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Via Agency Website & Courier

April 29, 2011

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Clearing Agency Standards for Operation and Governance (File S7-8-11)

Dear Ms. Murphy:

The Depository Trust & Clearing Corporation ("DTCC") appreciates the opportunity to provide comments to the Securities and Exchange Commission (the "Commission" or the "SEC") on its proposed rules regarding registration of clearing agencies and standards for the operation and governance of clearing agencies (the "Proposed Rules") set forth in Release No. 34-64017 dated March 3, 2011 (the "Release").[1]

INTRODUCTION

DTCC supports the efforts of the Commission to establish risk management standards for the operation and governance of clearing agencies and, more generally, promote financial stability, transparency and accountability in the financial system. DTCC believes that the Proposed Rules, as a whole, provide a clear and comprehensive set of standards for the operation and governance of clearing agencies that will effectively manage risks and promote the objectives of Section 17A of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").

DTCC has a number of general comments on the Proposed Rules, as well as specific comments on (i) certain Proposed Rules that DTCC believes the Commission should further clarify and refine and (ii) certain Proposed Rules that DTCC believes the Commission should not adopt. Given the detailed and technical nature of our specific comments, and to provide clearing agencies and market participants with sufficient time to evaluate the impact the Proposed Rules may have on them, DTCC respectfully

[1] Clearing Agency Standards for Operation and Governance, 76 Fed. Reg. 14,472 (Mar. 16, 2011).

requests that the Commission publish any modifications it may make to the Proposed Rules for an additional comment period.

Our comments on the Proposed Rules are preceded by a brief overview of DTCC, with specific reference to its wholly-owned clearing agencies and its trade information warehouse.

THE DTCC GROUP

DTCC, through its wholly-owned subsidiaries, provides clearing, settlement and information services for equities, corporate and municipal bonds, government and mortgage-backed securities, money market instruments and over-the-counter derivatives in the United States and globally.

DTCC has three wholly-owned subsidiaries that are registered as clearing agencies under the Exchange Act and that are subject to regulation by the Commission:

(a) The Depository Trust Company ("DTC") provides custody and asset servicing for 3.6 million securities issues from the United States and 121 other countries and territories, valued at almost $34 trillion. DTC is a central securities depository ("CSD").

(b) National Securities Clearing Corporation ("NSCC") processes substantially all broker-to-broker equity and corporate and municipal bond trades in the United States and provides clearing, risk management and central counterparty services and a guarantee of completion for a broad range of transactions. NSCC is a central counterparty ("CCP").

(c) Fixed Income Clearing Corporation ("FICC") processes the bulk of all trading in the US fixed-income marketplace. FICC operates two divisions: the Government Securities Division ("FICC-GSD") and the Mortgage-Backed Securities Division ("FICC-MBSD"). FICC-GSD provides clearing, risk management and central counterparty services in the fixed income and government securities markets. FICC-GSD is a CCP. FICC-MBSD provides clearing and risk management services in the mortgage-backed securities market. FICC-MBSD is not a CCP.[2]

DTCC also has a wholly-owned subsidiary, The Warehouse Trust Company LLC ("WTC"), which operates a centralized global repository for trade reporting and post-trade processing of OTC derivatives contracts (the "Trade Information Warehouse"). In addition to its repository services, *e.g.*, acceptance and public and regulatory dissemination of data reported by reporting counterparties, the Trade Information

[2] FICC-MBSD has filed a proposed rule change with the Commission to provide CCP services, but such proposed rule change has not yet been approved by the Commission.

Warehouse also provides legal recordkeeping and central life cycle event processing for credit default swaps, *e.g.*, calculating payments and bilateral netting, settling payments, credit events, early termination and company renames and reorganizations.

DTCC is a financial market utility owned by the financial institutions that are participants of its clearing agency subsidiaries. The participant community includes domestic and international broker-dealers, banks, mutual fund companies and investment banks.

GENERAL COMMENTS ON PROPOSED RULES

As stated above, DTCC believes that the Proposed Rules, as a whole, provide a clear and comprehensive set of standards for the operation and governance of clearing agencies that will effectively manage risks and promote the objectives of Section 17A of the Exchange Act and the Dodd-Frank Act. DTCC offers the following general comments on the Proposed Rules.

Consideration of Appropriate Global Standards in Connection with Proposed Rules

In the Release accompanying the Proposed Rules:

> (a) The Commission observes that Section 805(a) of the Dodd-Frank Act directs the Commission to take into consideration in its rulemaking relevant international standards and existing prudential requirements for clearing agencies that are designated as financial market utilities, and that the current international standards most relevant to risk management of clearing agencies are the standards developed by the Technical Committee of the International Organization of Securities Commissions ("IOSCO") and the Committee on Payment and Settlement Systems ("CPSS") of the Bank for International Settlements that are contained in (i) the 2001 report titled "Recommendations for Securities Settlement Systems" (the "RSSS Report", and the recommendations contained in the RSSS Report, the "RSSS Recommendations") and (ii) the 2004 report titled "Recommendations for Central Counterparties" (the "RCCP Report", and the recommendations contained in the RCCP Report, the "RCCP Recommendations").[3] The Commission also noted in the Release that CPSS and IOSCO were then in the process of revising their existing sets of international standards.[4] Since the publication of the Release, CPSS and IOSCO have issued for comment a consultative report titled "Principles for Financial Market Infrastructures" (the "PFMI Report", and the principles contained in the PFMI Report, the "PFMI Principles"). CPSS and IOSCO have requested comments on the PFMI Report by July 29, 2011.

