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November 17, 2010

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

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 29549-1090

**Re: Proposed Limits on Ownership or Voting Power of Derivative Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities – 75 Fed. Reg. 63732 (October 18, 2010)**

**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 – Exchange Act Release 63107**

Dear Mr. Stawick and Ms. Murphy:

The Futures Industry Association ("FIA")[1] is pleased to submit this letter in response to the requests for comment with respect to the rule proposals by the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC" and, together with the CFTC, the "Commissions") regarding conflicts of interest with respect to derivatives clearing organizations ("DCOs"), designated contract markets ("DCMs"), swap execution facilities ("SEFs"), clearing agencies that clear security-based swaps ("securities clearing agencies"), security-based SEFs and national securities exchanges that post or make available security-based swaps for trading.

[1] FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 30 of the largest futures commission merchants in the United States. Among FIA's associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than eighty percent of all customer transactions executed on United States contract markets.

**Summary.**

FIA acknowledges that clearinghouses and SEFs may from time to time be confronted with conflicts between the advancement of their own commercial interests and the goals that are intended to be advanced by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). We nonetheless respectfully submit that the adoption of restrictions on the ownership of clearinghouses and SEFs is inappropriate, at least at this time. In particular, FIA notes that Sections 726 and 765 of Dodd-Frank expressly provide that the adoption of ownership limits is permissive, rather than mandatory, and further provide for the adoption of rules only if, after review, the Commissions determine that such rules are necessary or appropriate to improve governance, mitigate systemic risk, promote competition or mitigate conflicts of interest.

Further, and as the Commissions noted in their respective rule proposals, the Commissions are authorized and required by other provisions of Dodd-Frank to take steps to ameliorate conflicts of interest, including through their review of the rules of DCOs and securities clearing agencies (collectively, "clearinghouses") and the rules of SEFs and security-based SEFs (collectively, "SEFs"). FIA accordingly believes it is inappropriate for the Commissions to adopt the proposed ownership restrictions before they have the benefit of the experience they will gain from the implementation of those other rules. Finally, FIA believes that the adoption of the ownership restrictions in the form in which they were proposed is potentially counter-productive because they are likely to inhibit the formation of new clearinghouses and SEFs and will concentrate risk in the existing clearinghouses.

FIA accordingly urges the Commissions to defer any further consideration of the proposed ownership restrictions until the Commissions have had the opportunity to gain experience with the implementation of the new regulatory regime that is mandated by Dodd-Frank. If the Commissions nonetheless conclude that they must adopt ownership restrictions at this time, FIA believes that the Commissions should include in their regulations a mechanism for clearinghouses to request and obtain waivers of those requirements where appropriate.

FIA supports that aspect of the Commissions' proposals that would require that at least 35% of the Board of Directors of a clearinghouse or SEF be public directors. FIA further supports the Commissions' proposals to expressly provide that employees of a member of a clearinghouse or SEF member or participant, as well as employees of the clearinghouse or SEF itself, will not be deemed to meet the independence standards that are required for public directors.[2] FIA has serious reservations, however, about that aspect of the Commissions' proposals that would require a clearinghouse to set aside a substantial portion of its Risk Management Committee or Risk Committees (hereafter, "Risk Management Committee") for public directors (and, in the case of the CFTC proposal, customer representatives). FIA is concerned that public directors

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[2] The CFTC and SEC proposals respectively refer to "public" and "independent" directors. Unless otherwise indicated, references in this letter to "public directors" are intended to refer to both "public directors" and "independent directors" as those terms are used in the Commissions' respective proposals.

and customer representatives, who can provide meaningful knowledge and insight when serving on the Board of a DCO or SEF, will typically lack the specialized knowledge and hands-on experience with margin and other risk systems (and, potentially, with the management of a clearing member default) that should be prerequisites to service on a Risk Management Committee.

FIA's concerns are ameliorated in part by that portion of the CFTC's proposal that would exempt the Risk Management Committee from these requirements if a Subcommittee of the Risk Management Committee is given the initial authority to establish membership eligibility criteria, approve (or deny) applications for membership and determine which products should be eligible for clearing, and we recommend that the SEC make a similar alternative available to the securities clearing agencies. As discussed in greater detail below, however, FIA believes strongly that the criteria for service on the Risk Management Committee (including a Subcommittee thereof) need to be qualitative rather than quantitative, and that it would be a mistake to impose rigid quotas that are unrelated to the management of risk. FIA accordingly urges the Commissions to omit from their final rules the requirements, currently contained in one or both of the Commissions' proposals, that 35% or more of the Risk Management Committee and any Subcommittee thereof be composed of public directors, that an additional 10% of the Committee or Subcommittee be representatives of customers, and that the Chair of the Committee or Subcommittee be a public director.

