of a broad spectrum of the clearing membership is compromised. We believe this would be the case if OCC were required to have 35% or more of its board comprised of independent directors.

As noted above, there is no reason to force OCC to make a destabilizing change in the balance of its Board of Directors and committees when the balance has worked so well. OCC believes there are other options available to address the Commission's concerns regarding potential conflicts of interest that are more compatible with a market-utility model.

We also believe that the required percentage of independent directors should be affected by the presence on the board of directors who, while they have a business interest in the clearing organization, also have potentially different interests from the interests of clearing members. OCC's Exchange Directors, who represent the stockholder Exchanges, are an example. Such directors may be seen as quasi-independent because they do not fall within the bright line exclusion from the Commission's proposed definition of "independent director" even though they are not fully disinterested. While Exchange Directors have an interest in OCC, their interest is not the same as the interest of Member Directors—especially Member Directors whose firms are security-based swap dealers. Exchange Directors have no interest in excluding smaller firms from membership or in setting membership or margin requirements at levels higher than required for

prudential reasons, nor are they motivated to protect markets conducted other than on exchanges. Where such directors are present, they make the 35%/51% independent director standards not only less necessary but also more cumbersome to apply, both because their presence increases the size of the board before any independent directors are added, and because they increase the number of independent directors needed to comprise the required percentage of the entire board.

Nominating Committee. Under the Proposed Rule, a Security-Based Swap Clearing Agency's nominating committee would be required either to have a majority of independent directors (Alternative I) or to be comprised solely of independent directors (Alternative II).<sup>10</sup> This nominating committee would be required to "identify individuals qualified to become Board members through a consultative process with the participants of the security-based swap clearing agency consistent with criteria approved by the Board and consistent with the provisions of [the rule], and administer a process for the nomination of individuals to the Board."<sup>11</sup> In OCC's case, this requirement is incongruous. OCC's nominating committee nominates only Member Directors. The Exchange Directors are selected by the respective stockholder exchanges that they represent with no role for the nominating committee. OCC's Public Director is currently nominated by the Chairman of the Board of Directors, with the approval of the Board. We would prefer that the Proposed Rules be modified to preserve OCC's ability to use its present method of nominating and approving independent directors. In the alternative, independent directors could be selected by a nominating committee consisting of other independent directors.

Risk Committee. The Proposed Rule would require a Security-Based Swap Clearing Agency, to the extent the clearing agency delegates to any committee, including a risk committee, authority to act on behalf of the board, to ensure that such committee is comprised of either 35% or a majority of independent directors (depending on whether Alternative I or Alternative II is applicable).<sup>12</sup> Unlike the CFTC's proposed rules, the Proposed Rule would neither mandate that the clearing agency maintain a risk committee to perform certain specified functions, nor would it require that such a committee, if formed, include representatives of customers. The Proposed Rule would not require that the chairman of a risk committee be an independent director. We applaud the Commission's more flexible approach to the use of a risk committee, although we believe that the independent director requirement is too large under either Alternative I or II if it is applied to the entire risk committee as well as other committees.

Risk committees are tasked with handling market/financial crises, as well as less momentous issues that nevertheless may need to be addressed on short notice. A risk committee therefore needs authority to act on behalf of the Board and therefore would be subject to the same independent director composition requirements (either 35% or majority, depending on which alternative is applicable) as the Board itself. We do not believe this is appropriate. Independent directors generally would lack necessary practical experience to deal with crises and have no "skin in the game." We believe member firms, and not independent directors, should therefore dominate any risk committee. We also believe strongly that any risk committee should be chaired by a representative of management and not an independent director. The Commission has wisely

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<sup>10</sup> 75 FR 65930, 31.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

allowed this under the Proposed Rules and we urge the Commission to retain this aspect of its proposal.

Rather than impose a 35% or 51% public director requirement on all committees with authority to act for the Board, we believe that it would be both more appropriate and more effective to address the most significant potential conflicts of interest in a more targeted way as the CFTC has proposed. The CFTC would allow a DCO to create a subcommittee to: (i) determine membership standards, (ii) approve or deny membership applications, and (iii) determine products eligible for clearing. Under the CFTC's proposal, such a subcommittee would itself be subject to the CFTC's composition requirements (which are substantially identical to the Commission's composition requirements), but would free the risk committee from those requirements. Under that alternative, OCC could retain its present risk committee composition and create such a subcommittee for the stated purposes.

The CFTC's proposal would require that 10% of the risk committee be composed of representatives of customers. For the reasons stated in our CFTC Comment Letter, we believe this requirement is not appropriate and applaud the Commission for not proposing a similar requirement.

Need for Exemptive Authority and Flexibility. The Commission notes in its Release that it would have authority under Section 36 of the Exchange Act to grant exemptions from any rule or any provisions of any rule under Regulation MC.<sup>13</sup> The CFTC included in its proposed rules authority to waive ownership and voting restrictions if the CFTC made certain findings, but it included no such authority to waive governance rules. We strongly believe that the Commission should be open to exercising its authority under Section 36 to grant exemptions from Regulation MC including both ownership/voting requirements and board/committee composition requirements where application of the rules' prescriptive requirements would not further the purposes of the regulation. The rigid and formulaic application of the Proposed Rules will certainly lead to unintended consequences if the Commission does not create needed flexibility by the judicious use of its exemptive authority. Indeed, OCC would require an exemption from the ownership requirements under either Alternative I or Alternative II for a very technical reason: the combined ownership in OCC of two affiliated exchanges exceeds 20% and one of them owns an OCC clearing member that it uses solely for the purpose of routing orders to other options markets. Although this situation was clearly not intended to be prohibited by the Proposed Rules, it appears that this could be the result because greater than 20% of OCC's equity ownership is technically held by affiliates of a clearing member.