[3] *See* Release, *supra* note 1, at 14,476.

[4] *See id.*

(b) The Commission states that it is proposing Rule 17Ad-22 because the Commission preliminarily believes that Proposed Rule 17Ad-22 will help facilitate prompt and accurate clearance and settlement, the safeguarding of securities and the protection of investors.[5] The Commission also notes that the Proposed Rule is consistent with the RSSS Recommendations and RCCP Recommendations (together, the "CPSS-IOSCO Recommendations") but "reflects modifications designed to tailor the proposed rule to the Exchange Act and the US clearance and settlement system".[6]

(c) The Commission requests comment on Proposed Rule 17Ad-22 generally and its consideration of the CPSS-IOSCO Recommendations in connection therewith.[7]

DTCC supports the application of appropriate global standards for the operation of financial market infrastructures (with necessary modifications to conform such standards to the requirements of the Exchange Act and US market practice), particularly those standards relating to sound risk management practices and fair and open participation requirements. DTCC agrees with the Commission that the application of global standards to clearing agencies will further the objectives and principles for clearing agencies under Section 17A of the Exchange Act and the Dodd-Frank Act. The application of global standards to clearing agencies will also prevent clearing agencies and their participants from incurring unnecessary expense associated with complying with different, and potentially conflicting, regulatory standards.

DTCC agrees with the Commission that the CPSS-IOSCO Recommendations are the current global standards for the operation of financial market infrastructures. However, given that the PFMI Report and the proposed PFMI Principles may significantly modify certain of these global standards, DTCC would urge the Commission to be prepared to move expeditiously, with due public notice and a comment process, to modify Rule 17Ad-22 as needed to appropriately preserve the alignment of the requirements of Rule 17Ad-22 with the global standards incorporated into the final PFMI Principles. The Commission may also wish to consider whether, in certain instances, deferring the formal adoption of parts of Proposed Rule 17Ad-22 until the PFMI Principles are finalized may be appropriate to ensure that the applicable standards remain in alignment.

Proposed Rules That Go Beyond Global Standards

In his statement at the March 2, 2011 Open Meeting to Propose Rules Regarding Clearing Agency Standards for Operation and Governance (the "March Open Meeting"), Commissioner Paredes requested comment on whether specific Proposed Rules are

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[5] *See id.*

[6] *Id.*

[7] *See id.*

"unduly burdensome or otherwise unwarranted, especially insofar as proposed clearing agency standards go beyond what international standards currently contemplate".[8]

DTCC believes, as a general matter, that the Commission should avoid adopting rules that go beyond global standards. Proposed Rules 17Ad-22(b)(5) through (7), in particular, providing for mandatory access to CCPs in certain circumstances, go beyond anything in current or proposed global standards. In our view, these Proposed Rules are unnecessary and counterproductive to the goal of fair and open access within a framework of safe and sound operation. See in this respect RCCP Recommendation 2 and PFMI Principle 18.[9]

Phase-In Periods for Implementation of Proposed Rules

In his statement at the March Open Meeting, Commissioner Paredes requested comment on whether any of the Proposed Rules "should be phased-in – such as over time or based on the volume of transactions that a clearing agency clears – so as not to unduly impede entry or erode the commercial viability of providing clearing services".[10]

The Release does not specify an effective date for any or all of the Proposed Rules. However, the Proposed Rules, whether they are adopted in their current form or revised as suggested by DTCC or other commenters, will require that clearing agencies (i) review their existing policies and procedures for compliance with the Proposed Rules, (ii) develop and draft new policies and procedures to implement new requirements of the Proposed Rules, (iii) prepare and obtain Commission approval for rule changes under Section 19(b) of the Exchange Act and (iv) in all likelihood, hire and train additional personnel. A number of the Proposed Rules impose new operational requirements on clearing agencies that may require very significant changes in their operational arrangements.

DTCC respectfully suggests that the implementation of the Proposed Rules be subject to appropriate phase-in periods to be determined by the Commission in consultation with the clearing agencies affected by the Proposed Rules.

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[8] Commissioner Troy A. Paredes, Speech by SEC Commissioner: Statement at Open Meeting to Propose Rules Regarding Clearing Agency Standards for Operation and Governance (Washington, D.C., Mar. 2, 2011), *available at:* http://www.sec.gov/news/speech/2011/spch030211tap-agencies.htm [hereinafter "Commissioner's Statement"].

[9] Both RCCP Recommendation 2 and PFMI Principle 18 provide only (and sufficiently in our view) that participation requirements should permit fair and open access without mandating any specific participation requirements.

[10] Commissioner's Statement, *supra* note 8.

Additional Modifications to Proposed Rules

In the Release accompanying the Proposed Rules, the Commission notes that it may, as international standards evolve, consider additional modifications to its rules as it determines appropriate based on its own experience and requirements under the Exchange Act.[11]

DTCC agrees that, as markets continue to globalize and standards continue to evolve, the Commission should consider additional modifications to its rules, as necessary and appropriate, to meet the important objective that the Commission's rules remain in alignment with global standards. However, DTCC believes it is imperative that, before any such modifications are implemented, the Commission provide clearing agencies and other market participants with (i) adequate time to review and comment on such modifications and (ii) appropriate phase-in periods to make any necessary changes in their operations to comply with such modified rules.

