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November 23, 2010

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

Re: File No. S7-27-10: Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps under Regulation MC (75 Fed. Reg. 65882)

Dear Ms. Murphy:

The International Swaps and Derivatives Association, Inc. ("ISDA") is writing in response to the proposed rules regarding ownership and governance requirements for security-based swap clearing agencies that clear security-based swaps ("SB SCAs"), security-based swap execution facilities ("SB SEFs") and national securities exchanges ("NSEs") that post or make available for trading security-based swaps (the "proposed rules") issued by the Securities and Exchange Commission (the "Commission") to implement provisions of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

ISDA was chartered in 1985 and has over 830 member institutions from 57 countries on six continents. Our members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the risks inherent in their core economic activities.

Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business through documentation that is the recognized standard throughout the global market, legal opinions that facilitate enforceability of agreements, the development of sound risk management practices, and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

ISDA respectfully submits the following comments regarding the proposed rules. We understand the concerns behind the current proposal and appreciate the opportunity to comment.

Ownership and Voting Limitations

The Dodd-Frank Act's Section 765 provides that the Commission shall adopt rules which may include numerical limits on the control of, or the exercise of voting rights with respect to, any SB SCA, or the voting rights with respect to, any SB SEF or NSE by what is referred to by the Commission in the release accompanying the proposed rules as a "Specified Entity."¹ The Commission is required to adopt such rules only "if" it is determined after review that such rules are "necessary or appropriate" to improve the governance of, or to mitigate systemic risk, promote competition, or mitigate conflicts of interest in connection with a security-based swap dealer or major security-based swap participant's conduct of business with, a SB SCA, SB SEF or NSE in which such security-based swap dealer or major security-based swap participant has a material debt or equity investment. We recommend additional study and review before determining that such rules are "necessary" or "appropriate." ISDA is concerned that the proposed rules, as currently drafted, may frustrate capital formation and dilute managerial expertise. As a consequence, the primary systemic risk reduction purpose of the Dodd-Frank Act may be compromised by the development of weak market facilities fostered by the proposed rules.

The ownership and voting limitations that would be imposed by the proposed rules represent novel restrictions on the ownership of SB SCAs and NSEs² and their equivalents. They go further than NFA, NYSE or FINRA rules. They also cross a boundary that Congress did not cross itself: the amendment that was proposed by Representative Lynch (D-MA)³ which would have imposed numerical limitations on the ownership of (among others) SB SCAs, NSEs and SB SEFs was ultimately rejected by Congress, in favor of Section 765. Such rejection and the "if" language of Section 765 of the Dodd-Frank Act make plain that Congress did not expect automatic adoption of the Lynch Amendment. Congress expected a meaningful administrative review and reasoned treatment of the derivatives market in transition. In other words, the statute suggests that there should be findings supporting any rules that are adopted, and the Commission should not act without developing that basis.

Due to the complexities of the market and the need to attract both capital and expertise, ISDA believes that the Commission should engage in a more robust review of the market and the need for ownership and voting requirements. Although the Commission notes the potential for conflicts, the Commission's release offers no evidence of wrongdoing.⁴ Simply put, this is not the developed record that might support a proposal that could have the unintended effect of constricting capital formation in the new market entities.

The core principles for SB SEFs and other similar requirements for SB SCAs and NSEs require safeguards concerning the financial resources, open access, risk management (including risk of member defaults), corporate governance, antitrust and conflict of interest considerations that the

¹ The "Specified Entities" include: (i) bank holding companies with over \$50,000,000,000 in total consolidated assets; (ii) a nonbank financial company supervised by the Board of Governors of the Federal Reserve System; (iii) an affiliate of (i) or (ii); (iv) a security-based swap dealer; or (v) a major security-based swap participant. We note that the ownership limitations that are specified in the proposed rule are not limited to Specified Entities and would apply to all participants in SB SCAs, SB SEFs and NSEs. However, a significant number of participants in those facilities are likely to be Specified Entities and as a practical matter, Specified Entities are the most likely source of capital and know-how for those facilities.

² SB SEFs are a new concept. As such they have not been regulated before.