#### *Suggested Fair Representation Model*

As mentioned above, OCC believes that the Proposed Rules are overly prescriptive. Security-Based Swap Clearing Agencies should retain the ability to demonstrate to the Commission that an alternative model effectively addresses the conflict of interest issues identified in the Release. If the Commission nevertheless prefers a more prescriptive and rules-based conflict of interest regime, we have proposed an alternative "fair representation" approach outlined in Appendix I. We believe this alternative would be effective in controlling the

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<sup>13</sup> Release at 65912.

particular conflicts of interest enumerated by the Commission while preserving sufficient member representation to be consistent with a fair representation model. A fair representation model is also consistent with the requirements of Section 17A of the Exchange Act, which requires all clearing agencies to have rules that “assure a fair representation of its shareholders (or members) and participants in the selection of its directors and administration of its affairs.”<sup>14</sup> OCC’s existing governance structure was carefully crafted to comply with Section 17A by ensuring that such fair representation is achieved.

The fair representation model set forth in Appendix I requires that at least 20% of the Board be comprised of independent directors, while requiring that at least 40% and not more than 60% of the Board consist of Member Directors. The remaining 20% to 40% of the Board could include representatives of non-member stockholders and exchanges or other execution facilities that submit transactions to the Security-Based Swap Clearing Agency for clearance.

Even though Member Directors could be up to 60% of the Board, they would be required to be representative of clearing members as a group. Because the fair representation model would be available only to firms that have, or (in the case of a start-up) can demonstrate a credible plan to have, at least 25 clearing members, this standard would be sufficient to ensure that the Security-Based Swap Clearing Agency is not dominated by a small group of large security-based swap dealers that can exclude other members for anti-competitive reasons.

OCC’s proposed provisions relating to nominating committees mirror OCC’s current By-Law provisions and reflect OCC’s experience that these rules work well to ensure balanced representation on the Board. Alternatively, the rule could simply require that a Security-Based Swap Clearing Agency have a nominating committee structure that is reasonably calculated to result in broad representation of clearing members and leave it to the regulatory process to determine whether a given proposal meets that standard. The Commission’s rules could also require that a Security-Based Swap Clearing Agency provide in its By-Laws a more specific standard for assuring a broad representation of member firms. Appendix I contains an example of such a formula. We believe it would not be appropriate for the Commission to attempt to adopt a highly prescriptive formula that would be applicable to all Security-Based Swap Clearing Agencies using the fair representation model.

We believe that it is critical that the overall composition and the chair of the risk management committee be left to the discretion of the Board. In OCC’s experience, this is a critical committee whose membership provides essential guidance and experience in setting overall risk management policy and handling crisis situations. We encourage the Commission to give the Board unfettered discretion in determining the composition of such a committee by allowing the composition standards to be applied only to a subcommittee charged with the specific tasks of determining product eligibility for clearing, membership standards and membership approval or disapproval, as the CFTC has proposed. We think a requirement of 20% independent directors on such a committee would be appropriate in a fair representation model, and the chair could be either the Management Director or an independent director. There might also be a

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<sup>14</sup> Exchange Act § 17A(b)(3)(C) (15 U.S.C. § 78q-1(b)(3)(C)).

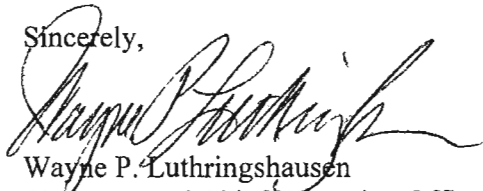
limitation on representation on the subcommittee of certain clearing members such as those listed in Section 765(a) of Dodd-Frank.<sup>15</sup>

With respect to ownership and governance, we think it is important to recognize that a market utility model that is operated on a not-for-profit basis will not attract investment, except by those who benefit from its services—and that group is most likely limited to clearing members and exchanges. The most direct beneficiaries are the clearing members. Accordingly, OCC believes that limitations on their ownership and voting, while not affecting OCC's current ownership structure, could pose a significant barrier to the creation of other clearing organizations based on a market utility model. If some ownership limits are deemed necessary, they should be limited to rules that prevent concentrated ownership by the largest dealers.

### Conclusion

OCC has generally been regarded as a model clearing organization. Operated as a market utility for the benefit of its participant exchanges, clearing members and the investing public, OCC is effectively a non-profit organization with a proud history of providing safe, reliable and low cost clearing services for increasing volumes of transactions through turbulent markets and financial crises since 1973. The clearing requirement imposed by Dodd-Frank is itself a recognition of the success of OCC and other clearing organizations in mitigating systemic risk and contributing to the safety of financial markets. We strongly believe that there is no sufficient justification for the Commission to require changes in a governance structure that has served OCC so well in order to address potential conflicts of interest that are already effectively addressed by OCC's governance model. Notwithstanding these comments, OCC also encourages the Commission to coordinate with the CFTC to adopt a "fair representation" alternative to the Proposed Rules that would be made available to any clearing organization that is operated as a not-for-profit market utility.

Sincerely,



Wayne P. Luthringshausen  
Chairman and Chief Executive Officer

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<sup>15</sup> Section 765(a) of Dodd-Frank empowered (but did not require) the Commission to adopt "numerical limits on the control of, or voting rights with respect to "[Security-Based Swap Clearing Agencies] that clear security-based swaps for "a bank holding company . . . with total consolidated assets of \$50,000,000,000 or more, a nonbank financial company [supervised by the Federal Reserve Board of Governors], an affiliate of such a bank holding company or nonbank financial company, a security-based swap dealer, major security-based swap participant, or associated person of a security-based swap dealer or major security-based swap participant." Section 726(a) similarly empowered the CFTC to adopt similar limits, and the CFTC has proposed adopting such limits. See 75 FR at 63732.

