



April 29, 2011

Via Electronic Submission: <http://www.sec.gov/rules/proposed.shtml>

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

Re: RIN No. 3235-AK74: 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:

Managed Funds Association (“**MFA**”)¹ appreciates the opportunity to provide further comments to the Securities and Exchange Commission (the “**Commission**”) on its proposed “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” (the “**Proposed Regulation**”)² related to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “**Dodd-Frank Act**”).³ MFA continues to support the Commission’s efforts to ensure that key instruments for market reform – security-based swap clearing agencies (“**SBSCAs**”), national securities exchanges and security-based swap execution facilities (collectively, “**SBS entities**”) – are governed in a manner that prevents conflicts of interest from undermining the Commission’s mission “to promote robust risk management, foster greater efficiencies, improve investor protection, and promote transparency in the market for security-based swaps.”⁴

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

² 76 Fed. Reg. 12645 (Mar. 8, 2011). The Proposed Regulation is contained in the Commission’s original notice of proposed rulemaking with respect to the Proposed Regulation. 75 Fed. Reg. 65882 (Oct. 26, 2010) (the “**Proposed Regulation Release**”).

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

⁴ Proposed Regulation Release at 65885.

We previously submitted a comment letter to the Commission on the Proposed Regulation,⁵ in which we:

- (1) expressed our support for the proposed “**Voting Interest Focus Alternative**” (as opposed to the proposed “**Governance Focus Alternative**”);
- (2) requested that the Commission affirmatively mandate customer and independent director representation on SBS entity boards of directors (“**Boards**”);
- (3) recommended that the Commission make Board members’ fiduciary duties to the relevant SBS entity an express, non-waiveable obligation;
- (4) advocated for greater availability of SBS entity corporate documents; and
- (5) asked the Commission to draft the final regulation to ensure that it is flexible and comprehensive enough to mitigate conflicts of interest effectively regardless of the actual Board or committee structure established at each SBS entity.

In light of the Commission’s and the CFTC’s other proposed rulemakings concerning conflicts of interest at SBS entities, we offer the following supplemental suggestions that we believe are necessary to mitigate conflicts, enhance SBS entity risk management, make use of available market expertise and ensure broader market representation.

I. Customer Representation on SBS Entity Governing Bodies

In proposed §§242.701 and 242.702, the Commission sets forth voting limitations and governance restrictions for each SBS entity.⁶ Both proposed §§242.701 and 242.702 require that a certain percentage of SBS entity governing bodies (including both an SBS entity’s Board and Board committees that are delegated authority to act on the Board’s behalf) be composed of independent directors.⁷ These percentages would apply not only to the Board itself, but also to

⁵ See MFA’s comment letter to the Commission dated November 26, 2010 responding to the Proposed Regulation Release available at: <http://www.sec.gov/comments/s7-27-10/s72710-82.pdf> (the “**November Letter**”).

See also, MFA comment letter to the Commodity Futures Trading Commission (“**CFTC**”) dated March 7, 2011 on “Governance Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities; Additional Requirements Regarding the Mitigation of Conflicts of Interest”, available at: <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=31117&SearchText=> (the “**March Letter**”).

⁶ Proposed Regulation Release at 65930-32.

⁷ Proposed §242.701 offers SBSCAs the choice to comply with one of two options to meet its requirements, the “Voting Interest Focus Alternative” in §242.701(a) or the “Governance Focus Alternative” in §242.701(b). The “Voting Interest Focus Alternative” places an emphasis on voting limitations and requires that 35% of the Board be composed of independent directors. The “Governance Focus Alternative” prioritizes governance restrictions and requires a majority be independent directors on the Board. Proposed §242.702, which would apply to national securities exchanges and security-based swap execution facilities, generally follows the same guidelines as the “Governance Focus Alternative” in proposed §242.701(b). For purposes of both proposed alternatives, in order to qualify as “independent”, a director must be determined not to have a material relationship with the relevant SB entity or any affiliates thereof.

any Board committee (including an “advisory committee”) that has been delegated authority to act on the Board’s behalf.⁸ In the Proposed Regulation Release, the Commission noted that the purpose of the independent director requirements is to promote open and fair access (with respect to both membership and product eligibility) as well as sufficient risk management standards.⁹

MFA supports the numerical independent director requirements in the Proposed Regulation, and in particular, the Commission’s extension of the percentage requirements to any Board committee authorized to act on behalf of the Board. We agree that if the Proposed Regulation did not extend the compositional requirement to all Board committees and subcommittees, an SBS entity could potentially evade the proposed Board independence standards by delegating the Board’s duties to a committee or subcommittee that does not have the same independence standard.¹⁰ However, we strongly believe that to further the goals of open and fair access and sufficient risk management, governing bodies of SBS entities should include not only independent directors, but also representation of different groups of market participants that will bring diverse perspectives to the decision-making process.

