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

Sent via Electronic Mail: dcodcmsefGovernance@cftc.gov

Re: RIN 3038-AD01 - Notice of Proposed Rulemaking: Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest (75 Fed. Reg. 63,732)

Dear Mr. Stawick:

The International Swaps and Derivatives Association, Inc. ("ISDA") is writing in response to a notice of proposed rulemaking in respect of the requirements for derivatives clearing organizations ("DCOs"), designated contract markets ("DCMs"), and swap execution facilities ("SEFs") regarding the mitigating of conflicts of interest (the "proposed rules") issued by the Commodity Futures Trading 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 726 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 DCO, SEF or DCM, by what is referred to by the Commission in the proposed rules as an "enumerated 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 swap dealer or major swap participant's conduct of business with, a DCO, SEF or DCM in which such swap dealer or major 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 rule.

The ownership and voting limitations that would be imposed by the proposed rules represent novel restrictions on the ownership of DCOs and DCMs[2] 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) DCOs, DCMs and SEFs was ultimately rejected by Congress, in favor of Section 726. Such rejection and the "if" language of Section 726 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 by

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[1] The "enumerated 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 swap dealer; (v) a major swap participant; or (vi) an associated person of (iv) or (v).

[2] 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

enumerated entities, other than an apparently unsubstantiated allegation as to problems in other markets, see Release text accompanying and n.34. 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 DCOs, DCMs and SEFs 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 proposed rules seek to address. See Dodd-Frank Act sections 725(c)(B), (C)(iii), (D)(iii), (N), (O), (P) and (Q); 725(d); 735(b)(9)(A); (15), (16), (17), (19), (21), (22); 733 (new section 5h of the Commodity Exchange Act) (f)(2)(A)(ii), (B)(i), (7), (11), (12), (13), for example. These safeguards would apply to all, including enumerated entities. We believe that these core principles and the rules directly related to them will be sufficient to treat any alleged, potential problems.

Absent the proposed Section 726 rules, the most likely sources of capital and know-how for new DCOs, SEFs and DCMs will be the enumerated entities. In fact, most successful U.S. 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 "prophylactic effect" intended.

DCOs, 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 DCOs that have their funds at risk have a legitimate interest in directing the use of the capital and other funds that they have provided.[4] Such expertly directed derivatives clearing houses have withstood our harshest markets.[5] 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.[6]

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[4] 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 <u>before</u> <u>equity</u> 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.

[5] LCH SwapClear, for example, functioned well through recent crises.

[6] "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

ISDA does not believe that enumerated entity-led DCOs will be resistant to expanding the scope of cleared trades, Rather, it is in the interests of enumerated entities to make new markets work, and work as efficiently and effectively as possible. [7] Enumerated 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 enumerated 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, DCOs will be subject to the multiple provisions listed above, which will require the rules of DCOs to provide for non-discriminatory clearing of swaps executed bilaterally or on or through the rules of an unaffiliated DCM or 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 DCOs that could harm DCO formation and growth.

In its 2007 final rule on conflicts of interest in self-regulation and self-regulatory organizations[8] in the futures context (the "DCM Release"), the Commission made the principal point that there was a long history of close holding of futures DCMs that has ultimately led to "vibrant commercial enterprises competing globally."[9] When resting on this observation in 2007 as the basic justification for new rules, the Commission did not prescribe ownership and voting limitations for futures DCMs. It proposed only public director requirements similar to those discussed below.

ISDA recommends that the Commission adopt a similar approach for these new market facilities that are yet to be formed and that are in need of capital and expertise to become as "vibrant" as the futures markets. We caution that the European markets will not be burdened with ownership limitations[10] and will obviously have immediate access to the resources of those with the deepest pockets and greatest knowledge. In fact, the Commission described its 2007 DCM Release as offering the "ideal," "carefully targeted" "solution to emerging structural conflicts of interest in self-regulation." In light of this, the Commission should discard the proposed rule's untested capital-raising restrictions.[11]

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

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[7] Contrast the interests of inexperienced DCO operators who may imprudently "rush to clear," taking on more risks than they can manage.

[8] 72 FR 6936 (February 14, 2007)

[9] Id. at 6938

[10] See n.80 of the text accompanying the Release, the Concurring Statement of Commissioner O'Malia and the Dissenting Statement of Commissioner Sommers.

[11] The colloquy between Representative Stephen Lynch (D-MA) and Chairman of the House Financial Services Committee Barney Frank (D-MA), is referenced at n.8 in the text accompanying the Release. Non-binding conversation on the floor of Congress is an inadequate basis for placing novel burdens on business.

of interest.[12] 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.[13]

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 SEC, the prudential regulators and the antitrust regulators. The major participants in the market, by virtue of their size 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 DCMs, SEFs or DCOs 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 the maintenance of the existing requirement that DCM Boards of Directors be composed of at least 35 percent "public directors" and extend this requirement to SEF and DCO Boards of Directors. The proposed rules are based on an untested assumption that there will be a sufficient pool of persons available who are unaffiliated with enumerated entities but who have requisite experience and willingness to serve as public directors of SEFs and DCOs. We think it may in fact be difficult to get enough appropriately[14] skilled individuals to credibly satisfy the 35 percent requirement that the Commission proposes. A failure to implement this requirement through appropriately experienced individuals will burden sensitive boards and committees, at the commencement of operations, with ineffective decision-makers. The DCM public director requirement is premised on the notion that public directors are a per se good. See DCM Release at 6937. In the new release accompanying the proposed rules, however, the need for expertise is stressed. See id. n.51, n.57. New and likely inexperienced board members

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[12] See the text accompanying the proposed rules at n.28 and the text of the speech of Chairman Shapiro of the SEC at http://www.sec.gov/news/speech/2010/spch101310mls-regmc.htm

[13] See The ISDA Mid-Year 2010 Market Survey at http://www.isda.org/.