cc: Mary L. Shapiro  
Chairman  
Securities and Exchange Commission

Kathleen L. Casey  
Commissioner

Elisse B. Walter  
Commissioner

Luis A. Aguilar  
Commissioner

Troy A. Paredes  
Commissioner

Robert Cook  
Director  
Division of Trading and Markets

## APPENDIX I

### Proposed “Fair Representation” Alternative

- The following “fair representation” governance and ownership/voting provisions are suggested to be added to the Proposed Rules as an alternative that would be available to Security-Based Swap Clearing Agencies that are operated as not-for-profit market utilities and that have or are reasonably expected to have, at least 25 clearing members.
- Governance Standards
  - Board Composition
    - Proposed Requirements
      - One representative of management shall be a director (“Management Director”)
      - Representatives of member firms (“Member Directors”) shall constitute at least 40% but not more than 60% of directors and shall reflect balanced representation of large and small firms, types of business and other relevant characteristics as provided in the governing documents of the Security-Based Swap Clearing Agency.
      - The rule could require a Security-Based Swap Clearing Agency to adopt an appropriate formula for balanced representation, *e.g.*, list firms in order of clearing volume and divide ordered list into 3 groups, each of which accounts for 1/3 of the total volume. Each group elects three directors.
      - Not less than 20% Independent Directors (as defined in the Proposed Rules).
      - Remaining directors may include representatives of exchanges and/or non-member owners of the DCO.
    - This model might result, in OCC’s case, in a 19 person board consisting of:
      - 9 Member Directors (47.4%)
      - 5 Exchange Directors (26.3%)
      - 4 Independent Directors (21%)
      - 1 Management Director (5.2%)
    - While Independent Directors would be less than 35% of OCC’s Board, the non-member directors as a group would have voting power greater than the

member directors while retaining a sufficient member representation to preserve a strong interest in the market utility model that OCC was created as.

- Committee Structure

- Risk Management Committee or Subcommittee with responsibility for: (i) clearing member eligibility standards; (ii) approval of clearing member applications; (iii) determination of products eligible for clearing:
  - Chair must be the Management Director or an Independent Director.
  - 20% Independent Directors.
  - Representatives of swap dealers, major swap participants and the largest clearing firms may not constitute a majority of the committee.
- Nominating Committee[s]
  - Member Director Nominating Committee
    - May consist entirely of clearing member representatives
    - No member of nominating committee may be affiliated with the same firm as a Board member
    - Nominating committee cannot nominate any person affiliated with any committee member
    - Must have same diversity of representation as Member Directors
  - Independent Director Nominating Committee
    - Independent Directors might be nominated either by the Management Director with approval of the Board or by a Committee as follows:
      - 50% Independent Directors or persons eligible to serve as Independent Directors.
      - Initial Independent Director Nominating Committee to be appointed by Board – thereafter the Committee chooses its successors subject to Board approval.
    - No requirement as to who can chair.
- Executive Committee (if any)



- 20% Independent Directors.
- Disciplinary Panels
  - At least one person who is not disqualified to be an Independent Director (“Independent Participant”).
  - Chaired by Independent Participant or Management Director or Executive Officer of the Security-Based Swap Clearing Agency.
- Ownership Standards
  - No ownership or voting limitation is needed in the fair representation alternative.

## APPENDIX II

### THE OPTIONS CLEARING CORPORATION

ONE N. WACKER DRIVE, SUITE 500, CHICAGO, ILLINOIS 60606

WAYNE P. LUTHRINGSHAUSEN

CHAIRMAN OF THE BOARD

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November 17, 2010

#### Via Electronic Mail

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

**Re: RIN 3038-AD01 Requirements for Derivatives Clearing Organizations  
Regarding the Mitigation of Conflicts of Interest.**

Dear Mr. Stawick:

This letter is submitted by The Options Clearing Corporation ("OCC") in response to the Commission's recent release (the "Release")<sup>1</sup> requesting comment on its proposed rules (the "Proposed Rules") for derivative clearing organizations ("DCOs"), designated contract markets, and swap execution facilities regarding the mitigation of conflicts of interest. The Proposed Rules are being promulgated in response to the mandate of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").<sup>2</sup> Our comments are limited to those aspects of the Proposed Rules that affect DCOs. We recognize that the Commission's proposed rules are similar to rules recently proposed by the Securities and Exchange Commission.<sup>3</sup> We applaud the efforts of the two agencies to co-ordinate their rule-making activity. We intend to file a comment letter with the SEC that is substantially similar to this comment letter.

#### Executive Summary

As a threshold matter, we note that, while OCC is registered as a DCO, it conducts 99% of its business as a registered securities clearing agency subject to the jurisdiction of the

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<sup>1</sup> Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, Commodity Futures Trading Commission, 75 FR 63732 (Oct. 18, 2010).

<sup>2</sup> Pub. L. 111-203.

<sup>3</sup> 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; Release No. 34-63107, File No. S7-27-10, 75 FR 65882 (Oct. 26, 2010).

Securities and Exchange Commission (“SEC”).<sup>4</sup> We believe it is inappropriate for OCC to be subject to the Commission’s Proposed Rules when so little of OCC’s activity is as a DCO, and especially since OCC does not clear swaps and has no present intention of doing so. OCC’s not-for-profit, market utility model through which it acts as the clearing organization for multiple exchanges has been widely praised as a model for the industry. OCC provides its clearing members with efficient, low-cost clearing services and superior risk management, thereby benefitting customers and the public. OCC’s governance structure was carefully designed with the participation of the SEC to provide fair representation to clearing members. OCC rules require that Member Directors be representative of OCC’s overall membership, which includes large and small firms thus assuring that the largest firms (including those that are the largest dealers in OTC derivatives) do not control the Board.