In particular, customers are important stakeholders in the over-the-counter (“OTC”) derivatives markets that: (i) have sophisticated derivatives product and risk management expertise; (ii) have significant knowledge about the issues market participants encounter when seeking direct and indirect clearing membership and access to best execution; (iii) are able to represent the substantial buy-side component of each market; and (iv) can act as a counterbalance to historically aligned and concentrated dealer interests. Therefore, we believe that customers should have their views reflected in the critical decisions of these governing bodies, which would also facilitate the Commission’s goal of “enhanced access to cleared products and clearing venues”.¹¹ In that vein, we respectfully request that in the final regulation the Commission:

- (1) affirmatively mandate that all governing bodies of SBS entities, especially risk management committees (“RMCs”), include non-dealer, customer representatives;¹²

⁸ Proposed §242.701(a)(5) and (b)(3) and §242.702(g).

⁹ Proposed Regulation Release at 65896, 65901 and 65908.

¹⁰ *Id.* at 65911. We note that in this respect, we believe that the Commission should make it clear in the Proposed Regulation that the percentage requirement applies to Board subcommittees in addition to Board committees. Otherwise, for instance, an RMC could delegate decisions affecting market structure to an RMC subcommittee that includes less than the proposed percentage or no independent director representation, leading to the effective exclusion of independent directors from critical decisions.

¹¹ *Id.* at 65883.

¹² In the Proposed Regulation Release at 65899, the Commission specifically solicited comments regarding whether an explicit requirement that customers of participants be included on the RMC would be appropriate to include in the final rules. We strongly believe such a requirement should be explicit.

- (2) affirmatively mandate that SBS entities, especially RMCs, include balanced representation from a number of different stakeholder groups, including dealers, customers, SBS entity management and independent directors;¹³ and
- (3) expressly prohibit any group from constituting a controlling majority, including independent directors.

We are concerned that without such affirmative mandates and prohibitions from the Commission and without application to each SBS entity governing body, SBS entities may not adequately take into account the views of all market participants. Thus, in our view, requiring customer representation and promoting less concentrated decision-making authority will foster transparency and confidence in SBS entities and create greater parity in their governance structure.

II. Responses to Arguments against Balanced RMC Governance

As discussed above, MFA strongly urges the Commission to mandate in the final regulation that RMCs include balanced representation from a number of different stakeholder groups such that no group constitutes a controlling majority. We believe that such diverse, pluralistic representation is essential because both the lack of transparency into RMC proceedings and the absence of diverse representation, including customer representation, on RMCs have inhibited market-based evolution of clearing offerings and broad market participant use and access. In addition, diversity is necessary at the RMC-level (and not solely the Board-level) because there are many decisions under the purview of RMCs, some of which are highly technical, that have a material impact on market structure and that are unlikely to fall within the scope of Board decision-making.¹⁴

We understand that with respect to SBS entity RMCs other commenters have supported continued dealer control of those RMCs, arguing that only dealers have proper incentives to engage in appropriate risk management.¹⁵ We disagree because we believe that other

¹³ We understand that other commenters have suggested that requirements to include independent directors or customer representatives will result in unskilled persons without the requisite expertise sitting on Boards. However, as discussed above, customers represent a group of persons with experience in the market that can bring balance and a varied perspective to Boards. Some entities and organizations, for instance the International Swaps and Derivatives Association, Inc. (“ISDA”), have acknowledged the importance of customer representation and include customers on their Boards.

¹⁴ In the November Letter, we provided a partial list of material features of security-based swap (“SBS”) clearing and execution that are subject to decision by the Boards and committees of SBS entities, the outcomes of which could have a significant impact on clearing, execution, transparency and competition, as well as on cost and liquidity of cleared SBSs. In addition, in the March Letter, we discussed the particular importance of customer representation on RMCs in the context of derivative clearing organizations, noting the potential for decisions made by the RMC to have a profound effect on market structure.

¹⁵ Specifically, such commenters have suggested that because dealers deposit capital in the SBSCA mutualization fund (a significant portion of which their customers finance) and that capital is at risk in the event of a clearing member default, only dealers will make appropriate decisions regarding the risk of default and SBSCA measures required to protect that capital.

stakeholders, including customers, SBS entity management and independent directors, also have strong incentives to protect SBS entity capital and make appropriate risk management decisions, and do not present the conflicts of interest of SBS dealers as noted in the Proposed Regulation Release.¹⁶

In particular, customers not only bring essential expertise and diversity to the RMC, but also can be directly impacted by disruptions at an SBS entity (*e.g.*, in the event of an insufficiently covered default of a major market participant). Moreover, depending on the final segregation model(s) adopted by the Commission and the CFTC, customers may also be exposed to loss due to mutualization of customer risk through the use of omnibus customer accounts. Similarly, since the employment and compensation of SBS entity management depends on the SBS entity's financial and reputational success, SBS entity management is motivated: (i) to expand the scope of SBS entity products and services; (ii) offer optimal capital, margin and cost management; and (iii) maintain SBS entity risk management boundaries that prevent losses to the SBS entity, its members and the markets. Lastly, because independent directors are prohibited from having any material relationship with the SBS entity, they are well-situated to help ensure that key RMC decisions result from objective, risk-based criteria intended to enhance the SBS entity's business.