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

are unlikely to make a contribution to start-up facilities. 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 DCMs, with the purpose of keeping at least three-quarters of facilities' directors truly proficient. As detailed below, we urge that a similar standard be applied to DCOs and that no public director requirement be formulated for SEFs at the present time because there is no clear understanding of what a SEF will be.

Nominating Committee

The proposed rules would require that each DCM, SEF and DCO 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, public directors would comprise at least 51 percent of the Nominating Committee and a public director would chair the Nominating Committee. The high proportion of public directors proposed for the Nominating Committee risks contradicting the requirement in the proposed rules that because of the highly specialized nature of DCM, SEF and DCO operation, each member of the Board of Directors should have sufficient expertise, where applicable, in derivatives products, risk management and clearing services.[15] 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 DCM, SEF or DCO. Consistently, we urge that public directors should comprise no more than 49 percent of the Nominating Committee.

SEFs

The proposed rule would require that SEF Boards of Directors be composed of at least 35 percent public directors. 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.[16] It is difficult to formulate rules (or to comment on proposed rules) that apply to SEFs without a clear understanding of what a SEF will be. Therefore, our position is that there is no basis for formulating a public director requirement for SEFs at the present time. In any event, there is no reason to believe that the requirements for SEFs should be any more restrictive than those we suggest for DCOs and DCMs.

The text accompanying the proposed rules specifically requests comment as to whether requiring a SEF to have a Regulatory Oversight Committee is necessary given that the Dodd-Frank Act requires each SEF to have a chief compliance officer (the same is not true at a DCM). Under the proposed rules, SEFs will be required to have a Regulatory

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[15] See note above.
[16] See ISDA's letter to the Commission and the SEC dated October 1, 2010.

Oversight Committee that is composed of 100 percent public directors. 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 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 SEF, given that 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 SEFs, it would be preferable for the bureaucracies of SEFs to be as streamlined as possible. Vesting regulatory oversight responsibilities with the chief compliance officer of the SEF, as envisaged by the Dodd-Frank Act, would be a sensible step in this direction.

DCOs

The proposed rule would require that DCO Boards of Directors be composed of at least 35 percent public directors . DCOs have been in existence for many years and are an important tool in systemic risk mitigation. DCOs have not previously been subjected to a public directors requirement. One of the Commission's concerns regarding conflicts of interest for DCOs relates to the determination of whether a swap contract is capable of being cleared.[17] Although it is true that DCOs will propose swaps as eligible for clearing, the Commission must review such proposals and has a duty to propose and review additional 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 the determination of the minimum criteria that an entity must meet in order to become a swap clearing member and whether a particular entity satisfies such criteria. 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 DCO 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 DCO, who do not represent a party at risk, would be unfair to the member firms of the DCOs and could pose an impediment to the legislative goal of encouraging the clearing of swap contracts. Therefore, we urge that no more than 25 percent of a DCO Board of Directors be made up of public directors.

Under the proposed rules, DCOs will be required to have a Risk Management Committee. It is proposed that the Committee would include 35 percent public directors and 10 percent

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[17] As we have previously noted, the view that potential clearing members will resist the expansion of clearing flies in the fact 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 DCOs.

representatives of customers. We agree with the statement in the text that accompanies the proposed rules that "[s]waps contracts, as well as commodity futures and options, are complex instruments. Managing the risks of such instruments requires expertise. In general, clearing members constitute the main source of such expertise." The fact that swap clearing members of DCOs that currently clear large volumes of swap contracts are enumerated entities does not alter this fundamental truth. We are concerned about a rule that mandates a percentage of public (i.e. non-clearing member, non-customer) representation on the Risk Management Committee rather than focusing on the expertise of each member of the Committee. We fully expect the Commission to regularly scrutinize the composition of the Risk Management Committee and the contributions of each of its members. In line with the overriding objective of the Dodd-Frank Act that institutions better manage their own risk, it is appropriate that those swap clearing members with their own funds at risk and who provide relevant expertise should be able to make risk management decisions at a DCO. We also believe that customers, themselves active users of swaps with significant expertise, should be represented on the Committee, particularly in circumstances where they may have funds at risk in the DCO. In complex default management situations, with their funds at risk, decision makers must be positioned to make immediate, informed choices. We support appropriate public representation; committed, knowledgeable public members of the Risk Management Committee can add to the risk management of DCOs. We believe, however, that the focus should be on the quality of the contribution of those members, not reliance on numerical thresholds.

In conclusion, Section 726 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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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,

Robert Pickel
Executive Vice Chairman