OCC believes, for the reasons discussed below, that its present governance structure is generally effective in addressing the potential conflicts of interest that are identified in the Commission’s Release. OCC believes that the Commission should limit its Proposed Rules to DCOs that clear swaps, thereby conforming both to the mandate of the Dodd-Frank Act and the SEC’s corresponding proposal.<sup>5</sup> Alternatively, OCC suggests that the Commission simply permit OCC to be subject to the conflict of interest rules proposed to be adopted by the SEC in recognition of the overwhelming majority of OCC’s clearing activity that is conducted subject to that agency’s jurisdiction. By their terms, those rules would be applicable only to the extent that OCC clears security-based swaps.

That said, OCC anticipates that it is likely to clear security-based swaps at some point in the future and will likely become subject to the SEC’s proposed conflict of interest rules even if it is not subject to those of the CFTC. Accordingly, we have developed a “fair representation” alternative that we believe would be a more appropriate and effective means for a clearing organization operated as a market utility to address the types of conflicts identified in the Release. We expect to present our suggestions to the SEC for its consideration as well.

As discussed in more detail below, we believe that the Proposed Rules as drafted are too prescriptive, are incompatible with a fair representation model, and are likely to lead to significant unintended consequences. Among our specific concerns are the following:

- The requirement of 35% public directors would result in a dilution of representation of clearing members, who are the constituents with the greatest interest in maintaining a market-utility model. Dilution of their interest will likely have adverse consequences for such a model. Notwithstanding the foregoing, OCC believes that public directors make an important contribution to the board of a clearing organization, and suggests that a standard of as much as 20% would be consistent with a fair representation model.
- Conflicts of interest can be effectively controlled by requiring that directors representing clearing members be representative of a diverse group of large and small firms and different types of business models. Firms identified as “enumerated entities” in the Proposed Rules need not control the board, and in OCC’s case they do not.

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<sup>4</sup> This is true whether measured by contract volume or open interest.

<sup>5</sup> 75 FR 65882, 65893-904.

- The Commission's proposed composition requirements for risk committees would be inappropriate if made applicable to the entire committee. Risk committees should not be chaired or dominated by public directors, who are unlikely to have the necessary practical experience or the availability or involvement to deal effectively with crises. On the other hand, the Commission's proposed alternative of applying its composition requirements only to a subcommittee that would make decisions whether or not to clear particular types of swaps, set membership standards and approve membership applications is, in our view, workable with the suggested reduction of the public director requirement to 20% in the case of the fair representation alternative. We believe that customer representation on the committee is inappropriate in any case.
- We do not believe that it is necessary or desirable to limit the percentage of ownership or voting rights that clearing members may have in a DCO if the DCO has governance standards meeting the requirements of an appropriate fair representation model. The imposition of such a limitation could be adverse to a nonprofit market utility clearing model because clearing members and participating exchanges are the only parties likely to invest in such a clearing organization. Limiting ownership by members could make such models very difficult to establish and maintain.

Whatever standards are ultimately included in its conflict of interest rules, we strongly believe that the Commission should retain waiver authority with respect to both governance and ownership/voting requirements. Given the risk of unintended consequences resulting from highly prescriptive rules, it is important to preserve some flexibility.

In response to the commission's request for concrete examples,<sup>6</sup> we have set forth below a detailed discussion of OCC's existing governance provisions that we believe reflect an appropriate fair representation standard. In addition, we have described below, and summarized in Appendix I to this letter, requirements that could be added to the Proposed Rules as an alternative available to clearing organizations that clear swaps and that are operated on a not-for-profit, market utility model. While requiring OCC to add some additional public directors, adoption of these standards would allow OCC to comply while maintaining the basic governance structure that has served it well throughout its history.

#### Discussion

We believe that the Commission has correctly identified the relevant potential conflicts of interest by seeking to mitigate conflicts that may influence decisions regarding: (i) whether a swap is capable of being cleared; (ii) minimum criteria for becoming a swap clearing member, and (iii) whether a particular applicant meets those criteria.<sup>7</sup> While we support the Commission's determination to carry out the mandate of Dodd-Frank by addressing these important issues, we are deeply concerned that the Proposed Rules are overly prescriptive and could have significant unintended consequences for the market-utility model of providing clearing services. We respectfully request that the Commission either limit the proposed rules to

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<sup>6</sup> 75 FR 63738.

<sup>7</sup> 75 FR 63733.

DCOs that clear swaps, permit OCC to be governed by the SEC's conflict of interest rules, or consider adopting a "fair representation" model in coordination with the SEC.

### OCC background information

Founded in 1973, OCC is currently the world's largest clearing organization for financial derivatives. OCC is the only clearing organization that is registered with the SEC as a securities clearing agency pursuant to Section 17A of the Securities Exchange Act of 1934 (the "Exchange Act") and with the CFTC as a DCO registered under Section 5b of the Commodity Exchange Act (the "CEA"). OCC clears securities options, security futures and other securities contracts subject to SEC jurisdiction, and commodity futures and commodity options subject to the Commission's jurisdiction. OCC clears derivatives for all nine U.S. securities options exchanges and five futures exchanges.<sup>8</sup> It has operated safely and effectively for over 35 years, including through the market crises in 1987 and 2008, mitigating systemic risk associated with derivatives trading.

OCC has always been operated as a non-profit market utility. Each year OCC returns to its clearing members the excess of clearing fees received over its operating costs plus an amount reasonably required to be retained as additional capital to support its clearing activities. OCC acts as the clearing organization for multiple exchanges, and identical contracts traded on more than one exchange and cleared through OCC are fungible in clearing member accounts at OCC. This model fosters competition among execution venues while minimizing clearing costs. Price competition among execution venues and low clearing costs, in turn, lower the cost of trading for public customers. OCC believes that its clearing fees—averaging 1.8 cents per trade side—are the lowest of any derivatives clearinghouse in the world.