³ http://www.house.gov/apps/list/speech/financialsvcs_dem/lynch_035.pdf

⁴ See n. 45 of the release accompanying the proposed rules, "The Commission's discussion is intended to forestall *possible* conflicts and does not reflect findings that particular conflicts are present."

proposed rules seek to address. See, for example, Section 763 of the Dodd-Frank Act (new section 3D(d) of the Securities Exchange Act) (1)(A)(ii), (2)(B)(i), (6), (10), (11) and (12), as well as Sections 6(b) and 17A of the Securities Exchange Act and related rules under the Securities Exchange Act. These safeguards would apply to all, including Specified Entities. We believe that these rules will be sufficient to treat any potential problems.

Absent the proposed Section 765 rules, the most likely sources of capital and know-how for new SB SCAs, SB SEFs and NSEs will be the Specified Entities. In fact, most successful US exchanges and clearinghouses that are currently operational were originally launched and backed by user-owners. The concept of a public exchange is relatively recent: the CME was a non-profit membership-owned organization until the year 2000 – it went public in 2002; NASDAQ demutualized and went public in 2000; the NYSE went public in 2006. How would these entities have developed, other than through the care and capital of their user-owners? One can as easily imagine hampered market formation as a result of the proposed rules as one can imagine that the proposed rules will have the effect intended by the Commission.

SB SCAs, in particular, rely on the resources provided by their members in order to maintain the very guarantees that make them attractive for systemic risk mitigation purposes. Members of SB SCAs that have their funds at risk have a legitimate interest in directing the use of the capital and other funds that they have provided.⁵ Such expertly directed derivatives clearing houses have withstood our harshest markets.⁶ Involvement, both as voting equity and in management, by those with “skin in the game,” should be categorized as appropriate representation and prudent oversight – and not as a conflict of interest.⁷

ISDA does not believe that Specified Entity-led SB SCAs will be resistant to expanding the scope of cleared trades. Rather, it is in the interests of Specified Entities to make new markets work, and work as efficiently and effectively as possible.⁸ Specified Entities have made massive strides in clearing in the recent years prior to the Dodd-Frank Act. It is manifestly in their best interests to continue this progress. At the same time, ordinary economic principles continue to apply to Specified Entities. Progress towards clearing requires substantial investment of human and financial capital, and that investment should be encouraged and rewarded, not placed in the keeping of those with less at stake. Finally, SB SCAs will be subject to the multiple provisions listed above, which will require the rules of SB SCAs to provide for non-discriminatory clearing of security-based swaps executed bilaterally or on or through the rules of an unaffiliated NSE or SB SEF. Should enlightened self-interest fail to produce the requisite conduct, enforcing compliance with this rule (among others) is a simpler and more effective means of reducing potential conflicts than the imposition of restrictions on the ownership of, or voting rights, in SB SCAs that could harm SB SCA formation and growth.

⁵ An anomaly of clearinghouses as compared to other entities is that capital may be sheltered behind margin and guarantee funds (and assessment hurdles), essentially subjecting these latter funds in the nature of “debt” to risk of loss before, and to the benefit of, equity. To extend the analogy of the prior sentence, it is the members’ “debt” that takes loss and is subject before equity to the risks that independent equity might wish to take. In other words, equity with limited risk may put those with potentially greater “skin in the game” at risk of loss.

⁶ LCH SwapClear, for example, functioned well through recent crises.

⁷ “So why am I putting skin in the game? Because if you do not have skin in the game, if you do not have a vested interest financially in the outcome, you do not care what happens, unfortunately, in too many cases.” – Senate Banking Committee Chairman Dodd, May 11, 2010

⁸ Contrast the interests of inexperienced SB SCA operators who may imprudently “rush to clear,” taking on more risks than they can manage.