**The Commissions' Proposals.**

The Commissions' proposals would impose limits on the ownership of DCOs, securities clearing agencies, SEFs, securities-based SEFs, DCMs and national securities exchanges. Specifically, the Commissions' respective proposals would place strict caps on the amount of voting equity interests that can be held by one or more specified categories of market participants:

- SEFs would be required to take steps to prohibit any of their members or participants (together with any such member's or participant's "related persons") from owning more than 20% of the voting equity in the SEF.

- Clearinghouses would be required to elect one of two alternative sets of restrictions. The first would impose a 20% limitation on the voting equity that any single member or participant in the clearinghouse may own, coupled with an aggregate 40% limitation on the voting equity that may be held by clearinghouse members or participants. (The CFTC – but not the SEC – would additionally apply the 40% cap to "enumerated entities," without regard to whether the enumerated entities are members of the DCO.[3])

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[3] The CFTC and SEC proposals respectively use the terms "enumerated entity" and "specified entity" to mean: (i) a bank holding company with total consolidated assets of $50 billion or more; (ii) a nonbank financial company that is supervised by the Board of Governors of the Federal Reserve System; (iii) an affiliate of such bank holding company or nonbank financial company; (iv) as applicable, a swap dealer or security-based swap dealer; and (v) as applicable, a major swap participant or major security-based swap participant. The CFTC definition (cont.)

> In the alternative, a clearinghouse could adopt a 5% cap on the voting equity that could be held by any of its members or participants or, under the CFTC proposal, by any enumerated entity.[4]

The Commissions have additionally proposed rules that would establish minimum requirements for the participation of public directors on the governing boards and the key operating committees of clearinghouses and SEFs. This requirement would be augmented in its application to the Risk Management Committee of a DCO, which would additionally be required to reserve its Chair for a public director and allocate 10% of its seats to customer representatives.

The Commissions have explained that their proposals are intended to facilitate the implementation of the new regulatory framework that is created by Dodd-Frank by seeking to mitigate the conflicts of interest that a clearinghouse may confront when determining (i) whether a swap or security-based swap is capable of being cleared, (ii) the minimum criteria that an applicant must satisfy in order to become a swap or security-based swap clearing member, and (iii) whether a particular applicant satisfies such criteria. The Commissions have further explained that their proposals are intended to address the potential conflicts of interest that may arise as a SEF balances its commercial interests and its self-regulatory responsibilities.

**The Commissions Should Withdraw or Defer the Proposed Ownership Restrictions.**

FIA believes that the adoption of ownership restrictions – and, in particular, the 40% aggregate ownership restrictions that have been proposed for clearinghouses – are likely to have unintended and undesirable consequences. FIA accordingly recommends that the Commissions withdraw or, at a minimum, defer any consideration of the ownership restrictions that are authorized by Sections 726 and 765 until such time as they have had experience with the implementation of the new Commodity Exchange Act ("CEA") core principles for DCOs and SEFs and the comparable provisions of the Securities Exchange Act of 1934 ("Exchange Act") that are applicable to securities clearing agencies and security-based SEFs.

*Dodd-Frank Does Not Mandate the Adoption of Ownership Limits.*

Sections 726 and 765 of Dodd-Frank do not require the Commissions to restrict the ability of market participants to hold significant ownership interests in clearinghouses or SEFs. The so-called "Lynch Amendment," which would have imposed an aggregate limit of 20% on swap dealers' ownership of clearinghouses or SEFs, was included in earlier versions of the House bill. Those limits were not included in the final version of Dodd-Frank that was enacted by Congress and signed into law by the President, however, and the floor colloquy between Congressmen

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additionally includes an associated person of a swap dealer or major swap participant. References in this letter to "enumerated entities" are, therefore, intended to apply equally to "specified entities."

4 The Commission's proposals would apply comparable restrictions on the voting rights that can be held by those market participants. In the interest of simplicity, this letter focuses primarily on the ownership restrictions, but our comments should be read to apply equally to the proposed restrictions on voting rights.