### OCC's Ownership and Governance Structure

OCC is owned equally by five options exchanges<sup>9</sup> and currently has approximately 120 clearing members. OCC's Board of Directors has 16 members consisting of nine clearing member directors ("Member Directors"), five directors nominated by the stockholder exchanges ("Exchange Directors"), one director who is not affiliated with any national securities exchange, national securities association, or broker or dealer in securities (the "Public Director") and the Chairman of OCC (the "Management Director"). While the Member Directors control the Board (with 9 of 16 seats), OCC rules require that Member Directors be representative of OCC's overall membership, which includes large and small firms, thus assuring that the largest firms (including those that are the largest dealers in OTC derivatives) do not control the Board.

Directors are ineligible to serve on OCC's Nominating Committee, which nominates both Member Directors and members of the next year's Nominating Committee, and no person

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<sup>8</sup> The participating options exchanges are BATS Options Exchange, C2 Options Exchange, Inc., Chicago Board Options Exchange, Inc., International Securities Exchange, NASDAQ OMX BX, Inc., NASDAQ OMX PHLX, Nasdaq Options Market, NYSE Amex Options, and NYSE Arca Options. OCC clears futures products traded on CBOE Futures Exchange, NYSE Liffe U.S., NASDAQ OMX Futures Exchange and ELX Futures, as well as security futures contracts traded on OneChicago.

<sup>9</sup> Two of OCC's stockholder exchanges—NYSE Amex Options and NYSE Arca Options—are under common ownership.

associated with the same firm as a member of the Nominating Committee may be nominated as a Member Director or a member of the next year's Nominating Committee.

OCC's Membership/Risk Committee is composed of the Management Director, the Public Director, and five Member Directors. This committee manages the risk of the clearinghouse, including making decisions on clearing membership. All clearing members must meet certain requirements regarding financial responsibility, operational capability, and experience and competence. Each clearing member must have an initial net capital of \$2,500,000 prior to being admitted, and in order to have contracts cleared, members must maintain a minimum of \$2,000,000 net capital, with increasing margin requirements for positions not adequately supported by capital. The committee's composition guarantees that the directors making critical risk management decisions not only have the required expertise to do so, but also that the committee is composed of members with a financial stake in the decisions made. The quality of OCC's risk management is reflected in the fact that OCC was the first clearing organization to receive a AAA credit rating from Standard and Poor's, which recently noted that OCC's financial safeguards functioned particularly well during the times of extreme market volatility in 2008 and 2009.<sup>10</sup>

OCC's carefully designed governance structure has allowed OCC to operate as a market utility, providing low cost clearing services to its members, while maintaining open access to members that meet OCC's membership requirements but ensuring that margin levels are set at appropriate levels to manage risk in a cost-effective manner.

#### OCC's Concerns with Proposed Board and Committee Composition Requirements

As noted above, OCC believes the proposed governance rules are too specific and prescriptive to be appropriate in all cases, and they are not appropriate in OCC's case. We have identified below the specific aspects of the Proposed Rules that we find to be ill suited to a fair representation model.

Public Directors. Where, as in OCC's case, a clearinghouse operated as a market utility provides significant board representation for stakeholders other than clearing members, adding sufficient numbers of public directors to meet the Commission's proposed 35% standard can unduly dilute clearing member influence on the board. This can in turn threaten the market utility model. Member directors have the strongest interest in the preservation of the market utility model because they represent clearing members who not only bear the financial burden of systemic risk management, but also directly benefit from low cost clearing services and appropriate margin levels. Preservation of OCC's market utility model depends on maintaining the appropriate balance among OCC's various constituencies. OCC's governance structure was carefully constructed with the active participation of the SEC to balance the competing interests among large and small clearing members, clearing members representing different business models, and the stockholder exchanges (which compete with each other). Increasing the public director requirement means that both small and large clearing firms would have a diminished role.

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<sup>10</sup> Standard and Poor's, *Full Analysis, Options Clearing Corporation* (March 12, 2010).

OCC recognizes that public directors can play a constructive role on a clearing organization's board of directors. There are talented and knowledgeable candidates available to serve this function, and they generally provide a perspective independent of the self-interest of any particular constituency. However, public directors—regardless of how experienced and knowledgeable they may be—are not a magic bullet to cure all conflict of interest issues. While public directors are useful, they should not have so large a presence on a board that fair representation of a broad spectrum of the clearing membership is compromised. We believe this would be the case if OCC were required to have 35% of its board comprised of public directors.

As noted above, there is no reason to force OCC to make a destabilizing change in the balance of its Board of Directors and committees when the balance has worked so well. OCC believes there are other options available to address the Commission's concerns regarding potential conflicts of interest that are more compatible with a market-utility model.

We also believe that the required percentage of public directors should be affected by the presence on the board of directors who, while they have a business interest in the clearing organization, also have potentially different interests from the interests of clearing members. OCC's Exchange Directors, who represent the stockholder Exchanges, are an example. Such directors may be seen as quasi-independent because they do not fall within the bright line exclusion from the Commission's proposed definition of "public director" even though they are not fully disinterested. While Exchange Directors have an interest in OCC, their interest is not the same as the interest of Member Directors—especially Member Directors whose firms are swap dealers. Exchange Directors have no interest in excluding smaller firms from membership or in setting membership or margin requirements at levels higher than required for prudential reasons, nor are they motivated to protect markets conducted other than on exchanges. Where such directors are present, they make the 35% public director standard not only less necessary but also more cumbersome to apply, both because their presence increases the size of the board before any public directors are added, and because they increase the number of public directors needed to comprise 35% of the entire board.

Nominating Committee. Under the Proposed Rule, a DCO's nominating committee would be required to be 51% public directors and chaired by a public director. This nominating committee would "identify individuals qualified to serve on the Board of Directors, consistent with criteria approved by the Board of Directors and with the composition requirements set forth [in the rule.]"<sup>11</sup> In OCC's case, this requirement is incongruous. OCC's nominating committee nominates only Member Directors. The Exchange Directors are selected by the respective stockholder exchanges that they represent with no role for the nominating committee. OCC's Public Director is currently nominated by the Chairman of the Board of Directors, with the approval of the Board. We would prefer that the Proposed Rules be modified to preserve OCC's ability to use its present method of nominating and approving public directors. In the alternative, public directors could be selected by a nominating committee consisting of other public directors.