In 2004 the Commission proposed rules on fair administration and governance of self-regulatory organizations; disclosure and regulatory reporting by self-regulatory organizations; recordkeeping requirements for self-regulatory organizations; ownership and voting limitations for members of self-regulatory organizations; ownership reporting requirements for members of self-regulatory organizations; and listing and trading of affiliated securities by a self-regulatory organization (the “SRO Release”).⁹ The SRO Release proposed that national securities exchanges and registered securities associations prohibit any member that is a broker or dealer from owning and voting more than 20% of the ownership interest in the exchange or the association, or a facility of the exchange or association. The SRO Release was never acted upon by the Commission but a number of exchanges have nonetheless adopted some of the governance concepts on their own initiative.¹⁰

ISDA recommends that the Commission refrain from adopting ownership and voting requirements for these new market facilities that are yet to be formed and that are in need of capital and expertise. Once those facilities have been allowed to develop, they may similarly decide to adopt some of the governance initiatives contained in the proposed rules. We caution that the European markets will not be burdened with ownership limitations¹¹ and will obviously have immediate access to the resources of those with the deepest pockets and greatest knowledge. In light of this, the Commission should discard the proposed rule’s untested capital-raising restrictions.¹²

The primary argument that has been made in support of the proposed rules is that the presently concentrated structure of the derivatives market creates the potential for conflicts of interest.¹³ We believe that this argument, although often cited, is based on the misconception that the OTC market is national and comprised only of US bank holding companies, rather than global in scope. As our recently published market survey confirmed, when viewed globally, the derivatives market is not highly concentrated.¹⁴

The five largest US-based dealers hold only 37 percent of notional outstandings in interest rate, credit and equity derivatives as at June 30, 2010. This contrasts with other reports in which the five largest US-based dealers appear to hold 95 percent of outstandings and dominate the OTC derivatives market. The difference lies in the fact that our market survey takes into account the global scope and scale of the derivatives business, while the other figures compare the five largest US-based dealers to the total held only by US bank holding companies. Actually 82 percent of outstandings are shared among the 14 largest international dealers.

Even if the derivatives market were as concentrated as has been suggested, the derivatives market will now be a highly regulated market supervised by the Commission, the CFTC, the prudential regulators and the antitrust regulators. The major participants in the market, by virtue of their size

⁹ Securities Exchange Act Release No. 50699 (November 18, 2004), 69 FR 71126 (December 8, 2004)

¹⁰ See n.70 of the release accompanying the proposed rules.

¹¹ See n.80 of the release accompanying the Commodity Futures Trading Commission’s proposed rule relating to requirements for derivatives clearing organizations, designated contract markets, and swap execution facilities regarding the mitigation of conflicts of interest, as well as the concurring statement of CFTC Commissioner O’Malia and the dissenting statement of CFTC Commissioner Sommers.

¹² We note the colloquy between Representative Stephen Lynch (D-MA) and Chairman of the House Financial Services Committee Barney Frank (D-MA) on the language that became Section 765 of the Dodd-Frank Act but caution that non-binding conversation on the floor of Congress is an inadequate basis for placing novel burdens on business.

¹³ See the release accompanying the proposed rules at n.40 and the text of the speech of Chairman Shapiro at <http://www.sec.gov/news/speech/2010/spch101310mls-regmc.htm>

¹⁴ See The ISDA Mid-Year 2010 Market Survey at <http://www.isda.org/>.

and importance, will similarly be under strict supervision. This level of supervision obviates any possible need for ownership and voting limitations.

ISDA is concerned that the proposed ownership and voting limitations for NSEs, SB SEFs and SB SCAs will have the perverse effect of slowing and weakening the very market developments that the Dodd-Frank Act is intended to achieve.

Public Directors

The proposed rules require that SB SCA Boards of Directors be composed of at least 35 percent “public directors” (in the case of Rule 701(a) of the proposed rules (the “Voting Interest Focus Alternative”)) or a majority of public directors (in the case of Rule 701(b) of the proposed rules (the “Governance Focus Alternative”)); they also require that SB SEF and NSE Boards of Directors be composed of a majority of public directors. The proposed rules are based on an untested assumption that there will be a sufficient pool of persons available who are unaffiliated with participants but who have requisite experience and willingness to serve as public directors of SB SCAs, SB SEFs and NSEs. We think it may in fact be difficult to get enough appropriately¹⁵ skilled individuals to credibly satisfy the 35 percent and/or 51 percent requirements that the Commission proposes. A failure to implement these requirements through appropriately experienced individuals will burden sensitive boards and committees, at the commencement of operations, with ineffective decision-makers. In the release accompanying the proposed rules the need for expertise is stressed.¹⁶ New and likely inexperienced board members are unlikely to make a contribution to start-up facilities.¹⁷ For purposes of both mitigating conflicts of interest and ensuring the maintenance of self-regulatory responsibilities, knowledgeable representation is preferable to requiring a high quota of directors who are independent but by definition may not possess the necessary technical skills and specialized experience. We would urge no higher than a 25 percent public director quota for SB SCAs and NSEs, with the purpose of keeping at least three-quarters of facilities’ directors truly proficient.¹⁸ As detailed below, we also urge that no public director requirement be formulated for SB SEFs at the present time and that additional requirements be formulated for the risk committee of SB SCAs.