Frank and Lynch[5] and subsequent correspondence from Members of Congress to Chairman Gensler and Chairman Shapiro do not change the fact that any ownership restrictions that may ultimately be adopted by the Commissions are permissive and not mandatory.

The statutory language is clear: the Commissions are authorized to adopt rules imposing limits on ownership only if they first determine, after review, that such rules are necessary or appropriate to improve the governance of clearinghouses or SEFs, or to mitigate systemic risk, promote competition, or mitigate conflicts of interest.[6] The CFTC is separately charged with the responsibility to adopt rules that give effect to the core principles for DCOs and SEFs (Dodd-Frank Sections 725(c) and 733); the SEC has comparable requirements in respect of securities clearing agencies and security-based SEFs (Dodd-Frank sections 763(b) and 763(c)). We do not view the existence of these independent requirements as a justification for the adoption of the proposed ownership restrictions. To the contrary, we believe it is clear that Congress envisioned that these requirements would be implemented independently, without regard to whatever action might ultimately be taken by the Commissions after the review that is required by Sections 726(b) and 765(b) of Dodd-Frank.[7]

The Commissions note in their respective proposals that they are required to adopt rules to give effect to Sections 726 and 765 by January 17, 2011 (180 days after the enactment of Dodd-Frank).[8] While the Commissions clearly are required to adopt rules pursuant to Sections 726 and 765 by January 17, it is equally clear that nothing in Sections 726 and 765 (or, for that matter, anywhere else in Dodd-Frank) requires the Commissions to adopt ownership restrictions at any time, much less before that date, and that the Commissions remain free to return to that subject in the future after implementing, and gaining experience with, the conflict mitigation and other rules that they will adopt pursuant to Dodd-Frank Sections 725(c) (DCOs), 733 (SEFs), 763(b) (securities clearing agencies) and 763(c) (security-based SEFs).

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5 *See* 75 Fed. Reg. 63732, 63732 n. 5 (October 18, 2010).

6 Dodd-Frank Sections 726(b), 765(b).

7 In this regard, we note that the European Commission's *Proposal for a Regulation of the European Parliament and of the Council on OTC Derivatives, Central Counterparties, and Trade Depositories* concluded that ownership limitations were unnecessary, but that structural governance requirements, such as those that would be adopted under Sections 725(c), 733, 763(b) and 763(c) of Dodd-Frank, "are considered more effective in addressing any potential conflicts of interest that may limit the capacity of [central counterparties ("CCPs")] to clear, than any other form of regulation which may have undesirable consequence on market structures (e.g., limitation of ownership, which would need to extend also to so-called vertical structures in which exchanges own a CCP)." *See* 75 Fed. Reg. 63732, 63743 n.78 (October 18, 2010).

8 75 Fed. Reg. 63732, 63733 (October 18, 2010) (CFTC); 75 Fed. Reg. 65882, 65884 (October 26, 2010) (SEC).

*The Commissions' Proposals Overlook Important Countervailing Considerations.*

The Commissions' proposals reflect the assumption that clearing members and the enumerated entities have an overriding economic incentive to limit the products that a DCO or securities clearing agency will clear and, by extension, the products that are subject to mandatory trading on a SEF or DCM (in the case of swaps) or on a security-based SEF or national securities exchange (in the case of security-based swaps). In particular, the Federal Register notices that accompany the Commissions' respective rule proposals note that over-the-counter ("OTC") markets tend to provide informational advantages to swap dealers relative to their end-user customers and go on to conclude that swap dealers, therefore, have an economic incentive to restrict the products that may be accepted for clearing by a DCO or securities clearing agency.[9]

This overlooks the fact that swap dealers and enumerated entities have substantial incentives under the applicable capital rules to submit their trades to a clearinghouse. Specifically, under Basel II, derivative transactions that are traded on exchanges that require daily payment and receipt of cash-variation margin may be excluded altogether from the risk-based capital requirements.[10] Furthermore, a banking organization may attribute an "exposure at default" of zero (effectively, a zero risk weight) to outstanding derivative transactions and any associated clearing fund deposits and collateral with a "qualifying central counterparty" (*i.e.*, a clearinghouse).[11] Swap dealers and other enumerated entities, therefore, will have a significant incentive to submit their trades to a clearinghouse that outweighs any potential pricing advantage they might gain by trading in the OTC markets.

