



November 26, 2010

Via Electronic Mail: rule-comments@sec.gov

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

Re: 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 comments to the Securities and Exchange Commission (the “Commission”) on its proposed rule related to “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

MFA supports the Commission’s efforts to ensure that key instruments for market reform – security-based swap clearing agencies (“SBSCAs”), national securities exchanges (“SBS exchanges”) and security-based swap execution facilities (“SB SEFs”) – 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”.³ We very much appreciate the Commission’s detailed appraisal of market concerns reflected in the Proposed Regulation Release and believe that the Proposed Regulation is a critical step towards mitigating conflicts of interest at SBSCAs, SBS exchanges and SB SEFs while preserving their competitiveness and ability to provide the best possible services to market participants. As set out below, however, we believe that to enhance the efficacy of the Proposed Regulation and to strike the optimal balance between safe risk management and comparative efficiency, the Proposed Regulation should incorporate certain additional criteria.

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 \$1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

² 75 Fed. Reg. 65882 (October 26, 2010) (the “Proposed Regulation Release”)

³ *Id.* at 65885.

In this spirit, we offer comments that we believe would strengthen the Proposed Regulation and help the Commission to achieve the goals set forth in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).

I. Consistency of Commission and CFTC Rules

We recognize that, unlike in other areas of Title VII, the Dodd-Frank Act does not require the Commission jointly to adopt rules with the Commodity Futures Trading Commission (“CFTC”) with respect to requirements for SBSCAs, SBS exchanges and SB SEFs.⁴ However, we believe that many of the key clearing entities will be subject to regulation by both the Commission and the CFTC. In addition, we believe that the language in Sections 726 and 765 of the Dodd-Frank Act is nearly identical because Congress intended for the related rulemakings to be as symmetrical as possible. Therefore, we strongly recommend that the Commission coordinate and reconcile the Proposed Regulation with the CFTC’s proposed rule⁵ to ensure, to the extent possible, consistency of treatment for clearing and execution of swaps and security-based swaps. Otherwise, there is potential that once adopted the rules could cause significant harm to the derivatives market by creating market fragmentation.

II. Conflicts and Concerns

We believe that in the Proposed Regulation Release, the Commission correctly identified certain key potential conflicts of interest that an SBSCA, SBS exchange or SB SEF may confront as well as the effects on each entity’s operations. However, below are additional conflicts and concerns that we believe are also essential for the Commission to take into account prior to adopting a final regulation.⁶

Incentives to Restrict Expansion or Efficiency of Security-Based Swaps Clearing. The Proposed Regulation Release recognizes that one of the key potential conflicts is that participants with undue control or influence over an SBSCA “could limit the scope of products eligible for clearing at the security-based swap clearing agency, particularly if there is a strong economic incentive to keep a product traded in the OTC market for security-based swaps.”⁷ Such economic incentives could manifest

⁴ The CFTC’s proposed rule refers to these entities as derivatives clearing organizations, designated contract markets and swap execution facilities.

⁵ Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 Fed. Reg. 63732 (Oct. 18, 2010) (the “CFTC Proposed Rule”).

⁶ Proposed Regulation Release at 65889, where the Commission poses various questions for input, including on the conflicts or interest that it identified as well as other existing conflicts concerns that commenters believe warrant scrutiny and the effects of those conflicts.

⁷ *Id.* at 65885. For example, as the Proposed Regulation Release notes at 65884-85, security-based swap clearing agencies will be required to be registered with, and regulated by, the Commission under Section 17A. In addition, all registered clearing agencies must comply with the standards in Section 17A, which include, but are not limited to, maintaining rules for promoting the prompt and accurate clearance and settlement of securities transactions, assuring the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible, fostering cooperation and coordination with persons engaged in the clearance and settlement of securities transactions, removing impediments to and perfecting the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions, and, in general, protecting investors and the public interest [footnotes omitted].

themselves not only in a more limited product expansion for cleared security-based swaps, but also in the costs associated with clearing security-based swaps relative to bilateral settlement.