Nominating Committee

The proposed rules would require that each NSE, SB SEF and SB SCA have a Nominating Committee that would identify individuals qualified to serve on the Board of Directors and would administer a process for the nomination of individuals to the Board of Directors. Under the proposed rules the Nominating Committee would be entirely comprised of public directors (except in the case of the Voting Interest Focus Alternative for SB SCAs, in which case public directors would comprise at least 51 percent of the Nominating Committee). Because of the highly specialized nature of NSE, SB SEF and SB SCA operation, we believe that each member of the

¹⁵ The appropriate skill set should include both OTC and cleared derivatives trading. This combined skill set is nascent.

¹⁶ See page 65925 of the release accompanying the proposed rules.

¹⁷ We agree with the statement in the release accompanying the proposed rules that “security-based swaps trading is complex and the pool of qualified candidates may be limited. There also may be costs in educating independent directors to become familiar with the manner in which these security-based swaps are traded and the new regulatory structure governing security-based swaps, which could slow Board processes at least initially.” See page 65921 of the release accompanying the proposed rules.

¹⁸ The same recommendations would apply equally to other Board Committees, other than the risk committee, which we discuss below.

Board of Directors should have sufficient expertise, where applicable, in derivatives products, risk management and clearing services. The public director requirement for the Nominating Committee risks contradicting this requirement.¹⁹ The Nominating Committee will have a far greater chance of nominating an appropriate Board of Directors to the extent that the Nominating Committee itself is governed by individuals with sufficient expertise and who represent the parties at risk in the particular NSE, SB SEF or SB SCA. Consistently, we urge that public directors should comprise no more than 49 percent of the Nominating Committee for all such facilities.

SB SEFs

The proposed rules would require that SB SEF Boards of Directors be composed of at least 51 percent public directors. SB SEFs will represent a new addition to the trading and execution landscape in the wake of the Dodd-Frank Act, and we note that they are yet to be fully defined.²⁰ It is difficult to formulate rules (or to comment on proposed rules) that apply to SB SEFs without a clear understanding of what a SB SEF will be. Therefore, our position is that there is no basis for formulating a public director requirement for SB SEFs at the present time. In any event, there is no reason to believe that the requirements for SB SEFs should be any more restrictive than those we suggest for SB SCAs and NSEs.

However, one point we wish to highlight in particular is that under the proposed rules, SB SEFs and NSEs will be required to have a Regulatory Oversight Committee that is composed of 100 percent public directors. However, the Dodd-Frank Act also requires each SB SEF to have a chief compliance officer (the same is not true for NSEs). The duties of the chief compliance officer are spelled-out in the Dodd-Frank Act itself: the chief compliance officer is required to individually assume responsibility for compliance (including by certifying under penalty of law that reports are accurate and complete) and to assume the types of responsibilities that a Regulatory Oversight Committee would otherwise be required to assume. Requiring a Regulatory Oversight Committee for SB SEFs risks the development of a duplication of functions between the Regulatory Oversight Committee and the chief compliance officer. Given the presence of a chief compliance officer at each SB SEF, given that SB SEFs may initially operate on a small-scale basis as the market adjusts to their presence, and given the need to encourage the growth and viability of SB SEFs, it would be preferable for the bureaucracies of SB SEFs to be as streamlined as possible. Vesting regulatory oversight responsibilities with the chief compliance officer of the SB SEF, as envisaged by the Dodd-Frank Act, would be a sensible step in this direction.