Prescriptive Versus Flexible Rules

In the Release accompanying the Proposed Rules, the Commission requests comment on whether certain Proposed Rules[12] should be more prescriptive or whether clearing agencies should be able to exercise discretion in determining how to comply with the Rules.

DTCC believes, as a general matter, that the Proposed Rules should be principles-based and not overly prescriptive. DTCC further believes that clearing agencies should be able to exercise reasonable discretion in determining how to comply with the Rules in a manner that is consistent with their existing structures and businesses and all applicable laws and regulations. Complex organizations such as DTCC have many subsidiaries that engage in many different activities and are subject to regulation by many different regulators. Such organizations need the flexibility, to the extent possible, to structure their enterprise-wide programs in a way that works with each business and complies with all applicable laws and regulations. This is particularly the case with respect to compliance programs, on which DTCC comments in detail on Proposed Rule 3Cj-1 (Designation of Chief Compliance Officer). If the Proposed Rules are overly prescriptive, organizations such as DTCC may be subject to conflicting requirements and may be forced to fragment certain enterprise-wide programs in order to comply with such conflicting requirements, which could substantially increase costs and compliance risks within such organizations. Further, if the Proposed Rules are overly prescriptive, they may prevent clearing agencies from being able to adapt quickly to changes in markets and global standards. DTCC believes that it is extremely important that the

[11] *See* Release, *supra* note 1, at 14,476.

[12] *See, e.g.*, Proposed Rules 17Ad-22(b)(1)-(b)(5), 17Ad-22(d)(1)-(d)(5), 17Ad-22(d)(7)-(d)(9), 17Ad-22(d)(11), 17Ad-25, 17Ad-26 and 3Cj-1. Release at 14,477-14,481, 14,484-14,490, and 14,497-14,500.

Proposed Rules provide clearing agencies with the flexibility to adapt quickly to such changes.

Policies and Procedures

DTCC notes that many of the Proposed Rules require clearing agencies to establish, implement, maintain and enforce written policies and procedures that are reasonably designed to achieve the goals of such Proposed Rules. DTCC believes that the precise form of these written policies and procedures should be a matter for the clearing agency to determine (as long as such policies and procedures fulfill the requirements of the Proposed Rules), and may include clearing agency rules and procedures, service guides, operational arrangements, compliance procedures, link and cross-guaranty agreements and materials relating to internal operations and controls.

DTCC also notes that the Release states that the policies and procedures established by clearing agencies pursuant to the Proposed Rules should be "readily accessible by the public" and that such policies and procedures "would generally be deemed to be a proposed rule change".[13] DTCC believes that there should be no change in the thresholds for filing proposed rule changes under Rule 19b-4[14], and that not all written policies and procedures prepared by a clearing agency in compliance with the Proposed Rules (and certainly no such written policies and procedures containing confidential or proprietary information about the clearing agency or relating to internal operations and controls) should have to be the subject of filings under Rule 19b-4.

OVERVIEW OF COMMENTS ON PROPOSED RULES

Proposed Rules that DTCC Supports as Drafted

DTCC fully supports the following Proposed Rules and believes such Rules should be adopted as proposed without changes:

Proposed Rule 17Ad-22(b)(1): Measurement and Management of Credit Exposures
Proposed Rule 17Ad-22(b)(2): Margin Requirements
Proposed Rule 17Ad-22(c)(1): Records of Financial Resources
Proposed Rule 17Ad-22(c)(2): Audited Financial Resources
Proposed Rule 17Ad-22(d)(1): Transparent and Enforceable Rules
Proposed Rule 17Ad-22(d)(2): Participation Requirements
Proposed Rule 17Ad-22(d)(4): Identification and Mitigation of Operational Risk
Proposed Rule 17Ad-22(d)(5): Money Settlement Risks
Proposed Rule 17Ad-22(d)(6): Cost-Effectiveness
Proposed Rule 17Ad-22(d)(8): Governance
Proposed Rule 17Ad-22(d)(9): Information on Services

[13] Release, *supra* note 1, at 14,484.

[14] 17 C.F.R. § 240.19b-4.

Proposed Rule 17Ad-22(d)(11): Default Procedures
Proposed Rule 17Ad-22(d)(13): Delivery Versus Payment
Proposed Rule 17Ad-22(d)(15): Physical Delivery Risk
Proposed Amendments to Rule 17Ab2-1: Registration of Clearing Agencies
Proposed Rule 17Ad-23: Confidentiality of Trading Information of Participants
Proposed Rule 17Ad-25: Procedures to Identify and Address Conflicts of Interest
Proposed Rule 17Ad-26: Standards for Board or Board Committee Directors

DTCC notes that Proposed Rules 17Ad-22(d)(8), 17Ad-25 and 17Ad-26 reflect a better approach to governance, conflicts of interest and board and committee composition than the provisions of Regulation MC on these subjects applicable to security-based swap clearing agencies, security-based swap execution facilities and national securities exchanges that post or make available for trading security-based swaps,[15] on which DTCC has previously commented.[16]

Proposed Rules that DTCC Supports with Certain Clarifications and Refinements

DTCC has specific comments on, and suggestions for changes in, the following Proposed Rules:

Proposed Rule 17Ad-22(a): Definitions
Proposed Rule 17Ad-22(b)(3): Financial Resources
Proposed Rule 17Ad-22(b)(4): Model Validation
Proposed Rule 17Ad-22(d)(3): Custody of Assets and Investment Risk
Proposed Rule 17Ad-22(d)(7): Links
Proposed Rule 17Ad-22(d)(10): Immobilization and Dematerialization of Certificates
Proposed Rule 17Ad-22(d)(12): Timing of Settlement Finality
Proposed Rule 17Ad-22(d)(14): Controls to Address Participants' Failure to Settle
Proposed Rule 17Aj-1: Dissemination of Pricing and Valuation Information
Proposed Rule 17Ad-24: Exemption from Clearing Agency Definition
Proposed Rule 3Cj-1: Designation of Chief Compliance Officer

[15] 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 Fed. Reg. 65,882 (Oct. 26, 2010) [hereinafter "SEC Regulation MC Release"].

