UNIVERSITY OF MARYLAND
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November 17, 2010

David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

Re: Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest.

Dear Mr. Stawick:

These comments are submitted in response to the Notice of Proposed Rulemaking[1] issued by the Commodity Futures Trading Commission ("CFTC" or "Commission"). It is critical that the rules be consistent with the legislative intent of the Dodd-Frank Wall Street Reform and Consumer Protection Act[2] (the "Dodd-Frank Act"). The Commission should, therefore, in the final rules: (1) eliminate the alternative five percent ownership limitation option, thereby holding all clearing organizations to a 20 percent individual ownership limitation and a 40 percent aggregate limitation; (2) extend the limitation to encompass economic interests as well as voting interests; (3) explicitly limit waivers to rare circumstances supported by substantial evidence that the limitations are inappropriate; (4) increase the required percentage of public directors on boards to 50 percent; (5) clarify the duties of independent board members in light of their role in promoting the public interest; and (6) mandate that 35 percent of derivatives clearing organization ("DCO") disciplinary panels be comprised of public directors.

I. Congressional Intent Concerning Conflicts of Interest

One of the main principals shaping derivatives regulation under the Dodd-Frank Act is to provide *free and open access* to clearing and exchange trading (including alternate swaps

[1] Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 Fed. Reg. 63732 (October 18, 2010) [hereinafter "Proposed Rules"].

[2] Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

execution facilities) by financial institutions.[3] This necessitates that traders and investors not be excluded from markets by "the control of clearing and trading facilities by entities such as swap dealers and major swap participants."[4] The Dodd-Frank drafters emphasized this goal in a host of public statements. In addition, the Lynch Amendment passed by the House of Representatives shed light on the importance of pursuing an unwavering pursuit of free and open access to clearing and exchange trading by financial institutions.

To prevent major Wall Street banks who are "swaps dealers" from taking control of DCOs, the Lynch Amendment[5] was added to the bill passed by the House of Representatives in December 2009.[6] The amendment would have imposed a 20 percent voting stake limitation on clearinghouse and trading facility ownership.[7] It also proposed that a majority of directors overseeing a DCO, SEF or board of trade[8] could not be associated with a restricted owner.[9] While the Lynch Amendment was not included within the final bill, the authority given to the Commission was extremely broad – so broad it fully accommodate the Lynch Amendment objectives, especially when read in light of the "free and open access" requirements.

II. Ownership and Voting Limits

The 20 percent individual ownership limitations with the 40 percent aggregate ownership limitation will enhance structural governance requirements by effectively limiting the influence of Wall Street bank swap dealers on DCOs and the other relevant entities. The alternative five

[3] *See*, e.g., S. REP. 111-176, at 32–35 (2010) (noting that draft provisions concerning OTC derivatives were designed to minimize non-cleared, off-exchange trades); Transcript of Public Roundtable on Governance and Conflicts of Interest in the Clearing and Listing of Swap, August 20, 2010, at 33, *available at* http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/derivative9sub082010.pdf (statement of Randy Kroszner, University of Chicago, Booth School of Business, "And the law is clear: Open access is the fundamental principle.") [hereinafter "Roundtable Tr."].

[4] *See* Dodd-Frank Act, §§ 726, 765, *supra* note 2. *See also* (Cong. Record, June 30, 2010, H5217) (in a colloquy with Rep. Lynch, House Financial Services Chair Barney Frank agreeing that Sections 726 and 765 of the Dodd-Frank Act require the SEC and CFTC to adopt rules eliminating the conflicts of interest arising from the control of clearing and trading facilities by entities such as swap dealers, security-based swap dealers, and major swap and security-based swap participants).

[5] H.Amdt.521 to H.R. 4173 (Dec. 10, 2009) [hereinafter "Lynch Amendment"].

[6] Lynch Amendment, *supra* note 5.

[7] *See* Lynch Amendment, *supra* note 5.

[8] The Commodity Exchange Act defines a board of trade in section 1a as "any organized exchange or other trading facility." Phillip McBride Johnson and Thomas Lee Hazen, DERIVATIVES REGULATION, §1.04[1] at 151 (Aspen, 2004) (citing 7 U.S.C. §1a, CCH Rep. ¶ 1002).