From the customers' perspective, if the cost of clearing security-based swaps that are not subject to mandatory clearing but which may be clearable is materially higher than transacting bilaterally, economic considerations or fiduciary obligations may prohibit such customers from clearing such clearable security-based swaps, and this in turn will delay the expansion of clearing to the full eligible product set. SBSCA governance determines or influences the key costs of clearing – including the margin requirements of the SBSCA and the capital and other requirements for direct clearing membership that in turn both affect clearing member costs and enable or limit clearing membership access. In addition, SBSCA governance is integral to fostering competition as well as to determining the costs charged to customers by SBSCAs and the additional charges imposed indirectly by clearing members on their customers' cleared products. As a result, we believe that as the Commission considers this Proposed Regulation, it should impose governance requirements that will encourage reasonable risk-based margining and fair pricing⁸ of all products submitted to clearing, whether or not they are subject to a mandatory requirement.

Additional Decisions that Impact Clearing and Execution Expansion and Efficiency. Attached as Annex 1 is a partial list of material features of security-based swaps clearing and execution that are subject to decision by the Boards and committees of SBSCAs, SBS exchanges and SB SEFs. The outcomes of those decisions could have a significant impact on clearing, execution, transparency and competition,⁹ as well as on cost and liquidity of cleared security-based swaps. Because of the potential materiality of these decisions, we believe that balanced governance is essential to ensuring that these decisions are not the product of imbalanced representation on Boards and committees of SBSCAs, SBS exchanges and SB SEFs.

III. Recommendations

In consideration of the above, we offer specific recommendations that we believe would appropriately bolster the Proposed Regulation and address the concerns we have raised.

A. Governance Recommendations

Customer Participation on Boards, Risk Committees and Regulatory Oversight Committees. MFA recognizes that the success of clearing will depend on the structure, governance and financial soundness of SBSCAs. As a result, we believe that the Proposed Regulation should affirmatively mandate that SBSCA, SBS exchange and SB SEF Boards, risk committees and regulatory oversight

The Commission has extensive experience administering these provisions to balance the competing public policy concerns that it identifies in the Proposed Regulation Release and some of which we discuss in this comment letter. MFA believes that this experience is highly relevant with regard to SBSCAs.

⁸ See e.g., Section 6(b)(4) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), 15 U.S.C. §78f(b)(4), which provides that "[t]he rules of the exchange provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities."

⁹ See Section 6(b)(8) of the Exchange Act, 15 U.S.C. §78f(b)(8), which prohibits the rules of an SBS exchange from imposing any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. Because SBSCAs and SB SEFs are integral to the enhanced clearing regime that will result from the rulemakings related to Dodd-Frank Act, it is important that the requirements imposed on SBSCAs and SB SEFs similarly prevent competition from being impaired.

committees, as applicable, include non-dealer, customer representatives. As approximately 50% of the trading volume of the OTC derivatives market, customers are important stakeholders and should have their views reflected in the critical decisions of these bodies. Moreover, customers' interests are generally well-aligned with regulators' goal to support the expansion of clearing, but with appropriate safety and soundness.

Requiring fair customer representation would result in greater consistency between the Proposed Regulation and the CFTC's Proposed Rule. Moreover, we are concerned that without such a mandate, SBSCAs, SBS exchanges and SB SEFs may not adequately take into account the views of all market participants. In our view, measures that require customer representation will foster transparency and confidence in these registered entities and greater parity in their governance structure.

Composition of SBSCA, SBS Exchange and SB SEF Boards and Committees. We agree with the Commission that "the most significant conflicts of interest that may have an adverse effect on statutory goals in Section 765 of the Dodd-Frank Act are those that arise when a small number of participants . . . exercise undue control or influence".¹⁰ Therefore, we support fair representation in governance of SBSCAs and SBS exchanges¹¹ and encourage the Commission to promote fair representation of SB SEFs.¹² We believe that the Proposed Regulation makes progress towards fulfilling this goal by requiring that independent directors have representation on each SBSCA, SBS exchange and SB SEF's Board and committees. We believe, however, that to completely effectuate fair representation and balanced governance, no group should constitute a controlling majority, including independent directors.¹³