[16] *See* Comments from Mr. Larry Thompson, General Counsel, DTCC, 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 (Nov. 26, 2010), *available at:* http://www.sec.gov/comments/s7-27-10/s72710-87.pdf [hereinafter "DTCC Comment Letter on Regulation MC"].

Proposed Rules that DTCC Believes the Commission Should Not Adopt

DTCC urges the Commission not to adopt the following Proposed Rules:

Proposed Rule 17Ad-22(b)(5): Non-Dealer Access
Proposed Rule 17Ad-22(b)(6): Portfolio Size and Transaction Volume Thresholds
Proposed Rule 17Ad-22(b)(7): Net Capital Restrictions

SPECIFIC COMMENTS ON PROPOSED RULES

Proposed Rule 17Ad-22(a): Definitions

Proposed Rule 17Ad-22(a) contains the following special definition of "participant":

> Participant as used in paragraphs (b)(3) and (d)(14) means that if a participant controls another participant or is under common control with another participant then the affiliated participants shall be collectively deemed to be a single participant for purposes of that subparagraph.

Paragraph (b)(3), referred to in the above definition of "participant", relates to the financial resources that a CCP must maintain to withstand a *participant* default in extreme but plausible market conditions. Paragraph (d)(14), referred to in the above definition of "participant", relates to the risk controls that a CSD must institute to ensure timely settlement in the event that the *participant* with the largest payment obligation is unable to settle.

DTCC agrees that, for purposes of paragraphs (b)(3) and (d)(14), a clearing agency should take account of the effect of a default by all of the participants in an affiliated group rather than just the effect of a default by a single participant. However:

(a) DTCC believes that it is confusing to use the term "participant" throughout the Proposed Rules (and in the Exchange Act and the rules and regulations thereunder) to refer to a single participant *and* to use the same term "participant" in just Proposed Rules 17Ad-22(b)(3) and (d)(14) to refer to an affiliated group of participants;

(b) DTCC believes it would provide clarity to use the term "participant family" in Proposed Rules 17Ad-22(b)(3) and (d)(14) to refer to an affiliated group of participants, as distinguished from a single participant; and

(c) DTCC believes that the term "control" should be defined (i) in an objective manner and (ii) based on information that is available to the clearing agency.

Accordingly, DTCC respectfully suggests that the special definition of "participant" in Proposed Rule 17Ad-22(a) be replaced with a definition of "participant family" as follows:

> "Participant family" means, collectively, each participant that controls, is controlled by or is under common control with another participant. Control for this purpose means the disclosed ownership of 50% or more of the voting securities or other interests of a participant.

This change would conform to the way that the clearing agencies in the DTCC group determine an affiliated group of participants for purposes of their resource calculations and risk management controls.

Proposed Rule 17Ad-22(b)(3): Financial Resources

Proposed Rule 17Ad-22(b)(3) provides as follows:

> (b) A clearing agency that performs central counterparty services shall establish, implement, maintain and enforce written policies and procedures reasonably designed to:
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> * * *
>
> (3) Maintain sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions; provided that a security-based swap clearing agency shall maintain sufficient financial resources to withstand, at a minimum, a default by the two participants to which it has the largest exposure in extreme but plausible market conditions.

The Commission asks with respect to Proposed Rule 17Ad-22(b)(3):

> Should the Commission provide additional guidance regarding what constitutes "extreme but plausible market conditions"? Does allowing clearing agencies providing CCP services discretion to interpret this term create uncertainty or introduce more risk into the financial system than might otherwise be the case?[17]

DTCC believes that the determination of what constitutes "extreme but plausible market conditions" is something that should be left to the discretion of the CCP, which is in the best position to know the range of market conditions – from normal to extreme – for the products in the markets that it clears. DTCC also believes that Proposed Rule 17Ad-22(b)(3) should explicitly state (what is implicit in the Commission's question) that it is the CCP which makes the determination of what constitutes "extreme but plausible market conditions", so that silence on this point does not create an inference that the

[17] Release, *supra* note 1, at 14,480.

determination of what constitutes "extreme but plausible market conditions" is made (or could be made) in any other manner or on a retrospective basis.

DTCC notes that CPSS and IOSCO also take the position that it is the CCP which should make the determination of what constitutes "extreme but plausible market conditions" for purposes of calculating the financial resources needed by a CCP to withstand a participant default. Paragraph 4.5.4 of the RCCP Report relating to RCCP Recommendation 5 provides, in relevant part, that:

> A CCP should make judgments about what constitutes 'extreme but plausible' market conditions. The conditions evaluated should include the most volatile periods that have been experienced by the markets for which the CCP provides its services. A CCP should also evaluate the losses that would result if levels of volatility observed in related products were also experienced in its products (this is particularly relevant when a CCP begins clearing a new product) and if usual patterns of correlations in prices among it products changed.