[9] *See* Lynch Amendment, *supra* note 5.

percent ownership limitation without an aggregate limitation for DCOs[10] undercuts the legislative intent of Dodd-Frank.

Congress made it clear that one of the purposes of the ownership limitation is to encourage "open and meaningful competition."[11] However, the alternative five percent ownership limitation without the 40 percent aggregate ownership limitation would allow "a mere 11 dealers to dominate the clearinghouse, control a majority of its members, and dictate decisions of the organization by banding together with shared ownership under [five percent]."[12] For example, ICE Trust LLC, an over-the-counter CDS clearinghouse that has cleared over $7.4 trillion of gross notional value since its inception on March 4, 2009,[13] is dominated by Goldman Sachs, Citigroup Inc., JPMorgan, Credit Suisse Group AG, Bank of America Corp., and other large dealers, and it has been criticized for excluding competitors from its dealings and for following inadequate risk management policies.[14] These large dealers would easily adapt to the five percent alternative limitation structure since it appears that no individual dealer has more than a five percent interest in ICE Trust and, by doing so, those large dealers can continue to exclude in a highly anticompetitive fashion other respected entities from participating and thus dominate the clearinghouse. In other words, ICE Trust would run its business *status quo ante* if the five percent limit is kept as an alternative measure.

Those entities that are denied membership in a DCO must rely upon the above-listed dealers and pay substantial fees for their services. Contrary to the above-listed dealers' argument for denying membership that diversifying membership would create systemic risk,[15] the truth of

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[10] Under the second alternative, no DCO member or enumerated entity could beneficially own more than 5 percent of any class of voting equity in the DCO or, directly or indirectly, vote an interest exceeding 5 percent of the voting power of any class of equity interest in the DCO. *See* Proposed Rules, *supra* note 1.

[11] *See* Letter from Stephen F. Lynch, U.S. House of Representatives, to the Commodity Futures Trading Commission (October 18, 2010), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26291&SearchText (hereinafter "Lynch Letter"); *see also* Letter from Michael E. Capuano, U.S. House of Representatives, to the Commodity Futures Trading Commission (October 28, 2010), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26341&SearchText (stating, "I am writing to convey my serious concerns that the CFTC and SEC have proposed rules under Sections 726 and 765 of the Dodd-Frank Financial Services Reform Act which do not follow the intentions of Congress. These sections direct the agencies to adopt rules that promote competition and mitigate systemic risk and conflicts of interest.").

[12] Lynch Letter, *supra* note 11.

[13] *See* Press Release, IntercontinentalExchange, *ICE CDS Clearing Reaches $12 Trillion in Notional Cleared; ICE Clear Europe Announces New CDS Clearing Member* (September 22, 2010), *available at* http://ir.theice.com/releasedetail.cfm?ReleaseID=509797.

[14] *See* Dawn Kopecki, *U.S. Derivatives Bill Bars Dealers From Owning Clearinghouses*, BLOOMBERG.COM, October 16, 2009, *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=agLyUl0aqYuk. *See also* Roundtable Tr., *supra* note 3.

[15] Roundtable Tr. at 95-96, *supra* note 3.

the matter is that such diversification would minimize credit risk and systemic risk. The magnitude of default would substantially decrease because there would be more members to absorb the shortfalls. Moreover, the elitist admission requirements proposed by ICE Trust would leave that clearinghouse to clear what they view as the less risky transactions while the remaining clearinghouses would be forced to clear riskier transactions. Never in the history of financial clearing have regulators allowed one facility to take the cream of the market.

