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Via Electronic Submission

September 13, 2019

Mr. Christopher Kirkpatrick
Secretary of the Commission
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Derivatives Clearing Organization General Provisions and Core Principles Notice of Proposed Rulemaking
RIN 3038-AE66

Dear Mr. Kirkpatrick,

I appreciate the opportunity to comment on the Commodity Futures Trading Commission's ("Commission" or "CFTC") proposed rules on "Derivatives Clearing Organization General Provisions and Core Principles" ("Proposal"). In my scholarship, I have analyzed the implications of different ownership structures on clearinghouses' risk profile;[1] I have looked at governance and financial mechanisms to more effectively align clearinghouses' economic incentives to those of their market participants;[2] and, more generally, I have studied the growing domestic and international regulation and role played by financial market infrastructures in the aftermath of the financial crisis. I welcome the chance to share my findings and views with the Commission and I remain available to further discuss them with the Commission. The Commission's Proposal clarifies, simplifies, and amends multiple sections of Part 39 of the CFTC Regulations that apply to Derivatives Clearing Organizations (DCOs), their risk management and reporting obligations. This letter focuses on three specific set of amendments: *(i) governance and composition of the governing boards - §§ 39.24, 39.26; (ii) default rules and procedures - § 39.16(c);* and *(iii) financial resources - § 39.11.*

I commend the Commission's rule making initiative and I support the current CFTC's Proposal to amend some provisions of the DCOs' regulatory regime. However, I encourage the Commission to continue to assess the regulatory architecture of DCOs, their governance, financial

[1] *See* Paolo Saguato, *The Ownership of Clearinghouses: When Skin in the Game is Not Enough: The remutualization of Clearinghouses*, 34 YALE. J. ON REG. 601, 633-34 (2017), available at https://digitalcommons.law.yale.edu/yjreg/vol34/iss2/5/.
[2] *See* Paolo Saguato, *Risky Middlemen*, REV. BANKING AND FINANCE LAW (2020 forthcoming) (on file with the author).

resilience, and recovery and resolution regimes. Clearinghouses, or central counterparties, operate with a unique "double layered capital" structure,[3] which allow them to operate as countercyclical systemic risk absorbers, but, at the same time, their unique economic structure exposes them to unique agency costs that potentially threaten their systemic resilience by misaligning the incentives of the clearing firms from those of their main stakeholders, namely clearing members and clients of the clearing members. The Commission should continue in its mission to simplify and strengthen our national derivatives makers and I respectfully hope for a more detailed reassessment of the still proposed rules on the governance and conflicts of interest of DCOs.[4] A systematic approach to the ownership, governance and financial resilience of clearinghouses is necessary to support resilient and efficient financial market infrastructures.

(i) *<u>Governance and composition of the governing boards - §§ 39.24, 39.26</u>*

The Proposal would require the participation of market participants (clearing members and their customers) on the Board of Directors or other board-level committees of the DCOs. While I agree with the benefits of a multi-stakeholder representation at the board level and a more direct engagement of market participants in the governance and supervision of clearinghouses, I respectfully believe that the approach adopted by the Proposal would not be conducive to better corporate governance.[5]

For these reasons, I encourage the CFTC to expand its analysis to the composition and role of the DCOs' risk committee and consider requiring at least half of the representatives of DCOs' risk committees to be composed of market participants—in particular clearing members—, to transform the risk committee from a mere advisory committee to a committee with decision making power. In addition, the CFTC should consider requiring the Board of Directors of DCOs to provide formal and comprehensive explanations to the market participants (clearing members and their users) and to the Commission anytime it dissents from the deliberation of its risk committee.

Clearing members provide clearinghouses with loss absorbing financial resources (i.e. margin and guaranty fund contributions) and are contractually bound to support the clearing business with additional contributions (i.e. assessment contributions) if the pre-funded resources were not sufficient to absorb the losses of the default of one or more of their clearing members. However, despite the substantial size of the members' contributions, members are not formally entitled to any representation on clearinghouses' boards of directors and their risk committee.[6] Despite the good practices of clearinghouses to appoint representatives of their clearing members and market participants in governing boards, I support the present CFTC's proposal and I encourage the Commission to address the concerns raised above.

(ii) *<u>Default rules and procedures - § 39.16</u>*

[3] "Capital" is not used in its corporate finance meaning as "equity capital," but in a very broad sense to include equity capital and guaranty fund contributions;

[4] *See* Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 Fed. Reg. 63,732 (proposed Oct. 18, 2010) (to be codified at 17 C.F.R. pts. 1, 37, 38, 39, and 40), http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2010-26220a.pdf; Governance Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities; Additional Requirements Regarding the Mitigation of Conflicts of Interest, 76 Fed. Reg. 722 (proposed Jan. 11, 2011) (to be codified at 17 C.F.R. pts. 1, 37, 38, 39, and 40), http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2010- 31898a.pdf.

[5] Simple representation in the board of directors without any voting power is not an effective governance and supervisory tool.

[6] This analysis is primarily focused on systemically important DCOs.

The Proposal would amend certain aspects of the default procedures under § 39.16. In particular, the Commission would require the creation of a default committee composed also of clearing members and their clients that would be convened in the event of a default to support the DCOs in managing it. I support this proposal as a sound coordination mechanism between clearinghouses and their primary providers of loss absorbing financial resources. I respectfully posit that the Commission should explore the costs and benefits of further increasing and formalizing the role of clearing members and their clients in the default procedure. As primary underwriters of the clearing business, clearing members should have a primary role in setting default procedures.

Furthermore, the Commission proposes to require DCOs to publish on their website an immediate note of any declaration of default of any of its members. The Commission justifies this proposed amendment to support the integrity and the stability of the market. However, I respectfully believe that requiring an immediate public notice is unnecessary and potentially counterproductive to an effective default procedure. As such, this proposed rule should be omitted in the final rulemaking. To effectively conduct a default procedure and to avoid the risk of panic spreading in the market, a clearinghouse should be able to operate as an information insensitive nexus with its members and the Commission (and eventually with the Federal Reserve, in case of a systemically important financial market utility). Markets should be notified only at completion of the default procedure, to avoid the risk of spillovers.[7]

(iii) *Financial resources - § 39.11*

I support the Commission's Proposal on financial and operational capital. However, I respectfully encourage the Commission to look into the ratios between clearinghouses' own capital—i.e. "skin in the game"—and members' guaranty funds deposits in the clearinghouses' "default waterfall" and to analyze the effects they have on clearinghouses' risk profiles.

The views and opinions expressed in this letter are my personal ones and not those of George Mason University.

I value the opportunity to comment on this important Proposal. If the Commission or staff have any questions, you are welcome to contact me at psaguato@gmu.edu or 703-993-8278. I look forward to continuing a dialogue with the Commission on clearinghouses and derivatives markets.

Sincerely,

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[7] Gary Gorton, *Clearinghouses and the Origin of Central Banking in the United States*, 45 J. ECON. HIST. 277 (1985)