The alternative to having a CCP determine what constitutes "extreme but plausible market conditions" for purposes of compliance with Proposed Rule 17Ad-22(b)(3) would be for the Commission to provide guidance to CCPs on what "extreme but plausible market conditions" means for different CCPs clearing different products in different markets. DTCC believes that the better approach is for this to be left to the discretion of the CCP, and reflected (as the lead-in language of Proposed Rule 17Ad-22(b)(3) provides) in written policies and procedures that the CCP establishes, implements, maintains and enforces.

The Commission also asks with respect to Proposed Rule 17Ad-22(b)(3):

> Should the Commission require all clearing agencies providing CCP services, instead of only those clearing security-based swaps, to maintain sufficient financial resources to withstand a default by the two participants to which it has the largest exposures in extreme but plausible market conditions? Should all or any subset of clearing agencies be required to maintain sufficient financial resources based on more or less than two participant defaults? For example, should the financial resources requirements be different for certain clearing agencies, such as security-based swap clearing agencies or those designated as systemically important under the Clearing Supervision Act? Should the Commission require that financial resources be measured based on a different standard than resources needed to withstand default by a certain number of participants, such as a percentage of the total business conducted by the clearing agency?[18]

[18] *Id.* at 14,479.

DTCC does not believe that any CCP should be required to maintain resources to withstand a default by the two participant families (rather than the one participant family) to which it has the largest exposure in extreme but plausible market conditions. CCPs currently measure the required amount of financial resources based on a default by the single largest participant family. No historical or empirical case has yet been made for any change in the way that CCPs currently measure the sufficiency of their financial resources, and no cost-benefit analysis has been done on the impact of any such change on the operations and economics of CCPs and their participants. DTCC therefore believes that, at least at this point in time, there should be no change, by regulatory rulemaking, in the existing standard.

Accordingly, DTCC respectfully suggests that Proposed Rule 17Ad-22(b)(3) be revised as follows (including the change from "participant" to "participant family" in accordance with the change suggested in Proposed Rule 17Ad-22(a) above):

> (b) A clearing agency that performs central counterparty services shall establish, implement, maintain and enforce written policies and procedures reasonably designed to:
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> * * *
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> (3) Maintain sufficient financial resources to withstand, at minimum, a default by the participant <u>family</u> to which it has the largest exposure in extreme but plausible market conditions[~~; provided that a security-based swap clearing agency shall maintain sufficient financial resources to withstand, at a minimum, a default by the two participants to which it has the largest exposures in extreme but plausible market conditions~~]. <u>The clearing agency shall determine what constitutes "extreme but plausible market conditions" taking account of a range of relevant stress scenarios.</u>

DTCC does not believe that any other changes are needed in Proposed Rule 17Ad-22(b)(3).

Proposed Rule 17Ad-22(b)(3), revised as suggested above, would conform to RCCP Recommendation 5, which provides that "A CCP should maintain sufficient financial resources to withstand a default by the participant to which it has the largest exposure in extreme but plausible conditions". DTCC is aware that CPSS and IOSCO have proposed for comment in PFMI Principle 7 a possible change in the amount of liquidity a CCP must have from what RCCP Recommendation 5 now provides (a default by a single participant) to either (i) a default by the *one* participant *and its affiliates* that would generate the largest aggregate liquidity need for the CCP or (ii) a default by the *two* participants and *their affiliates* that would generate the largest aggregate liquidity need for the CCP. However, unless and until there is industry and regulatory consensus on this issue, as well as a consistent and flexible global approach, DTCC does not believe there should be a Commission mandate to require any CCP to increase its liquidity

resources, and otherwise re-engineer its risk management controls, to take account of the failure of two participant families rather than one.

Proposed Rule 17Ad-22(b)(4): Model Validation

Proposed Rule 17Ad-22(b)(4) provides as follows:

> (b) A clearing agency that performs central counterparty services shall establish, implement, maintain and enforce written policies and procedures reasonably designed to:
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> * * *
>
> (4) Provide for an annual model validation consisting of evaluating the performance of the clearing agency's margin models and the related parameters and assumptions associated with such models by a qualified person who does not perform functions associated with the clearing agency's margin models (except as part of the annual model validation) and does not report to a person who performs these functions.

DTCC believes that Proposed Rule 17Ad-22(b)(4) is overly prescriptive in two respects:

> (a) it mandates that model validation be performed on an *annual* basis, instead of leaving that to the discretion of the CCP, which is in the best position to determine the appropriate frequency of model validation; and
>
> (b) it mandates a particular way to ensure that the person who validates the model has the necessary independence to do the job, instead of leaving that to the discretion of the CCP, which is in the best position to determine how to achieve the agreed goal of performing a candid assessment that is free from outside influences.

DTCC believes that a regulatory requirement of model validation on an annual basis is unnecessary (and may be overly burdensome) in the absence of (i) any material change in the model or (ii) any material change in the market environment that may affect the model. DTCC likewise believes that independent model validation can be achieved in a less directive manner.

DTCC has a comprehensive model risk policy to identify, assess, monitor, mitigate and report on model risk. The policy applies to models that are used to (i) measure risk to the clearing agencies (including the CCPs) in the DTCC group and (ii) make decisions about financial risk measurement and management. The policy is subject to ongoing revision as required by changes in business conditions, regulations and innovations in modeling techniques. The DTCC model risk policy provides for model validation to be performed on a periodic basis according to a risk-based schedule.