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<sup>11</sup> 75 FR 63752.

Risk Committee. The Proposed Rule would require a DCO's risk committee to be composed of 35% public directors and 10% customer representatives. It would also require that the chairman of the risk committee be a public director. OCC believes strongly that the risk committee must be chaired by a representative of management rather than a public director and that member firms should predominate in its composition. The risk committee is tasked with handling market/financial crises, as well as less momentous issues that nevertheless may need to be addressed on short notice. Public directors generally would lack necessary practical experience to deal with crises and have no "skin in the game." That said, the Commission's alternative of creating a subcommittee to determine: (i) membership standards, (ii) approve or deny membership applications, and (iii) determine products eligible for clearing is workable for OCC. Such a subcommittee would be subject to the composition requirements, and would free the risk committee itself from those requirements. Under that alternative, OCC would retain its present risk committee composition and create such a subcommittee for the stated purposes.

We believe that customer representation on a risk committee is inappropriate, especially where the composition requirement applies only to a subcommittee with the limited function of determining product and membership eligibility. Customers' interests in each of these areas are served by maximum openness consistent with good risk management, and a "fair representation" model that includes balanced representation of large and small firms and some public directors should be sufficient to ensure that. Requiring customer representation for this function alone with no other involvement with the DCO is likely to result in participation by someone who is too remote from the business to be effective. In addition, involving customers in decisions about appropriate margin levels is potentially troubling because clearing margin requirements can be reflected in customer margin requirements, and customers have an economic interest in minimizing their own margin requirements. While DCO members similarly may have an interest in keeping margin requirements low, this interest is balanced by the fact that they may be assessed to make up losses resulting from the failure of other members. While customers and members alike share an interest in ensuring that the clearinghouse remains solvent, this interest is much more remote than the interests of members in not having to make up losses resulting from the default of an inadequately margined member. In addition, in a clearing organization such as OCC, which clears for a wide variety of securities and futures products that are used by different groups of customers, it would be difficult to define any meaningful customer representation. On the other hand, OCC strongly supports customer involvement in decision-making with respect to OTC derivative products. We believe that the most appropriate means of achieving that is through the creation of an advisory committee that would include end-users of those products as well as dealers. This committee could address on an advisory basis a wide range of topics including but not limited to those issues that are addressed by the Risk Committee. Indeed, OCC's current plan is to create such a committee in connection with its intention to clear OTC index options.

#### Additional Comments

Limit the Proposed Rules to DCOs that clear swaps. Section 726 of Dodd-Frank requires the Commission to adopt rules "to mitigate conflicts of interest" which may include "numerical limits on the control of, or the voting rights with respect to, any [DCO] *that clears swaps . . .*" (emphasis added). Congress referred to DCOs three times in Section 726, and in each case was careful to add the qualifier "that clears swaps." Congress's intention is similarly reflected in



Section 725(d), which requires the CFTC to “adopt rules mitigating conflicts of interest in connection with the conduct of business by swap dealers or major swap participants that conduct business with . . . a DCO *that clears swaps* in which the swap dealer or major swap participant has a material debt or material equity investment” (emphasis added). By applying the Proposed Rules to all DCOs without regard to whether they clear swaps or have any intention of doing so, the Commission has needlessly gone beyond the mandate of Dodd-Frank.

The Proposed Rules are not well-suited to the circumstances of non-swap clearing DCOs. The Proposed Rules specifically address the concerns outlined in Dodd-Frank and are particularly tailored to the conflicts that are likely to arise where DCOs might seek to clear swaps to which their clearing members are counterparties and the clearing of which those members may fear will reduce their own profits. To allow these specific concerns to determine the governance structure for all DCOs is inappropriate. The SEC has restricted its proposed conflicts of interest rules to those securities clearing agencies that clear security-based swaps. The broader goal of inter-agency harmonization would be best served by the Commission adopting final rules that are similarly limited.

Waiver of Commission Rules for OCC. While OCC is dually registered with both the Commission and the SEC, the overwhelming majority of OCC’s clearing activities relate to its role as a securities clearing agency. OCC’s current governance structure was carefully worked out with the active participation of the SEC to meet the fair representation standards of Section 17A of the Exchange Act, taking into consideration OCC’s unique ownership structure and the expectation that OCC would be operated as a market utility. The interests of the participant exchanges, members and the public were all taken into consideration, and the model has endured and thrived for many decades. It would be unreasonable, as well as unnecessary, to disrupt this model by imposing a rigid set of prescriptive rules designed as a “one size fits all” solution for DCOs engaged in activities in which OCC has no intention of engaging.

Even if the Commission chooses to impose the Proposed Rules on all DCOs, the Commission should ensure that it has retained sufficient flexibility to waive or modify the rules where necessary or appropriate to carry out the purposes of the CEA as amended by Dodd-Frank. The Proposed Rules wisely grant the Commission waiver authority with respect to the ownership rules, and that authority should be extended to the governance rules as well.

We believe that so long as OCC does not clear swaps—and perhaps even if it did—it would be appropriate to permit OCC to be governed by the rules applicable to SEC-regulated clearing agencies that clear security-based swaps. Section 5b(h) of the CEA as amended by Dodd-Frank expressly permits the CFTC to exempt, conditionally or unconditionally, a DCO from registration as such to allow it to clear swaps if the CFTC finds that the DCO is subject to comparable comprehensive supervision and regulation by the SEC. If the Commission is empowered to do that, it can certainly take the lesser step of simply allowing a clearing agency that is also registered as a DCO to comply with the conflict of interest rules of the SEC.