Moreover, a well-managed DCO should never experience default on an obligation regardless of the number of members. For example, CME Group, which operates the largest central counterparties in the world, recently stated that "[i]n its 110-plus years of existence, CME has never defaulted on an obligation to its clearing members, nor have its clearing members defaulted on their obligations to CME."[16] Notably, CME has 69 clearing members listed.[17] If CME never experienced default with its 69 members, why does ICE Trust with a mere 14 members object to the diversification?[18]

During the Roundtable, large swaps dealers argued that broad ownership would weaken the capital base of clearinghouses.[19] Their narrow view implies that only the large swaps dealers are ready and able to satisfy the capital requirements, when in fact those large swaps dealers are the ones who caused the near collapse of the U.S. financial system. Needless to say, there is an array of financially healthy institutions, including hedge funds, private equity funds, and wealthy institutional investors, that can satisfy strict, but reasonable, capital requirements for clearinghouses. It is well recognized that DCOs will be profitable[20] and there are financially strong institutions that will fill the void left by strict ownership limitations. And, if there are not

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[16] Letter from CME Group to the Secretariat of the Basel Committee on Banking Supervision, *Consultative Document: Strengthening the resilience of the banking sector*, at 11 (April 16, 2010), *available at* http://www.bis.org/publ/bcbs165/cmegroup.pdf.

[17] *See* Official Website of CME Group, Clearing Firms, *available at* http://www.cmegroup.com/tools-information/clearing-firms.html (last visited on Nov. 15, 2010).

[18] Roundtable Tr. at 16, *supra* note 3 (Jonathan Short, Intercontinental Exchange, stating that "And one of the things that I think needs to be carefully considered is the clearinghouses' obligation to manage that risk and perhaps the limitations that have to be placed on SEFs or other market participants in their access to the clearinghouse. I'm not saying that that eviscerates open access -- it certainly doesn't -- but I think there's the balance there, and the members of the clearinghouse are ultimately the parties that are underwriting this risk and responsible for it.").

[19] *See e.g.*, Roundtable Tr. at 18-19, *supra* note 3 (Bill Hill, Morgan Stanley, stating that "So not only do you need to have clearing members who have enough capital, you know, to recapitalize the clearinghouse if a member defaults, but they have to be able to keep the clearinghouse flat from an economic risk perspective […] And if they can't do that, by introducing them as a clearing member into the clearinghouse, you actually increase risk in the clearinghouse because at a time when a member is defaulting, the clearinghouse won't be able to absorb the losses.").

[20] Roundtable Tr. at 21, *supra* note 3 (Bill Hill, Morgan Stanley, stating that "I think there's a bit of a misconception that somehow clearing makes trades less profitable. That's clearly not the case.").

enough institutions to fill the void, that might very well be a basis for a good faith exception to those ownership caps that is advocated herein.

Furthermore, the limitation on ownership of voting equity, by itself, is not sufficient to mitigate conflicts of interest. It is not correct to say that only a shareholder who has voting equity interest has "direct influence over a DCO, DCM, or SEF Board of Directors [because] the shareholder has the ability to exercise voting rights with respect to e.g., election, compensation, or removal of directors."[21] This is because a DCO, DCM, or SEF is likely to create special entities that have no direct or indirect equity voting interests, *i.e.* limited partnerships, where there is no direct voting equity interest, but still exerts influences on a decision-making process of a DCO, DCM, or SEF. For example, ICE Trust LLC would completely bypass the ownership limitation since it is wholly owned by ICE US Holding Co. As a general partner of ICE US Holding Co., ICE owns fifty (50) percent and the other half is owned by the founding members[22] (large swap dealers) as *limited partners*. Those large swaps dealers are Bank of America, Barclays Capital, Citi, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan Chase, Merrill Lynch, Morgan Stanley, Nomura, BNP Paribas, RBS and UBS. If the Commission only adopts the limitation on ownership of voting equity, those large swap dealers would not need to change the ownership structure to be in compliance of the limitation rules.

In light of this, the Commission should impose limits on economic interests to mitigate these kinds conflicts of interest. During the joint CFTC/SEC Roundtable on conflicts of interest and governance,[23] this very issue was raised by Heather Slavkin of the AFL-CIO, who stated as follows: "I think most of us can imagine a situation where someone owns 5 percent of our company and asks us to do something. I don't think it matters if that person gets to vote for the board of directors, that person has real influence regardless of whether it's formal influence, there is going to be influence over the decision making, there's going to be influence over the strategy and innovation and the trajectory of the institution in general…"[24] Therefore, the Commission should impose the same 20 percent individual as well as the 40 percent aggregate restrictions on entities that have *economic interests*. This would assure open access and encourage competition for the better of the public.

