

COMMENT LETTER

November 17, 2010

ICI Comment Letter on SEC and CFTC Proposals to Mitigate Conflicts of Interest at Swap Entities (pdf)

November 17, 2010 Ms. Elizabeth M. Murphy Secretary Securities and Exchange Commission 100 F Street, N.E. Washington, D.C. 20549 Mr. David A. Stawick Secretary Commodity Futures Trading Commission Three Lafayette Centre 1155 21st Street, N.W. Washington, D.C. 20581 Re: Ownership Limitations and Governance Requirements for Swap and Security-Based Swap Clearing Agencies and Trading Facilities (SEC File No. S7-27-10 and CFTC RIN 3038-AD01) Dear Ms. Murphy and Mr. Stawick: The Investment Company Institute¹ is writing to provide comments on the proposals by the Securities and Exchange Commission and the Commodity Futures Trading Commission that would mitigate conflicts of interest by imposing governance, voting, and ownership limitations on entities where swaps are cleared and may be traded (collectively “swap entities”).² Sections 726 and 765 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) empower the Commissions to adopt rules as necessary to improve the governance of swap entities or to mitigate

¹ The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$12.05 trillion and serve over 90 million shareholders.

² See 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 FR 65882 (October 26, 2010), available at <http://www.sec.gov/rules/proposed/2010/34-63107.pdf> and Proposed Limits on Ownership or Voting Power of Derivative Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities, 75 FR 63732 (October 28, 2010), available at <http://www.cftc.gov/LawRegulation/FederalRegister/ProposedRules/2010-26220.html>.

Throughout this letter, we will use the term “swaps” to refer to both swaps and security-based swaps.

Ms. Elizabeth M. Murphy Mr. David A. Stawick November 17, 2010 Page 2 of 4

systemic risk, promote competition, or mitigate conflicts of interest in connection with the interaction between swap dealers and major swap participants, on the one hand, and swap entities on the other. As participants in the swap markets, funds have a strong interest in ensuring that these markets are highly competitive, transparent, and efficient, and operate in a manner that treats all market participants fairly. To that end, we recommend that the Commissions require swap entities to include investor representatives on their boards of directors. Requiring investor representation in the governance structure of swap entities

would minimize conflicts of interest by better balancing the advancement of commercial interests with the fulfillment of self-regulatory responsibilities. A regulatory framework that aids in controlling conflicts of interest at swap entities should, in turn, reduce systemic risk in the swap markets.

I. Investor Representation on Swap Entity Boards

The SEC and CFTC proposals would impose on swap entities substantially similar structural governance requirements with respect to their boards of directors and board committees. We support measures to limit the influence and control that any one set of a swap entity's members may attempt to exert over a swap entity's operations.³ We believe that such measures are necessary to control conflicts of interest that may exist, including: limiting membership to minimize risk exposure and preserve the swap entity's profits; limiting the scope of products eligible for clearing, particularly if there is a strong incentive to keep a product traded in the OTC market; and maintaining lower risk management controls to reduce the amount of collateral and liquidity that the swap entity's members are required to post. Quite simply, a swap entity could put its interests and those of its members ahead of its regulatory responsibilities by failing to take necessary action or appropriately manage risk exposure. Given the importance of the board of directors of a swap entity in monitoring and controlling conflicts of interest, it is imperative that the composition of a swap entity board include investor representation.⁴ Guaranteeing investor representation on the board would ensure a governance structure that serves investors and satisfies the goals of the Dodd-Frank Act, as stated above. Investor representation would not impede the competitive interests of a swap entity but would help to limit risks to the entity and the markets overall. Investor representation also would level the playing field for swap entities by creating a governance structure wherein swap entities operate under similar restraints on the influence of owner and member self-interests, which would benefit new entities in the market.

³ For purposes of this letter, "members" refers to members, participants, and enumerated entities as used by the Commissions in their proposals.

⁴ To benefit from a diverse group of market participants, some equities clearing organizations and stock exchanges already include investors on their boards. For example, DTCC's Board is made up of 18 directors; 14 are from participants, including international broker-dealers, correspondent and clearing banks, mutual fund companies, and investment banks.

Ms. Elizabeth M. Murphy
Mr. David A. Stawick
November 17, 2010
Page 3 of 4

II. Investor Representation on Board Advisory Committees

The Commissions' proposals include provisions that would allow for industry representation on board advisory committees. The CFTC proposal, for example, specifically includes a requirement that 10 percent of the Risk Management Committee of a swap entity be composed of customers of clearing members who also routinely execute swap contracts and who have experience in using pricing models for such contracts. We strongly support investor representation on board advisory committees.⁵ These committees are designed to facilitate meaningful discussion on important issues before the board. Nevertheless, such advisory committee representation should not be a substitute for investor representation on the board itself. This is particularly true in the developing swap markets where, at this time, investors have access to only a handful of swap entities for clearing and trading.

* * * * *

If you have any questions on our comment letter, please feel free to contact me directly at (202) 326-5815, Heather Traeger at (202) 326-5920, or Ari Burstein at (202) 371-5408.

Sincerely, /s/ Karrie McMillan
Karrie McMillan
General Counsel

cc: The Honorable Mary L. Schapiro, Chairman
The Honorable Kathleen L. Casey, Commissioner
The Honorable Elisse B. Walter, Commissioner
The Honorable Luis A. Aguilar, Commissioner
The Honorable Troy A. Paredes, Commissioner
Robert W. Cook, Director
Division of Trading and Markets
Securities and Exchange Commission
The Honorable Gary Gensler, Chairman
The Honorable Michael V. Dunn, Commissioner

⁵ Both the New York Stock Exchange and the Nasdaq Stock Market, for example, have board advisory committees composed of institutional investors, i.e., the

NYSE Institutional Traders Advisory Committee and the Nasdaq Quality of Markets
Committee. Ms. Elizabeth M. Murphy Mr. David A. Stawick November 17, 2010 Page 4 of 4
The Honorable Jill E. Sommers, Commissioner The Honorable Bart Chilton, Commissioner
The Honorable Scott D. O'Malia, Commissioner Commodity Futures Trading Commission

Copyright © by the Investment Company Institute. All rights reserved. Information may be
abridged and therefore incomplete. Communications from the Institute do not constitute, and
should not be considered a substitute for, legal advice.