In contrast, at times dealer incentives may not be aligned with protection of SBS entity capital and risk management. At present, the dominant dealers in the OTC derivatives markets also comprise a large portion of the boards of directors of significant entities in both the OTC and cleared derivatives markets, including ISDA, The Depository Trust & Clearing Corporation ("DTCC"), Markit Group Limited ("**Markit**"), LCH.Clearnet Group Ltd ("**LCH.Clearnet**") and IntercontinentalExchange, Inc./The Clearing Corporation ("**ICE/TCC**"). In addition, these same dealers also have representation on the RMCs of entities expected to become SBS entities.¹⁷ Without implementation of our recommendations, such interlocking governance in the SBS market raises concerns regarding SBS entities' ability to meet the needs of the all derivatives market participants as well as the Dodd-Frank Act goals of increasing central clearing and encouraging more open, transparent and competitive derivatives markets.¹⁸

In sum, while we believe that in light of their expertise, market position and vital role in clearing, dealers should be well-represented on SBS entity RMCs, other constituents also have strong incentives to protect SBS entity capital and the integrity of SBS entity processes, and thus, these constituents should also have representation on SBS entity RMCs. As a result, we respectfully recommend the Commission implement the recommendations discussed in Section I above. Moreover, in light of the critical function served by SBS entity RMCs, the Commission

¹⁶ Proposed Regulation Release at 65884-89.

¹⁷ For instance, representatives of Barclays/Lehman, Goldman Sachs, JP Morgan and UBS sit on the Boards of ISDA, DTCC, Markit, LCH.Clearnet and ICE/TCC, while representatives of both Deutsche Bank AG and Credit Suisse First Boston sit on the Boards of ISDA, Markit, LCH.Clearnet and ICE/TCC. Additionally, dealers often appoint trading desk personnel, or risk managers allied with dealer trading desks, to SBS entity RMC posts rather than other individuals within the organization whose immediate incentives might be more in line with dealer capital preservation.

¹⁸ Preamble to the Dodd-Frank Act; Dodd-Frank Act, Section 765(b).

might further consider designating a regulatory representative to participate in, or at a minimum, audit in real time, SBS entity RMC proceedings.

III. Requirement to Report Risk Management Committee Conflicts

In the Proposed Regulation Release, the Commission sought comment on whether it should require the Board of an SBS entity to report to the Commission if it disagrees with a recommendation of the RMC.¹⁹ We think it appropriate for a Board to review and re-examine for conflicts of interest any decision that the RMC approves, including decisions approved despite significant dissent from RMC members. Where such review reveals an underlying conflict of interest, we believe that the Board, consistent with general corporate governance principles, should be able to overturn the RMC's decision. We would recommend that the Commission allow any dissenting RMC member to initiate the appeal or review process, if it could reasonably show that there was an underlying conflict of interest or that the RMC did not undertake an appropriate process to avoid a conflict of interest.

For example, with respect to an RMC's decision to set exclusionary membership criteria, the Board would be obliged to review it by determining whether the RMC made its decision based on objective, risk-based criteria, rather than through a majority vote of RMC members with unresolved conflicts of interest. This right to appeal will help provide essential balance and is particularly important in the event that there is no express requirement that the Board must have customer representation. At the same time, we think it should be sufficient for this right to appeal to apply only to decisions that meet this burden of proof, in order to balance the need to have a material constraint on decisions informed by conflicts of interest with the need to prevent excessive appeals from delaying the functioning of and decision-making by the RMC or Board.

Further, we believe that the Commission should require SBS entities to implement procedures that mandate a full review by the RMC of RMC subcommittee decisions that are material to market structure. Combined with our recommendations regarding requiring customer representation on governing entities discussed in Section I above, this measure would ensure necessary input by a diverse group of affected market participants and guarantee appropriate transparency. Where such RMC review leads to the rejection of an RMC subcommittee recommendation, the SBS entity should report that divergence of views to the Commission.

¹⁹ *Id.* at 65899.

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

Respectfully submitted,

/s/ Stuart J. Kaswell

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

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

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