The Commission should be mindful that if DCOs are controlled by large swaps dealers, they will be able to bundle the clearing requirement with the execution requirement as an explicit or implicit condition of clearing. This raises potential conflicts of interest and undermines the tenets of the Dodd-Frank Act – "free and open access" and "open and meaningful competition." During the Roundtable, Mr. Olesky from Tradeweb raised the same concern, "As we see in the

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[21] *See* Proposed Rules, *supra* note 1.

[22] "Bank of America, Barclays Capital, Citi, Credit Suisse, Deutsche Bank, Goldman Sachs, J.P. Morgan, Merrill Lynch, Morgan Stanley and UBS … are the initial clearing members of ICE Trust." Press Release, IntercontinentalExchange, *ICE Trust to Begin Processing and Clearing Credit Default Swaps* (March 9, 2009), *available at* http://ir.theice.com/releasedetail.cfm?ReleaseID=369373.

[23] Roundtable Tr., *supra* note 3.

[24] Roundtable Tr. at 153, *supra* note 3.

futures markets and other markets, if you have both execution and clearing, we think it's very important for there to be a competitive environment among execution venues. And in order to have that competitive environment among execution venues, that requires really equal and fair access from any execution venue into a clearing corp."[25] These potential conflicts of interest should be properly addressed in the Commission's final rulemaking process.

Lastly, although flexibility is a necessary regulatory mechanism, the Commission should grant the available waiver only in rare circumstances where by a showing of substantial evidence that the imposition of the limitations is absolutely inappropriate for certain DCO ownership structures. As such, the waiver should be applicable only where the requirements are shown by substantial evidence to be completely *inappropriate* to achieving the goals of "free and open access" to the relevant statutory institutions.

III. Structural Governance and Ownership Restriction Requirements

The Commission should adopt both the structural governance requirements[26] and the ownership restriction requirement as currently proposed.[27] The legislative record shows that Congress was responsive to the importance of mitigating conflicts of interest to have free and open access and intended to empower the Commission with the necessary tools to effectively achieve this goal.[28] The structural governance requirements would be effective to mitigate conflicts of interest in decision making processes[29] and the ownership restriction would remove the type of interconnectedness between financial institutions that contributed to the financial crisis.

On another note, the Commission had correctly decided that stricter structural governance requirements do not justify more lenient limits on the ownership of voting equity and the

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[25] *See* Roundtable Tr. at 19, *supra* note 3.

[26] The proposed rules impose specific composition requirements on DCO, DCM, or SEF Boards of Directors. Also, the proposed rules require that each DCO, DCM, or SEF has a nominating committee and one or more disciplinary panels. Further the proposed rules require that (i) each DCO has a risk management committee and (ii) each DCM or SEF has a regulatory oversight committee and a membership or participation committee. In each case, the proposed rules impose specific composition requirements on such committees or panels. *See* Proposed Rules, *supra* note 1.

[27] The proposed rules limit DCM or SEF members (and their related persons) from (i) beneficially owning more than twenty (20) percent of any class of voting equity in the registered entity or (ii) directly or indirectly voting (e.g., through proxy or shareholder agreement) an interest exceeding twenty (20) percent of the voting power of any class of equity interest in the registered entity. Similar rules apply to DCO. *See* Proposed Rules, *supra* note 1.

[28] Statement of Representative Barney Frank, "*Dealing with a conflict of interest* that [Representative Stephen Lynch] has been a leader in identifying *is essential if [the Dodd-Frank Act] is going to work*. So I completely agree with him. Yes, we mean both of [Sections 726 and 765], and it is a mandatory rulemaking." 156 Cong. Rec. H5217 (2010) (emphasis added).