The DTCC model risk policy provides that all models must be certified as valid by a qualified independent reviewer, defined as "a qualified reviewer that did not develop and does not currently own the model". The reviewer may be an individual or unit within the organization or an outside consultant. The review covers theory, mathematics and implementation in computer code. Benchmarks against results from alternative validated models are recommended where practical.

The DTCC model risk policy, specifically with respect to the frequency of model validation and the independence of the reviewer from outside influences, is tailored to the needs of the clearing agencies (including the CCPs) in the DTCC group, the risks inherent in the products in the markets they clear and the structure of their businesses. DTCC believes that these matters are best left to the discretion of the organization, so long as the goals of the model validation process are achieved. With respect to the independence of the model validation process in particular, DTCC notes that in the recently released Supervisory Guidance on Model Risk Management, the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency state that independence "may be supported by separation of reporting lines" but that independence "should be judged by actions and outcomes, since there may be additional ways to ensure objectivity and prevent bias".[19]

In its discussion of Proposed Rule 17Ad-22(b)(4), the Commission states, with respect to its proposal that model validation be conducted on an annual basis, that:

> The Commission preliminarily believes that conducting the model validation on an annual basis would provide a sufficiently frequent evaluation period because model performance ordinarily would not be expected to vary significantly over short periods but should be re-evaluated as market conditions change.[20]

In its discussion of Proposed Rule 17Ad-22(b)(4), the Commission states, with respect to its proposal that the person conducting the model validation be a person that does not perform functions associated with the clearing agency's margin models (except as part of the annual model validation) and does not report to a person who performs these functions, that:

> The Commission preliminarily believes that the person validating the clearing agency's model should be sufficiently free from outside influences so that he or she can be completely candid in their assessment of the model.[21]

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[19] Supervisory Guidance on Model Risk Management, Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency, at 9 (Apr. 4, 2011).

[20] Release, *supra* note 1, at 14,480.

[21] *Id*.

DTCC believes that the stated goals of the Commission – to re-evaluate model performance as market conditions change and to ensure that the person conducting the model validation is sufficiently free from outside influences to perform a candid assessment of the model – can be achieved without mandating the specific frequency of model validation and a specific method to ensure the independence of the person performing the model validation. In fact, DTCC believes that the Commission's own language quoted above to describe the necessary independence of the person who validates the model – that the person be sufficiently free from outside influences to be completely candid in his or her assessment of the model – should be incorporated into the Proposed Rule in place of the language that now appears, because the proposed language is (i) vague in part (referring to "functions associated with the clearing agency margin models") and (ii) overly restrictive in part (prohibiting the model validator from reporting to a person who performs any of these "associated" functions).

Accordingly, DTCC respectfully suggests that Proposed Rule 17Ad-22(b)(4) be revised as follows:

> (b) A clearing agency that performs central counterparty services shall establish, implement, maintain and enforce written policies and procedures reasonably designed to:
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> * * *
>
> (4) Provide for [~~an annual~~] periodic model validation consisting of evaluating the performance of the clearing agency's margin models and the related parameters and assumptions associated with such models by a qualified person who [~~does not perform functions associated with the clearing agency's margin models (except as part of the annual model validation) and does not report to a person who performs these functions~~] is sufficiently free from outside influences to perform a candid evaluation of such models.

DTCC does not believe that any other changes are needed in Proposed Rule 17Ad-22(b)(4). In particular, in response to a specific question from the Commission,[22] DTCC does not believe that the Commission should prescribe any specific qualifications or credentials for the person who conducts the model validation or require that an outside consultant be engaged. DTCC believes that the better approach is for these matters to be left to the discretion of the CCP, and reflected (as the lead-in language of Proposed Rule 17Ad-2(b)(4) provides) in written policies and procedures that the CCP establishes, implements, maintains and enforces.

Proposed Rule 17Ad-22(b)(4), revised as suggested above, would conform to RCCP Recommendation 4, which does not prescribe annual model validation or any one specific way to ensure the integrity of the validation process. RCCP Recommendation 4

[22] *See id.*

provides, in relevant part, that "The models and parameters used in setting margin requirements should be risk-based and reviewed regularly". Similarly PFMI Principle 6 provides that "A CCP should cover its exposures to its participants for all products through an effective margin system that is risk-based and reviewed regularly". There is no reason why the Proposed Rule should go beyond current and proposed global standards.

Proposed Rule 17Ad-22(b)(5): Non-Dealer Access
Proposed Rule 17Ad-22(b)(6): Portfolio Size and Transaction Volume Thresholds
Proposed Rule 17Ad-22(b)(7): Net Capital Restrictions

Proposed Rules 17Ad-22(b)(5) through (7) provide as follows:

> (b) A clearing agency that performs central counterparty services shall establish, implement, maintain and enforce written policies and procedures reasonably designed to:
>
> * * *
>
> (5) Provide the opportunity for a person that does not perform any dealer or security-based swap dealer services to obtain membership at the clearing agency to clear securities for itself or on behalf of other persons.
>
> (6) Have membership standards that do not require that participants maintain a portfolio of any minimum size or that participants maintain a minimum transaction volume.
>
> (7) Provide a person that maintains net capital equal to or greater than $50 million with the ability to obtain membership at the clearing agency, with any net capital requirements being scalable so that they are proportional to the risks posed by the participant's activities to the clearing agency; provided, however, that the clearing agency may provide for a higher net capital requirement as a condition for membership at the clearing agency if the clearing agency demonstrates to the Commission that such a requirement is necessary to mitigate risks that could not otherwise be effectively managed by other measures and the Commission approves the higher net capital requirement as part of a rule filing or clearing agency registration application.