It further appears that the Commissions may not have adequately considered to the very real prospect for competition between and among the existing clearinghouses. For example, and as noted by the SEC in its proposal, five clearinghouses were authorized by the SEC to clear credit default swaps ("CDS").[12] It is true that only two of those clearinghouses, each of which is owned in substantial part by swap dealers, have been successful in doing so. It would be a mistake to generalize from that experience, however, because there is reason to believe that the success of those clearinghouses was attributable primarily to their development of a robust and specialized infrastructure that was uniquely related to CDS clearing. In any event, FIA believes that the vigorous competition that will be fostered by Dodd-Frank (which includes a requirement that DCOs and securities clearing agencies provide comparable treatment to economically equivalent instruments) will facilitate robust competition between and among the DCOs and securities clearing agencies that are seeking to clear over-the-counter products, without regard to their ownership.

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9 75 Fed. Reg. 63732, 63734 (October 18, 2010); 75 Fed. Reg. 65882, 65885 (October 26, 2010).

10 12 C.F.R. Parts 208 and 225, Appendix A, section III.E.1.e.

11 *See* 12 C.F.R. Part 208, Appendix F; 12 CFR Part 225, Appendix G. The Basel Committee on Banking Supervision has indicated it will be revisiting this treatment.

12 75 Fed. Reg. 65882, 65884 n.17 (October 26, 2010).

As discussed more fully below, we further believe that the adoption of ownership restrictions could have the unintended effect of inhibiting, rather than enhancing, competition. If the Commissions nonetheless believe that ownership restrictions are necessary, FIA would urge the Commissions to evaluate all types of ownership arrangements and consider whether any restrictions that may be adopted should apply not only to enumerated entities and members of the clearinghouses, but also to other potential forms of concentrated ownership, such as sovereign wealth and private equity funds and clearinghouses that are owned by one or more exchanges.

*The Ownership Restrictions Would Create Barriers to Entry and, Therefore, Would Be Contrary to the Public Interest and the Purposes of Dodd-Frank.*

The vast preponderance of the resources backing a clearinghouse typically are supplied by clearing members.[13] This required commitment of funds is over and above the operating capital, intellectual property and human resources that are required to form and operate a clearinghouse. A new entrant in these markets, therefore, needs to raise sufficient capital from its founders and initial clearing members to be a credible alternative to the established clearinghouses.

Given these business realities, it is impractical to think that market participants will make the substantial contributions of capital and other property that are required to form a new clearinghouse if they cannot be assured a substantial and meaningful role in its governance and operations. For its part, the CFTC has acknowledged that the enumerated entities are the most likely source of funding for new DCMs and SEFs and indicated that "the benefits of sustained competition between new DCMs and SEFs outweigh the incremental benefit of better governance through limitations on the aggregate influence of the enumerated entities."[14] FIA believes that same rationale applies with even greater force to the clearinghouses. Given that there are likely to be only a small number of new clearinghouses,[15] it is especially important that the Commissions not create additional barriers to entry in this vitally important segment of the marketplace.

For all of the foregoing reasons, FIA believes that the Commissions should not adopt the proposed ownership restrictions, at least not until the Commissions have had an opportunity to

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[13] As an example, the combined security deposits (*i.e.*, guaranty fund contributions) and guaranty fund assessment liabilities of Chicago Mercantile Exchange ("CME") clearing members totals more than $8 billion; CME stockholders, by comparison, have only $100 million at risk if a futures clearing member were to default. *See* http://www.cmegroup.com/clearing/cme-clearing-overview/safeguards.html. This is not unusual – clearinghouse guaranty funds and assessment liabilities are typically far greater than the stockholders' equity in those clearinghouses.

[14] 75 Fed. Reg. 63732, 63745 (October 18, 2010).

[15] The SEC has indicated that it does not expect there to be a large number of securities clearing agencies that clear security-based swaps, based on the significant level of capital and other financial resources necessary for the formation of a clearing agency. 75 Fed. Reg. 65882, 65915 n.192 (October 26, 2010).

implement and monitor the workings of the new regulatory framework that has been created by Dodd-Frank, including the review that is required by Sections 726(b) and 765(b) of Dodd-Frank.