While the currently proposed ownership restrictions and governance requirements of the SEC and the CFTC are similar, they are not identical. Imposing on OCC the obligation to comply with both could potentially lead to conflict, or even if there is no actual conflict, to a set of cumulative provisions and restrictions which address the same issues in different ways, are in

that sense either redundant or more restrictive than either set of regulations would have been standing alone, and which, in the aggregate, neither regulator would have thought wise to impose.

Waivers and Flexibility. The waiver authority included in the Proposed Rule is far too limited because it applies only to ownership and voting provisions and not to governance provisions and because, even with respect to voting, the Proposed Rule strongly implies that any waiver would be temporary. The rule should be modified to give the Commission express authority to waive governance rules. These rules will certainly lead to unintended consequences if the Commission does not provide itself with adequate flexibility. Waivers of ownership and voting provisions should be available on a permanent basis in appropriate circumstances. Indeed, OCC would require waiver of the ownership requirements under the Proposed Rule for a very technical reason: the combined ownership in OCC of two affiliated exchanges exceeds 20% and one of them owns an OCC clearing member that it uses solely for the purpose of routing orders to other options markets. Although this situation was clearly not intended to be prohibited by the Proposed Rule, as drafted it appears that it would be prohibited because greater than 20% of OCC's equity ownership is held by affiliates of a clearing member.

#### Suggested Fair Representation Model

As mentioned above, OCC believes that the Proposed Rules are overly prescriptive. DCOs should retain the ability to demonstrate to the Commission that an alternative model effectively addresses the conflict of interest issues identified in the Proposed Rule. If the Commission nevertheless prefers a more prescriptive and rules-based conflict of interest regime, we have proposed an alternative "fair representation" approach outlined in Appendix I. We believe this alternative would be effective in controlling the particular conflicts of interest enumerated by the Commission in the Release while preserving sufficient member representation to be consistent with a fair representation model.

The fair representation model set forth in Appendix I requires that at least 20% of the Board be comprised of Public Directors, while requiring that at least 40% and not more than 60% of the Board consist of Member Directors. The remaining 20% to 40% of the Board could include representatives of non-member stockholders and exchanges or other execution facilities that submit transactions to the DCO for clearance.

Even though Member Directors could be up to 60% of the Board, they would be required to be representative of clearing members as a group. Because the fair representation model would be available only to firms that have, or (in the case of a start up) can demonstrate a credible plan to have, at least 25 clearing members, this standard would be sufficient to ensure that the DCO is not dominated by a small group of large swap dealers that can exclude other members for anti-competitive reasons.

The proposed provisions relating to nominating committees mirror OCC's current By-Law provisions and reflect OCC's experience that these rules work well to ensure balance of representation on the board. Alternatively, the rule could simply require that a DCO have a nominating committee structure that is reasonably calculated to result in broad representation of clearing members and other constituencies and leave it to the regulatory process to determine

whether a given proposal meets that standard. The Commission's rules could also require that a DCO provide in its By-Laws a more specific standard for assuring a broad representation of member firms. Appendix I contains an example of such a formula. We believe it would not be appropriate for the Commission to attempt to adopt a highly prescriptive formula that would be applicable to all DCOs using the fair representation model.

We believe that it is critical that the overall composition and the chair of the risk management committee be left to the discretion of the board. In OCC's experience, this is a critical committee whose membership provides essential guidance and experience in setting overall policy and handling crisis situations. We applaud the Commission's proposal to give the board unfettered discretion in determining the composition of such a committee by allowing the composition standards to be applied only to a subcommittee charged with the specific tasks of determining product eligibility for clearing, membership standards and membership approval or disapproval. We think a requirement of 20% public directors on such a committee would be appropriate in a fair representation model, and the chair could be either the Management Director or a Public Director.

With respect to ownership and governance, we think it important to recognize that a market utility model that is operated on a not-for-profit basis will not attract investment except by those who benefit from its services—and that group is most likely limited to clearing members and exchanges. The most direct beneficiaries are the clearing members. Accordingly, OCC believes that limitations on their ownership and voting, while not affecting OCC's current ownership structure, could pose a significant barrier to the creation of other clearing organizations based on a market utility model. If some ownership limits are deemed necessary, they should be limited to rules that prevent concentrated ownership by the largest dealers.

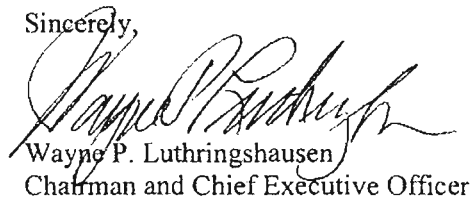
All governance and ownership provisions should be subject to a general waiver authority to allow the Commission to address specific situations as necessary to achieve the policy goals.

### Conclusion

OCC has generally been regarded as a model clearing organization. Operated as a market utility for the benefit of its participant exchanges, clearing members and the investing public, OCC is effectively a non-profit organization with a proud history of providing safe, reliable and low cost clearing services for increasing volumes of transactions through turbulent markets and financial crises since 1973. The clearing requirement imposed by Dodd-Frank is itself a recognition of the success of OCC and other clearing organizations in mitigating systemic risk and contributing to the safety of financial markets. We strongly believe that there is no sufficient justification for the Commission to require changes in a governance structure that has served OCC so well in order to address potential conflicts of interest with respect to products that OCC does not clear and does not intend to clear. Accordingly, OCC is respectfully requesting that it not be made subject to those rules either by limiting them to DCO's that clear swaps or, alternatively, by permitting OCC to be governed by the conflict of interest rules of the SEC. Notwithstanding these comments, OCC also encourages the Commission to coordinate with the

SEC to adopt a “fair representation” alternative to the Proposed Rules that would be made available to any clearing organization that is operated as a not-for-profit market utility.