General Comments on Proposed Rules 17Ad-22(b)(5) through (7)

DTCC believes that Proposed Rules 17Ad-22(b)(5) through (7) are overly prescriptive and that, in any event, the Commission does and will have sufficient other authority to monitor the membership practices of CCPs under:

> (a) Section 17(b)(3)(F) of the Exchange Act, which gives the Commission authority to ensure that the rules of a clearing agency "are not designed to permit

> unfair discrimination in the admission of participants or among participants in the use of the clearing agency. . . ."
>
> –and–
>
> (b) Proposed Rule 17Ad-22(d)(2), which DTCC fully supports, that would require all clearing agencies (both CCPs and CSDs) to "have participation requirements that are objective, publicly disclosed, and permit fair and open access".

DTCC also believes that Proposed Rules 17Ad-22(b)(5) through (7) do not conform to current or proposed global standards relating to participation in CCPs:

> RCCP Recommendation 2 provides, in relevant part, that "A CCP's participation requirements should be objective, publicly disclosed, and permit fair and open access".
>
> –and–
>
> PFMI Principle 18 provides that "An FMI should have objective, risk-based, and publicly disclosed criteria for participation, which permit fair and open access".

Section 17(b)(3)(F) of the Exchange Act and Proposed Rule 17Ad-22(d)(2), mentioned above, are fully consistent with RCCP Recommendation 2 and PFMI Principle 18. Proposed Rules 17Ad-22(b)(5) through (7), on the other hand, are not. There is no reason why these Proposed Rules should go beyond current and proposed global standards for participation in CCPs.

Membership Standards of CCPs in the DTCC Group

The CCPs in the DTCC group have different membership standards tailored to their different businesses but share certain common requirements:

> (a) membership is available to (i) entities that are subject to state, federal or foreign governmental regulation (banks, broker-dealers, clearing agencies, insurance companies, investment companies, etc.) and (ii) other market participants which can demonstrate that their businesses and capabilities are such that they may reasonably expect to benefit from access to the services and facilities of the CCP;
>
> (b) applicants must satisfy certain specified capital requirements which vary by membership category and entity type, and have the financial resources to make their deposits to the clearing fund of the CCP and otherwise meet their payment obligations to the CCP;

> (c) applicants must satisfy certain specified operational requirements to ensure that they can transmit files to and receive files from the CCP, and otherwise be able to communicate and maintain connectivity with the CCP; and
>
> (d) applicants must have (i) an established business history of a specified length or (ii) personnel with sufficient operational background and experience to ensure that the applicant is able to conduct its business.

It should also be noted that the CCPs in the DTCC group monitor membership standards on an ongoing basis. Members are required to submit annual audited financial statements to the CCP. The CCP also receives monthly or quarterly regulatory reports (FOCUS reports, CALL reports, etc.) for members. As part of such ongoing monitoring, a credit risk-rating matrix is utilized to risk-rate members. The risk-rating of a member determines the level of financial review that is performed by the CCP, and may impact the amount of the member's required deposit to the clearing fund of the CCP.

As indicated above, the standards for membership in the CCPs in the DTCC group are clear, objective and nondiscriminatory. Access is not limited on any grounds other than risk – credit risk, operational risk, compliance risk and legal risk. Before denying any application for membership, the CCP must provide the applicant with a precise written statement setting forth the specific grounds for denial and notify the applicant of its right to request a hearing on its application.

Specific Comments on Proposed Rules 17Ad-22(b)(5) through (7)

Proposed Rules 17Ad-22(b)(5) through (7), although well-intentioned, are unnecessary and counterproductive to the goal of fair and open access within a framework of safe and sound operation. DTCC has the following specific comments on these Proposed Rules.

a. Proposed Rule 17Ad-22(b)(5)

Although the CCPs in the DTCC group do not limit membership to dealers, DTCC is concerned that any regulatory mandate to admit specific entities as members of a CCP could undermine the impartial development and application of risk-based standards for membership.

In its discussion of Proposed Rule 17Ad-22(b)(5), the Commission states:

> . . . the Commission recognizes that persons who are not dealers or security-based swap dealers may fail to meet other standards for membership at a clearing agency, such as the operational capabilities required for direct participation. Proposed Rule 17Ad-22(b)(5) would not prohibit clearing agencies that provide CCP services from taking these factors into account when establishing membership criteria for non-dealers. Rather, the proposal would prohibit clearing agencies that provide CCP services from denying membership on fair

> and reasonable terms to otherwise qualified persons solely by virtue of the fact that they do not perform any dealer or security-based swap dealer services.[23]

This commentary, particularly the language in the first and second sentences that the Proposed Rule would not prohibit a CCP from taking other factors such as "operational capabilities required for direct participation" into account (to which should be added financial resources and creditworthiness), although welcome in its attempt to reconcile the goal of promoting correspondent clearing with the goal of limiting risk with appropriate membership standards, is not in the Proposed Rule. Further, the language in the third sentence that the Proposed Rule would prohibit CCPs from denying membership to "otherwise qualified persons" begs the question of just what it means to be "otherwise qualified". While the Proposed Rule could possibly be revised to make it more clear that a CCP may still take other factors into account in making membership decisions, DTCC believes the better approach is to continue to allow CCPs to determine, subject to Commission oversight, membership standards (including different standards and categories for different types of members) and how best to promote correspondent clearing in a safe and sound manner.

b. Proposed Rule 17Ad-22(b)(6)

Although the CCPs in the DTCC group do not condition membership on any particular portfolio size or transaction volume thresholds, DTCC is concerned that any regulatory mandate on portfolio size and transaction volume thresholds could undermine the impartial development and application of risk-based standards for membership.