*Any Ownership Restrictions That May Be Adopted Should Be Moderated.*

If the Commissions nonetheless decide to adopt ownership restrictions at this time, FIA would urge the Commissions to increase the permitted ownership ceilings to levels that will encourage market participants to invest substantial amounts of capital in new clearinghouses. In this regard, we would ask that the Commissions recognize that the domestic DCOs generally are owned (i) directly by their members and participants or (ii) directly or indirectly by, or in common with, the exchanges for which they provide clearing services and which were, in turn, formed and owned by their respective members.[16] In other words, the clearinghouses all have their origins in membership organizations that simply would have not passed muster under the Commissions' proposals.

FIA, therefore, would urge the Commissions not to act upon this aspect of their proposals until they have conducted an empirical evaluation of whether it is possible, much less likely, that a new DCO or securities clearing agency will ever be formed by a consortium of 20 (or more) owners, each of whom would own 5% or less of the business, or that clearing members and enumerated entities will be willing to make the commitments of capital and intellectual property that are necessary to form a new clearinghouse if they can own no more than 40% of the voting equity in the aggregate. If the Commissions nonetheless believe that they must adopt ownership restrictions at this time without first evaluating the likely adverse effects upon the formation of new clearinghouses, FIA would recommend that the aggregate ownership limits be eliminated altogether and that the alternative test be recalibrated to permit any single member or participant to own as much as 10%, rather than 5%, of the clearinghouse.

*The Commissions Should Give Themselves Needed Flexibility.*

As noted, FIA believes it would be ill-advised to adopt the proposed ownership restrictions at this time. FIA nonetheless commends the CFTC for its willingness to consider the granting of waivers to DCOs for a reasonable period of time, and we urge the SEC to adopt a similarly flexible approach for securities clearing agencies. The CFTC proposal, however, would condition any such waiver on a finding by that agency that the ownership restrictions are not necessary or appropriate to: (i) improve the governance of the DCO; (ii) mitigate systemic risk; (iii) promote competition; (iv) mitigate conflicts of interest in connection with a swap dealer's or major swap participant's conduct of business with the DCO with respect to fair and open access and participation and product eligibility; and (v) otherwise accomplish the purposes of the Commodity Exchange Act. We believe that requiring that each of these requirements be satisfied as a condition of granting the waiver is unnecessarily restrictive, and believe that the

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16 The one exception to this rule is OCC, which provides clearing services to exchanges and markets in addition to the five securities option marketplaces that own OCC.

Commissions would be better served by an arrangement that permits them to grant a waiver, where appropriate, if one or more (but not necessarily all) of those criteria are satisfied.

**The Commissions Should Approach With Caution Rules That Would Dictate the Composition of a Clearinghouse's Risk Management Committee.**

The Commissions' proposals would require that at least 35% of the governing Board of a clearinghouse or SEF be public directors.[17] FIA has previously supported such a standard with respect to DCMs and supports the extension of this requirement to clearinghouses and SEFs. The Commissions' proposals also would make clear that employment by a clearinghouse or SEF, or by a member or participant in one of the foregoing, is sufficient to exclude an individual from characterization as a public director. FIA supports those clarifications and believes that they are important safeguards if the independence requirements are to be meaningfully applied.[18] We nonetheless believe that the one-year and three-year "look back" periods that are included in the CFTC's and SEC's respective proposals are unnecessary and will make it more difficult than necessary for clearinghouses and SEFs to attract candidates with the necessary qualifications and skills to serve in these important positions.

In this regard, FIA has serious reservations about that aspect of the Commissions' proposals that would extend the public director requirements to a clearinghouse's Risk Management Committee[19] and, in the case of DCOs, additionally require (i) that the Chair of the Risk Management Committee be a public director and (ii) that an additional 10% of the Committee be set aside for customer representatives. Further, and as discussed in greater detail below, the duties and responsibilities of a Risk Management Committee are functionally different than those of a Board of Directors (or, for that matter, the other Committees of a clearinghouse, SEF, DCM or national securities exchange), and FIA accordingly believes that it would be unwise to adopt a mandate that the Risk Management Committee include public directors.

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[17] The SEC proposal would further require that a majority of the Board of a securities clearing agency be independent directors if the securities clearing agency elects the alternate 5% ownership test.