SB SCAs

The proposed rules would require that SB SCA Boards of Directors be composed of at least 35 percent public directors (in the case of the Voting Interest Focus Alternative) or 51 percent public directors (in the case of the Governance Focus Alternative). SB SCAs have been in existence for many years and are an important tool in systemic risk mitigation. SB SCAs have not previously been subjected to a public directors requirement. One of the Commission's concerns regarding conflicts of interest for SB SCAs relates to the determination of whether a security-based swap contract is capable of being cleared.²¹ Although it is true that SB SCAs will propose

¹⁹ See note above.

²⁰ See ISDA's letter to the Commission and the CFTC dated October 1, 2010.

²¹ As we have previously noted, the view that potential clearing members will resist the expansion of clearing flies in the face of economic reality, and the real progress of the OTC markets to clearing in recent years. As we also have previously noted, an alternative conflict of interest may be manifested by a rush to clear on the part of over-eager poorly-managed SB SCAs.

security-based swaps as eligible for clearing, the Commission must review such proposals and has a duty to propose and review additional security-based swaps for clearing. The ability of the Commission to make such determinations is the ultimate mitigant of this highly-feared, but potential conflict of interest, and is certainly more effective than the public director requirement. The other conflicts of interest that are mentioned in the proposed rules relate to restrictions on access to the SB SCA and the lowering of risk management controls to reduce the amount of collateral that participants would be required to contribute and liquidity resources they would have to expend as margin. Again, these criteria will be subject to regulatory scrutiny. Furthermore, given that it is the capital, guarantee funds and margin of the member firms of the SB SCA that are at risk, those member firms have a legitimate interest in upholding the minimum criteria that proposed members must satisfy. They also have a legitimate interest in fully vetting proposed members. Requiring the presence of an unduly large proportion of public directors on the Board of a SB SCA, who do not represent a party at risk, would be unfair to the member firms of the SB SCAs and could pose an impediment to the legislative goal of encouraging the clearing of security-based swap contracts. Therefore, we urge that no more than 25 percent of a SB SCA Board of Directors be made up of public directors.

Under the proposed rules, SB SCAs may establish such other committees of the Board of Directors, including a risk committee, as they deem appropriate. The release specifically requests comment as to whether there should be special requirements relating to the risk committee, or its equivalent, of the Board of Directors, and suggests that one possible alternative approach could be to provide separate requirements applicable only to the risk committee that reflect the highly specialized risk management expertise required of directors serving on that committee and that, for example, instead of requiring that the risk committee be composed of at least 35% independent directors (where such committee is delegated authority to act on the Board of Directors' behalf), the requirement could specify a smaller number of independent directors, and also explicitly require that other interested persons, such as customers of participants, be represented on the risk committee. We support this suggestion and believe that the risk committee should be a vital component of each SB SCA. We also agree with the statement in the release that accompanies the proposed rules that "it may be argued that participant-related directors may in general have greater risk management expertise and experience than non-participant-related directors."²² In line with the overriding objective of the Dodd-Frank Act that institutions better manage their own risk, it is appropriate that security-based swap clearing members, with their own funds at risk, and with their unmatched expertise in the subject-matter, should be able to make risk management decisions at a SB SCA, with less input from public directors. In particular, in complex default management situations, with members' funds at risk, decision-makers must be positioned to make immediate, informed choices. We support appropriate public representation; committed, knowledgeable public directors can add to the risk management of SB SCAs. Nevertheless, we would be concerned about a rule that mandates certain percentages of public director representation rather than focusing on the expertise of each director. We fully expect the Commission to regularly scrutinize the composition of the risk committee and the contributions of the directors.

In conclusion, Section 765 of the Dodd-Frank Act requires a review, and rules only to the extent "necessary or appropriate." We recommend that the Commission engage in a robust review and study of the markets prior to implementing rules which may limit these new market entities' access to capital and qualified personnel.

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²² See page 65888 of the release accompanying the proposed rules.

ISDA appreciates the ability to provide its comments on the proposed rules and looks forward to working with the Commission as the rulemaking process continues. Please feel free to contact me or ISDA's staff at your convenience.

Sincerely,

A handwritten signature in black ink, reading "Robert C. Pickel". The signature is written in a cursive, flowing style.

Robert Pickel
Executive Vice Chairman