In particular, we believe that it is critical that the Commission impose requirements that affirmatively limit the representation of clearing members on Boards and committees to a percentage that is less than what would constitute control under the corporate constitutive documents applicable for the relevant Board or committee. Establishing that clearing members cannot as a group control risk committees, regulatory oversight committees or similar governance bodies, and that decisions are taken by a plurality of independent directors, customers, officers and employees, as well as clearing members, will help ensure that key decisions result from objective, risk-based criteria intended to enhance the SBSCA, SB SEF and SBS exchange's business and ongoing safety and soundness.

Expressly Impose Fiduciary Obligation on Board Members. While we agree that it is implicit that all members of the Board of a SBSCA, SBS exchange or SB SEF have a fiduciary duty to such

¹⁰ Proposed Regulation Release at 65885.

¹¹ See Section 6(b)(3) of the Exchange Act, 15 U.S.C. §78f(b)(3), which already requires the rules of each SBS exchange to "assure a fair representation of its members in the selection of its directors and administration of its affairs and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of the exchange, broker, or dealer."

¹² See Proposed Regulation Release at 65912, noting that, unlike SBS exchanges, SB SEFs are not currently subject to "fair representation" requirements.

¹³ See e.g., Proposed Regulation Release at 65897, where the proposed Voting Interest Focus Alternative would require SBSCA nominating committees to have a majority of independent directors; *Id.* at 65901-02, where the proposed Governance Focus Alternative would require: (i) a majority of independent directors on SBSCA Boards, and (ii) SBSCA nominating committees to be entirely composed of independent directors; and *Id.* at 65908-12 where the proposed governance requirements for SB SEFs and SBS exchanges would require: (i) a majority of independent directors on SB SEF and SBS exchange Boards, (ii) a majority of independent directors on SB SEF and SBS exchange committees (other than nominating committees), and (iii) SB SEF and SBS exchange nominating committees and regulatory oversight committees to be entirely composed of independent directors.

registered entity,¹⁴ we believe that the Commission should make this an express, non-waiveable obligation. Such a fiduciary duty reinforces the alignment of interests between the Board members and the registered entity that would help to mitigate the conflicts of interest at issue in the Proposed Regulation Release.

Availability of SBSCA, SBS Exchange and SB SEF Corporate Documents. As mentioned in the Proposed Regulation Release, one of the goals of the Dodd-Frank Act was to increase transparency.¹⁵ As a result, we recommend that the Commission require SBSCAs, SBS exchanges¹⁶ and SB SEFs to provide to the Commission detailed minutes of all Board, committee and subcommittee meetings, subject to the Commission providing appropriate protections to avoid public disclosure and preserve the confidentiality of sensitive commercial information. We believe this mandated transparency is essential for the Commission to have the information necessary to properly oversee these registered entities.

In addition, we believe that the Commission's final regulation should compel SBSCAs, SBS exchanges and SB SEFs to make publicly available all Board and committee charters, procedural rules and similar documents as well as the identities of Board and committee members. Publication will permit monitoring of conflicts of interest. Also, since clearing will affect many market participants that will not have direct participation on the Boards or committees of SBSCAs, SBS exchanges or SB SEFs, we believe that they have a strong interest in having this information be widely accessible.

Anti-Avoidance. We note that while currently the Boards, risk committees and regulatory oversight committees, as applicable, are the key governance bodies at a number of SBSCAs, SBS exchanges and SB SEFs, such entities may also vest the authority of such Board or committees in one or more other committees. We would ask that the Commission draft the final regulation so that it is both flexible and comprehensive enough to ensure that it effectively mitigates conflicts of interest as intended by the Commission and described herein, regardless of the actual Board or committee structure established at each SBSCA, SBS exchange or SB SEF. Similarly, several SBSCAs have advisory committees comprised of customer representatives. While these committees have been a useful source of advice and expertise to the SBSCAs, they typically do not have any decisional authority and should not be used as a substitute for customer representation and other conflict mitigation requirements on Boards and committees as described herein.