[18] FIA has noted in the past that it is "vitally important that DCMs include a significant number of Board Members that are recognized to be independent of the DCM and its members." *See* February 20, 2009 letter from John M. Damgard, FIA, to David A. Stawick, CFTC, re Regulatory Governance; Conflicts of Interest in Self-Regulation and Self-Regulatory Organizations (74 Fed. Reg. 3475 (Jan. 21, 2009)). FIA accordingly supports those aspects of the Commissions' proposals that would codify and extend this requirement to clearinghouses and SEFs.

[19] The SEC proposal would apply these requirements to the Risk Management Committee only if the Committee is authorized to act on behalf of the Board. The SEC proposal would in such circumstances require that the Risk Management Committee have the same composition as the Board (35% public directors, if no clearing agency participant owns more than 20% of the securities clearing agency or a majority of public directors, if the clearing agency elects the alternative test, which does not permit a clearing agency participant to own more than 5% of the securities clearing agency).

*Very Few Public Directors Will Have Meaningful Risk Management Expertise.*

Proposed CFTC Regulation 40.9(b)(3) would expressly require that the public directors of a DCO possess "sufficient expertise ... in financial services, risk management and clearing." While we agree that this is a laudable goal, we think that the Commissions may be substantially overestimating the extent to which there are qualified individuals with the inclination and with the necessary experience skill relating to the relevant products to serve as members of a Risk Management Committee.

As the SEC noted in its proposal, "[c]learing and settlement is a highly specialized area and it may be difficult to find independent directors with relevant experience."[20] We agree. We further note that otherwise-qualified individuals will in some cases not be permitted by their employers to serve on the Board or committees of another company and that it is highly unlikely that a clearinghouse would permit an individual to serve as a public director if that individual is already serving on the Board of another clearinghouse. There may be antitrust considerations that may prevent the appointment of the same individual to serve on the Boards of competing clearinghouses.[21] If despite these reasons, the same individual is appointed to the Boards of different clearinghouses, that individual may be compelled by fiduciary duties to recuse himself or herself from so many key decisions so as to be ineffective as a Board member for either clearinghouse.

*The Risk Management Committee Needs to Consist of Qualified Personnel.*

Risk management is at the very core of a clearinghouse's business. Risk management suffuses every determination that is made by a clearinghouse, beginning with its thresholds for membership and the minimum capital and guaranty fund requirements for its clearing members; its selection of clearing and settlement banks; its determination of the levels of margin that it charges on a daily basis and that it monitors and modifies in response to changing risks; its determination of settlement prices; its development and continuous refinement and testing of its risk systems; its decision to clear (or not to clear) particular products and to permit all or fewer than all of its clearing members to participate in that process; and, finally, its management of emergencies, including (but not limited to) clearing member defaults.

It is for this reason that Risk Management Committees have historically been comprised of seasoned representatives of the firms whose capital backs the clearinghouse. Unlike public directors, whose fiduciary duties may require them to focus on the maximization of profits for the benefit of the stockholders of the clearinghouse, members of the Risk Management Committee who are employed by clearinghouse participants "have a unique financial incentive to

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[20] 75 Fed. Reg. 65882, 65921 (October 26, 2010).

[21] *See* Section 8 of the Clayton Act, 15 U.S.C. § 19.

ensure that the [clearinghouse] has sufficient collateral from each participant to withstand a participant default in almost all market conditions."[22]

We therefore have the utmost concern about the unintended effects of a rule that would have clearinghouse risk management practices and the management of defaults being overseen by a Committee whose members are not all seasoned professionals who understand the special attributes of complicated financial products. Unlike, for example, the disciplinary processes of a DCM, where the views of non-members can provide a useful perspective even if they have no substantive expertise in the underlying subject matter, there is no room for inexperience on the Committee that is charged with oversight of the risk management of a clearinghouse.[23]

It is, therefore, of tremendous concern to FIA that the very individuals who have the expertise, skill and experience that is required to oversee the risk management of a clearinghouse could be marginalized by the mandatory inclusion of a minimum number of inexperienced personnel on the Risk Management Committee. This would be problematic in normal market conditions, but could be disastrous in an emergency, particularly if one or more of the experienced members of the Committee is unavailable for any reason. In such a case, decisions could end up being made by a quorum of the Committee that is disproportionately comprised of public directors who are neither experienced in the resolution of a default nor employed by or accountable to clearing members with "skin in the game."

