From: Kulkin, Matthew <MKulkin@PattonBoggs.com>
Sent: Tuesday, October 5, 2010 1:55 PM
To: DCOGovernance <DCOGovernance@CFTC.gov>
Subject: FW: DTCC Letter to Commissioner Chilton on Conflicts of Interest/Governance
Attach: DTCC Letter to CFTC Commissioner Chilton.pdf

Good afternoon,
Ms. Ritter asked that I forward the attached letter to the governance & position limit team for publication on the CFTC website.

Please let me know if you need any other information.

Best,
Matt

--
Matthew B. Kulkin
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From: Kulkin, Matthew
Sent: Thursday, September 30, 2010 5:58 PM
To: 'eritter@cftc.gov'
Subject: DTCC Letter to Commissioner Chilton on Conflicts of Interest/Governance

Elizabeth,

Thank you for taking the time to meet with Pete Axilrod from the Depository Trust & Clearing Corporation on Wednesday.

As a follow-up, he asked that I email you the attached letter addressing proposed rules on conflicts of interest and governance. I believe that this letter was also faxed to Commissioner Chilton and you earlier this afternoon.

Please let me know if you have any questions. We look forward to speaking with you again soon.

Best,
Matt

--
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DTCC

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September 30, 2010

Commissioner Bart Chilton
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Regarding Proposed Rules on Governance Arrangements and Mitigation of Conflicts of Interest

Dear Commissioner Chilton:

Following our conversation on September 29 at your office with you and your counsel, Elizabeth Ritter, we wanted to follow up on the thoughts we shared regarding proposed rules under consideration by the CFTC that would govern conflicts of interest as mandated under Section 727 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act).

In particular, we wanted to offer an approach to conflicts of interest that would address the situation in which a particular swap, group, category, type, or class of swaps would otherwise be subject to mandatory clearing (as determined by the Commission under 7(a)(3) of the Dodd-Frank Act, adding a new Section 723(h) to the Commodity Exchange Act), but, due to conflicts of interest on the part of swaps dealers, no DCOs are prepared to clear the product. This approach would not resort to the very blunt instrument of aggregate numerical DCO ownership or governance caps on a particular class of market participants, which are nowhere mentioned in the Act and which, in our view, would serve as an undesirable restraint of trade. Such an aggregate ownership cap approach appears to have been rejected in Europe and could, for instance, prevent cooperatives with a broad base of ownership, like DTCC, from possibly serving as a DCO -- even though in other markets such a cooperative approach is embraced as the vital infrastructure of the capital markets.

Our proposed approach is fairly straightforward and directly addresses the issue of maximizing the use of DCOs to clear swaps where regulators determine that could be accomplished in a safe and sound manner under Section 2(h)(2) of the Commodity Exchange Act.

First, it is important that DCO governance require a board of directors comprised of representatives across the broad base of participants in the relevant markets (i.e., not from only one class of market participant), as well as independent directors (i.e., directors who are not associated with market participants or DCO shareholders). There should also be a means of assuring, through shareholders agreements or through actual shareholding and governance documents, that directors associated with any particular class of market participants are generally acceptable to that class. This sort of approach to governance where there may be non-alignment of interest among various market participants has been used in the past – for instance in the formation of the Government Securities Clearing Corporation in the late 1980s as an industry owned utility to clear US Government Securities.

Second, if no consensus can be reached among the various classes of market participants represented on the DCO board (and the independent directors) either (1) that a particular class of swaps should be cleared by the DCO or (2) on the conditions (e.g., margin requirements etc.) that should be attached to the clearing of such swaps, then there should be a process by which the parties wanting the DCO to clear the product or to clear it under less onerous conditions should be able to appeal to the appropriate regulator(s). The regulator(s) would then evaluate the proposal of the appealing parties against the standards contemplated by Section 2(h)(2)(D)(ii) of the Commodity Exchange Act, and resolve the dispute.

It seems that the typical case of this that could arise out of conflict of interest concerns would be one where a number of buy-side institutions have large notional exposures to a class of swaps and where adequate liquidity and pricing information is fairly demonstrable from information reported to swap data repositories, but nevertheless, the DCO declines to clear the instruments or imposes unduly burdensome conditions on their clearance. We suspect, however, that if the Commission can establish *prima facie* criteria for mandatory clearing along these lines, as contemplated by Section 2(h)(2)(D)(ii) of the Commodity Exchange Act, then such disputes would be highly unlikely.

Finally, we would urge that those involved in the decision making process at DCOs regarding new instruments for clearing (other than the independent directors) be required to bear some financial risk in the event the DCO mismanages the risks associated with clearing these instruments. Otherwise parties with no financial risk could, with impunity, force others to take on risk with no motive to consider the implementation of appropriate risk mitigation.

We recognize that you are receiving ideas from many stakeholders on this issue at this time and we would be pleased to work with you, or with others in any further consultations you may conduct as you assess what may be the best way forward to enhance safety and soundness and enhance equity and transparency in the derivatives markets.

We were grateful for your time and look forward to providing our further thoughts during any formal comment period provided by the Commission as it moves forward with the rulemaking process.

Sincerely,

/s/ Peter Axilrod

Peter Axilrod
Managing Director
OTC Derivatives Services

cc: Elizabeth Ritter