Sincerely,



Wayne P. Luthringshausen  
Chairman and Chief Executive Officer

cc: Gary Gensler  
Chairman  
Commodity Futures Trading Commission

Michael V. Dunn  
Commissioner

Jill E. Sommers  
Commissioner

Bart Chilton  
Commissioner

Scott D. O'Malia  
Commissioner

Ananda Radhakrishnan  
Director  
Division of Clearing and Intermediary Oversight

**APPENDIX I**  
**Proposed “Fair Representation” Alternative**

- The following “fair representation” governance and ownership/voting provisions are suggested to be added to the Proposed Rules as an alternative that would be available to clearing organizations that are operated as not-for-profit market utilities and that have or are reasonably expected to have, at least 25 clearing members.
- Governance Standards
  - Board Composition
    - Proposed Requirements
      - One representative of management shall be a director (“Management Director”)
      - Representatives of member firms (“Member Directors”) shall constitute at least 40% but not more than 60% of directors and shall reflect balanced representation of large and small firms, types of business and other relevant characteristics as provided in the governing documents of the DCO.
      - The rule could require a DCO to adopt an appropriate formula for balanced representation e.g., list firms in order of clearing volume and divide ordered list into 3 groups, each of which accounts for 1/3 of the total volume. Each group elects three directors.
      - Not less than 20% Public Directors (as defined in the Conflict Rules)
      - Remaining directors may include representatives of exchanges and/or non-member owners of the DCO
    - This model might result, in OCC’s case, in a 19 person board consisting of:
      - 9 Member Directors (47.4%)
      - 5 Exchange Directors (26.3%)
      - 4 Public Directors (21%)
      - 1 Management Director (5.2%)
    - While public directors would be less than 35% of OCC’s Board, the non-member directors as a group would have voting power greater than the member directors while retaining a sufficient member representation to preserve a strong interest in the market utility model that OCC was created to be.

- Committee Structure
  - Risk Management Committee or Subcommittee with responsibility for: (i) clearing member eligibility standards; (ii) approval of clearing member applications; (iii) determination of products eligible for clearing:
    - Chair must be the Management Director or a Public Director
    - 20% Public Directors
    - Representatives of Enumerated Entities may not constitute a majority of the committee
  - Nominating Committee[s]
    - Member Director Nominating Committee
      - May consist entirely of clearing member representatives
      - No member of nominating committee may be affiliated with the same firm as a Board member
      - Nominating committee cannot nominate any person affiliated with a committee member
      - Must have same diversity of representation as Member Directors
    - Public Director Nominating Committee
      - Public Directors might be nominated either by the Management Director with approval of the Board or by a Committee as follows:
        - 50% Public Directors or persons eligible to serve as Public Directors
        - Initial Public Director Nominating Committee to be appointed by Board – thereafter the Committee chooses its successors subject to Board approval
      - No requirement as to who can chair
  - Executive Committee (if any)
    - 20% Public Directors
  - Disciplinary Panels

- At least one person who is not disqualified to be a Public Director (“Public Participant”)
  - Chaired by Public Participant or Management Director or Executive Officer of the DCO
- Ownership Standards
  - No ownership or voting limitation is needed in the fair representation alternative.

## APPENDIX II

The following are the specific provisions of the Commission's proposed Conflict Rules that OCC believes should be amended:

### **Part 39 (Derivatives Clearing Organizations)**

Proposed Section 39.13 (g)(1)—General. Add new sub-section specifying that “nothing in this section shall apply to a DCO that does not clear swaps.”

Proposed Section 39.13(g)—Risk Management Committee. OCC believes that the proposed rule as drafted would be generally workable with the critical condition that the Commission retain the provision that would allow the creation of a subcommittee to address membership eligibility, admission of new members and product eligibility. In addition, however, we believe that the requirement of 10% customer representation should be eliminated and that, if a DCO elects the “fair representation” alternative,” the requirement of 35% public director participation be modified to require 20% public directors, provided that representatives of Enumerated Entities shall not constitute a voting majority of the committee (or delegated subcommittee). Finally, whether or not the fair representation alternative is elected, the rule should permit the committee (or subcommittee) to be chaired by either a public director or a management director.

Proposed Section 39.25 (a)—General. Add new sub-section (4) specifying that “nothing in this section shall apply to a DCO that does not clear swaps.”

Proposed Section 39.25(b)—Limits on Voting Equity Ownership and the Exercise of Voting Power. This provision should be amended by adding an alternative to subparagraph (2). The alternative would provide either that the restriction on ownership and voting is inapplicable to the Fair Representation Alternative or would create a less burdensome restriction applicable to the Fair Representation Alternative so that it would be easier for members to own a DCO.

Proposed Section 39.25(b)(3)—Waiver. This provision should be modified in subparagraph (ii) to state that a waiver may be granted either permanently or for a period of time.

### **Part 40 (Provisions Common to Registered Entities)**

Proposed Section 40.9 (a)—General. Add new sub-section (3) specifying that “nothing in this section shall apply to a DCO that does not clear swaps.”

Proposed Section 40.9(b)—The Board of Directors. Subparagraph (b)(1) This provision should be amended by adding an alternative to subparagraph (i). The alternative would provide that a DCO that is operated as a market utility shall have a Board of Directors that is composed of at least 20% public directors provided that member directors do not constitute more than 60% of the board, that member directors are selected by a method that ensures that such directors are fairly representative of all types and sizes of member firms, and that the remaining members of the board, other than one or two management director(s), are representatives of exchanges and/or non-member stockholders.



Proposed Section 40.9(c)—Committees and Panels. The provisions relating to executive committees and nominating committees would need to be modified to provide alternative standards for DCOs electing to operate under the fair representation alternative in order to reduce the public director requirement on those committees and make the other adjustments necessary to permit the committee structures referred to in Appendix I.

New Section 40.9(d)—Waiver. A new section should be added allowing the Commission to waive the requirements set forth in 40.9(b) and (c) regarding Board of Directors and Committee composition upon application of a DCO and demonstration by the DCO that it has adopted alternative means sufficient to meet the policy objectives of those provisions.