There are no "do-overs" in clearing and settlement. The inability to manage and respond promptly and appropriately in a crisis can have catastrophic consequences. We, therefore, urge the Commissions to withdraw their respective proposals that at least 35% of the members of the Risk Management Committee be public directors and allow the clearinghouses to bring their own expert judgment to bear in the selection and staffing of their Risk Management Committees.

*The Risk Management Committee is Subject to Oversight by a Board with Public Directors.*

FIA nonetheless recognizes that there is a perception, which we believe to be ill-founded, that there are certain inherent conflicts in the administration and management of the clearinghouses that need to be ameliorated through the diversification of membership on clearinghouse Boards and Committees. As noted above, FIA does not object to the overarching requirement that at least 35% of the Board of a clearinghouse or SEF be public directors. It bears emphasis that it is the Board of Directors that has ultimate authority and control over all of the policies and decisions that are made by a clearinghouse, including its Risk Management Committee. We

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22 75 Fed. Reg. 65882, 65888 (October 26, 2010).

23 No one would seriously suggest that the members of the Audit Committee of a clearinghouse (or, for that matter, a public company) should not be required to have experience in accounting and financial matters. We believe that the same logic applies with equal force to the Risk Management Committee, which should not be compelled to appoint members who lack expertise in risk management and urge the Commissions to recognize that the criteria for appointment to a Risk Management Committee need to be qualitative, and not quantitative.

therefore respectfully submit that it is unnecessary, and inappropriately prescriptive, to establish detailed requirements for the composition of the Risk Management Committee given that the Committee's decisions are in all cases subject to oversight (including, where appropriate, disapproval) by the clearinghouse's Board of Directors.

*The CFTC's Subcommittee Proposal Should Be Modified and Adopted by Both Commissions.*

If the Commissions nonetheless conclude that the Risk Management Committee must include a public director to give effect to the purposes underlying Dodd-Frank, we would support the alternative approach that has been proposed by the CFTC that allow the Risk Management Committee of a DCO to establish one or more Subcommittees that meet the composition requirements of the proposed rule. More particularly, the CFTC proposal would permit the formation of a Risk Management Subcommittee that would be given the authority, in the first instance, to establish membership eligibility criteria, approve (or deny) applications for membership, and determine which products should be eligible for clearing.[24] FIA believes that this is a reasoned and pragmatic approach that fairly balances the Commissions' stated concerns with the need to ensure that the most sensitive risk management decisions, including the adoption of margin systems and the management of a clearing member default, are overseen by clearing member representatives with substantial, real-world risk management experience. FIA accordingly recommends that the SEC make a similar alternative available to the securities clearing agencies.

FIA believes it would be a mistake, however, to transpose onto the Risk Management Subcommittee the same structural difficulties that are discussed above in the context of the Risk Management Committee. FIA, therefore, recommends that the Commissions allow the clearinghouses to create Risk Management Subcommittees that would be given the initial responsibility to make the determinations set forth in the CFTC proposal if the Subcommittee has at least one public representative.[25] FIA further recommends as an additional safeguard that any such public representative be required to have skill and experience in clearing and settlement commensurate with that of other members of the Risk Management Subommittee (but that any such public representative not additionally be required to be the Chair of the Risk Management Subcommittee).

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[24] *See* 75 Fed. Reg. 63732, 63740-41 (October 18, 2010).

[25] As noted above, the CFTC proposal envisions that the Risk Management Committee could delegate to the Subcommittee the responsibility in the first instance to: (i) determine the standards and requirements for initial and continuing clearing membership eligibility; (ii) approve or deny (or review approvals or denials of) clearing membership applications; and (iii) determine products eligible for clearing. 75 Fed. Reg. 63732, 63740-41 (October 18, 2010). If it did so, the Risk Management Committee would no longer be subject to the public director and other composition requirements set forth in the CFTC proposal. *Id.* FIA envisions that such an approach, modified as suggested above, would appropriately allow the Risk Management Committee to retain responsibility, subject to review by the clearinghouse's Board, of the adoption and modification of the clearinghouse's risk models; the oversight of the clearinghouse's margin system and requirements; periodic reviews of the Chief Compliance Officer's and Chief Risk Officer's performance; and the resolution of a clearing member default.