B. Ownership and Voting Recommendations

SBSCA Ownership Restrictions. With respect to the voting and ownership limitations of SBSCAs, we support the proposed "Voting Interest Focus Alternative" for limiting ownership of voting equity and the exercise of voting rights at SBSCAs. We believe that this approach, which has both individual and aggregate voting limitations, is consistent with the Commission's goal of ensuring that single interests do not control or influence a SBSCA and restrict access.¹⁷ We also believe that the

¹⁴ *Id.* at 65888 and 65919.

¹⁵ *Id.* at 65882.

¹⁶ *See* Section 19(b) of the Exchange Act, which requires self-regulatory organizations ("SROs") to file proposed changes, additions or deletions to that SRO's rules with the Commission and requires the Commission to provide public notice of the rule change with the terms of substance or a description of the subjects and issues involved. Although we believe this level of disclosure provides some important data to both the Commission and the public, we believe that disclosure of additional information is necessary to provide the necessary transparency to the Commission and market participants.

¹⁷ Proposed Regulation Release at 65885.

aggregate voting limitations safeguard against clearing members' profit sharing motivation to support one SBSCA at the expense of another. However, unlike the Voting Interest Focus Alternative, the Commission's proposed "Governance Focus Alternative" does not include an aggregate limit on ownership or voting control. Without an aggregate limit, we think the Governance Focus Alternative does not adequately address the control and profit sharing concerns that are motivating the Proposed Regulation. Therefore, we recommend that the Commission either eliminate the proposed Governance Focus Alternative or revise it so that it also includes an aggregate limit.

In addition, although we do not object to the Commission's ability to "waive the voting and ownership limits if it makes certain findings, including a finding that such a waiver would be consistent with the exchange's self-regulatory obligations",¹⁸ in practice, we believe that the Commission should grant waivers sparingly and only after a full assessment of the potential impact of the related conflicts of interest to the SBSCA, the clearing regime and the financial markets.

MFA appreciates the opportunity to comment on the Commission's Proposed Regulation. If the Commission or its staff has questions, please do not hesitate to call Carlotta King or the undersigned at (202) 367-1140.

Respectfully submitted,

/s/ Stuart J. Kaswell

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

CC: The Honorable Mary Schapiro
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes

¹⁸ *Id.*, footnote 64, at 65891.

Annex 1 – Additional SBSCA, SBS Exchange and SB SEF Governance Decisions that Impact Clearing and Execution Expansion and Efficiency

- Contract Structure – Is the relationship to the clearing member one of principle-to-principle versus agency? What is the comparative cost or documentation burden of one or the other? Does the contract or the relationship to the clearing member permit close-out or transfer or netting of a position freely, or is there a requirement to seek the clearing member’s consent or pay an unwind fee? Does the contract or associated trade flow require the use of third party services? If so do these services require additional fees?
- Portability – Are positions held through one clearing member freely portable, absent the default of the original clearing member, to another clearing member? Is partial portability of a portfolio permitted, or must it be the complete portfolio?
- Straight-Through-Processing – Is a trade once executed immediately accepted or rejected for clearing, or is there a period of uncertainty when the customer faces the counterparty risk of the executing dealer? If so, how long is that period of uncertainty?
- Four-Way Execution – Can trades executed between a customer and an executing broker that is not a direct clearing member be accepted for clearing? Immediately, or with delay?
- Anonymity – If a trade is executed with a broker that is not a direct clearing member, does the executing broker’s identity remain anonymous to the customer’s clearing member?
- Transparency – Are end-of-day settlement prices published? Is there a charge to view them when published? Are intra-day execution prices available?
- Suitability for Electronic Trading – Is the design of the cleared instrument or its trade processing flows suitable for electronic trading? Are there barriers to electronic trading?
- Execution Format – On a SBS exchange or SB SEF, what is the price discovery format? Are binding prices displayed? Who is permitted to transact with whom? Are there restrictions on customers’ access to liquidity providers’ quotes? Are interactions anonymous or disclosed?