[29] The decision making process would include determination of whether an entity is eligible to become clearing members and whether to accept new contracts.

exercise of voting power, or *vice versa*.[30] Notably, ICE Trust—which, as noted above, is dominated by a few very large swaps-dealing entities—advertises that its board is independent.[31] The Commission must keep in mind that the very fact that ICE Trust claims independence when they were the target for the initial 20 percent restriction demonstrates that having independent directors by itself is not enough to meet that statute's "free and open access" requirements.

IV. Board Requirements

The Commission should increase the required percentage of public directors to 50 percent, which is consistent with the Commission's initial proposal in the DCM Conflicts of Interest Release.[32] Some market participants have voiced a concern that a 50-percent requirement would be hard to implement because there is little to no availability of experienced and qualified persons to serve on the board. I disagree. There are academics, former regulators, and other participants in the market who can bring solid market expertise and the necessary levels of diversity to the board. One only has to look at witness lists to key hearings relating to the Dodd-Frank Act, the Financial Crisis Inquiry Commission, and the many roundtables held by the Commission in the run-up to the proposed rulemakings to see that there are a plethora of qualified individuals to serve on these boards in an independent capacity. In this regard, although each member of DCO, DCM, or SEF boards of directors should have sufficient expertise in financial services, risk management, and clearing services, all expertise of that type need not come from people who work for swap dealers and major swap participants.

V. Committees

The Commission is correct to require that at least 51 percent of the Nominating Committee of the institutions in question to be comprised of public directors and to require a public director to chair the Nominating Committee. This will protect the integrity of the process by which the DCO, DCM, or SEF selects public directors because the majority of the Nominating Committee would not be bound by multiple fiduciary duties tied to the large swap dealers and market participants.

With respect to the disciplinary panel, the Commission should mandate at least 35 percent of the disciplinary panel of DCO, DCM and SEF be comprised of public directors, instead of including "at least one public participant."[33] In order to ensure an appropriate level of public representation at every level of DCO, DCM and SEF decision making, more than one public director who does not owe fiduciary duties to swap dealers or major market participants

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[30] *See* Proposed Rules at 20, *supra* note 1.

[31] "ICE Trust management is independent of its clearing members. As an LLC, ICE Trust is independently governed by an 11 member Board of Managers." ICE Trust Overview, *ICE Trust U.S. Clearing House for Credit Default Swaps (CDS),* at 5, *available at* https://www.theice.com/publicdocs/clear_us/ICE_Trust_Overview.pdf.

[32] *See* 72 FR 6936 (Feb. 14, 2007).

[33] *See* Proposed Rule at 30, *supra* note 1.

should provide an outside voice and help to ensure that the public's interests are represented and protected.

VI. Risk Management Committee for DCO

The Commission is correct to require at least 35 percent of the Risk Committee to be comprised of public directors and 10 percent of customers of clearing members. Risk Committees are of particular importance. Because Congress explicitly recognized that "clearing is at the heart of reform,"[34] a Risk Committee's decision as to whether to clear must reflect the public interests, as well as market experts. Therefore, a Risk Committee that is dominated by swaps dealers—just as ICE Trust, which is currently comprised of nine members from its "Participant Group" and three members from ICE—would be unacceptable.

VII. Definition of Public Director

The CFTC is also correct in including employment relationships into the bright-line tests used in defining public director. It is well-known that a financial interest arising from an employment relationship would impair an individual's independence insofar as their competence to serve on the boards of directors of DCOs, DCMs, or SEFs. Furthermore, an employee of members of DCOs, DCMs, and SEFs should not be qualified as a public director since the employee would have a fiduciary duty to serve in the best interest of the firms that are members of DCOs, DCMs, or SEFs. In order to mitigate the conflicts of interest, as aforementioned, it is critical that boards of directors include 50 percent independent and public directors who do not have a financial or employment relationship that is likely to impair their independence. Furthermore, "immediate family"[35] of anyone who has a financial or employment relationship should not be qualified as a public director to prevent the appearance of conflicts of interest.

Sincerely,

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[34] *See* Lynch Letter, *supra* note 11.

[35] The proposed "public director" definition includes an expanded definition of "immediate family" that includes certain family members, whether by blood, marriage or adoption, and also includes any person residing in the home of the director or his immediate family. *See* Proposed Rules, *supra* note 1.