In this regard, we believe the Commissions' concerns about the potential for conflicts in the administration and management of the clearinghouses would appropriately be addressed by a requirement that the dissenting views, if any, of the members of the Risk Management Subcommittee be forwarded to the Board for its consideration and by a requirement that a person whose application for membership in the clearinghouse is denied by the Subcommittee be given the right to appeal that decision to the Risk Management Committee and the Board. We believe that the Board, at least 35% of whose members would be public directors, would in each of these cases be in a position to take action to address and, if appropriate, modify or countermand the decisions of the Committee or Subcommittee.

We anticipate that the Commissions would review the actions that are taken (or not taken) by the Board in response thereto as part of their respective reviews of the clearinghouses' compliance with the conflict of interest provisions of the CEA and the Exchange Act. The Commissions would then be in a position to take further steps as necessary if it appeared that the actions of clearinghouse Boards in response to any such perceived conflicts were insufficient or inappropriate, including by the adoption of further rules by the Commissions. FIA believes that this measured approach, which would be based upon and illuminated by real-world experience, is vastly preferable to adopting prescriptive rules at this nascent stage of development of the market for cleared OTC products.

We further suggest that any requirement for the inclusion of a public representative on the Risk Management Subcommittee be modified to make clear that the members of the Subcommittee need not also be members of the Board. Such a modification would allow the clearinghouses to more readily nominate individuals with appropriate risk management skills without additionally requiring that those individuals agree to serve on the Board. More importantly, this modification would allow the clearinghouses to identify individuals with highly specialized knowledge who may not have the broad-gauged experience that is expected of Board members (or may not be interested in holding a Board position) but who understand the risks associated with a particular product class or derivative products generally.

**Conclusion.**

FIA recognizes that Dodd-Frank directs the Commissions to accomplish two important, but potentially conflicting, goals: implementing a comprehensive regulatory framework that promotes the competitive execution of swaps and the reduction of risk through clearing, while at the same time managing the potential for any resulting conflicts of interest in the operation and management of clearinghouses and SEFs that are formed and funded by industry participants.

FIA nonetheless believes that the Commissions' proposed ownership restrictions would, if implemented as proposed, be counterproductive because they would likely have the effect of making it far more difficult for new clearinghouses and SEFs to compete with existing institutions. FIA accordingly recommends that the Commissions not adopt the ownership restrictions, at least at this time. If the Commissions do decide to adopt ownership restrictions, FIA would urge the Commissions to eliminate altogether the aggregate limits on the ownership

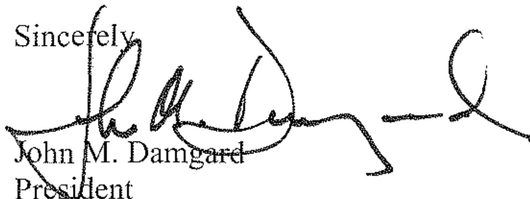
interests that may be held by the members of a clearinghouse and enumerated entities. Absent such a step, we are concerned that market participants will not make the capital and other commitments that will be necessary if they are going to innovate and compete with the existing DCOs and securities clearing agencies.

Finally, while FIA supports a 35% public participation requirement at the clearinghouse and SEF Board level, we believe that the application of a similar requirement to a clearinghouse's Risk Management Committee could have the effect of increasing risk, without a commensurate public benefit, if inexperienced individuals are given a voice in the establishment of margin requirements and the management and resolution of a default. FIA believes, however, that allowing a clearinghouse to constitute a Risk Management Subcommittee that has an appropriately qualified public representative is a reasoned and appropriate compromise that, if modified as discussed above – specifically, by providing for the review, by a Board of Directors whose members include a substantial complement of public directors, of the dissenting views that may be expressed by Subcommittee members and of appeals of adverse membership determinations – would balance the Commissions' objectives with the need for sound and experienced management of the risk functions of a clearinghouse.

* * *

FIA appreciates the opportunity to submit these comments regarding the proposed ownership limitations and governance requirements for clearinghouses and SEFs. If the Commission has any questions concerning the matters discussed in this letter, please contact Barbara Wierzynski, FIA's Executive Vice President and General Counsel, at (202) 466-5460.

Sincerely,



John M. Damgard
President

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

Honorable Mary L. Schapiro, Chairman
Honorable Elisse B. Walter, Commissioner
Honorable Kathleen L. Casey, Commissioner
Honorable Luis A. Aguilar, Commissioner
Honorable Troy A. Paredes, Commissioner