In its discussion of Proposed Rule 17Ad-22(b)(6), the Commission states:

> . . . the proposed rule would not prohibit a clearing agency that provides CCP services from considering portfolio size and transaction volume as one of several factors when reviewing a potential participant's operations. Rather, the proposed rule would prohibit the establishment of minimum portfolio sizes or transaction volumes that by themselves would act as barriers to participation by new participants in clearing. Such minimum thresholds would not function as a good indicator of whether a participant is able to meet its obligations to a clearing agency. [footnote omitted].[24]

This commentary, particularly the language in the first sentence that the Proposed Rule would not prohibit a CCP "from considering portfolio size and transaction volume as one of several factors when reviewing a potential participant's operations", although welcome in its attempt to reconcile the goal of promoting participation in CCPs with the goal of limiting risk with appropriate membership standards, is not in the Proposed Rule. Further, such language begs the question of just how much weight a CCP may give to

[23] Release, *supra* note 1, at 14,481.

[24] *Id*. at 14,482.

portfolio size and transaction volume without running afoul of the mandate of the Proposed Rule – either when the CCP is considering an application for membership or when the CCP is considering whether the continued membership of a participant in the CCP is consistent with the risk-based membership standards of the CCP. While the Proposed Rule could possibly be revised to make it more clear that a CCP may consider portfolio size and transaction volume in either such case, DTCC believes the better approach is to continue to allow CCPs to determine, subject to Commission oversight, membership standards (including the weight, if any, to be given to portfolio size and transaction volume) and how best to ensure that access to CCPs is fair and open.

c. Proposed Rule 17Ad-22(b)(7)

As demonstrated above, the CCPs in the DTCC group employ a variety of *quantitative* and *qualitative* measures to determine the creditworthiness of applicants and members.

DTCC does not believe that one test of creditworthiness, large net capital, should become the sole test of creditworthiness, let alone the sole basis for requiring that an applicant be admitted as a member of a CCP. Net capital, without regard to other risk factors, does not conclusively establish creditworthiness or any of the other generally accepted qualifications for becoming a member of a CCP. It should also be noted that not all market participants utilize a net capital computation, which could give some applicants and members an advantage over others in terms of gaining and retaining membership in a CCP.

DTCC does not believe that large net capital necessarily correlates with an ability to discharge the various financial *and* operational obligations a member has to a CCP, *e.g.*, its ability to post margin on a regular basis, absorb losses incident to the particular risk-profile of its business and the markets in which its operates, maintain connectivity with the CCP, satisfy its operational commitments and requirements and provide financial reports and other disclosures on a timely basis. Net capital (or other calculation of capital for market participants that do not utilize a net capital computation) should be, as it is at the CCPs in the DTCC group, *a* measure but not (at $50 million or any other fixed amount) *the* measure of creditworthiness, let alone entitlement to become a member of a CCP.

Rather than adopt Proposed Rule 17Ad-22(b)(7), DTCC believes the better approach for the Commission is to continue to allow CCPs to determine, subject to Commission oversight, membership standards (including capital requirements and other measures of creditworthiness) and how best to ensure that access to CCPs is fair and open.

Proposed Rule 17Ad-22(d)(3): Custody of Assets and Investment Risk

Proposed Rule 17Ad-22(d)(3) provides as follows:

> (d) Each clearing agency shall establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable:

* * *

(3) Hold assets in a manner whereby risk of loss or of delay in its access to them is minimized; and invest assets in instruments with minimal credit, market and liquidity risks.

It appears from the Commission's discussion of Proposed Rule 17Ad-22(d)(3) that the "assets" referred to in the Proposed Rule are assets of the clearing agency that are available to the clearing agency to facilitate settlement in the event of a participant default, *e.g.*, clearing fund assets, retained earnings, etc., rather than the assets of participants held in custody by the clearing agency. For example, it is noted in the discussion that clearing agencies typically hold such assets in highly liquid form such as cash and treasury and agency securities in the custody of banks[25], which is how the clearing fund assets of the CCPs in the DTCC group are held.

The text of Proposed Rule 17Ad-22(d)(3), however, unlike the Commission's discussion of the Proposed Rules, does not make it clear that the assets which are the subject of the Proposed Rule are the assets of the clearing agency that are available to the clearing agency to facilitate settlement in the event of a participant default rather than the assets of participants held in custody by the clearing agency.

DTCC notes that there is a similar lack of clarity in the text of RCCP Recommendation 7 on which Proposed Rule 17Ad-22(d)(3) is modeled. RCCP Recommendation 7 provides that "A CCP should hold assets in a manner whereby risk of loss or of delay in its access to them is minimised. Assets invested by a CCP should be held in instruments with minimal credit, market and liquidity risks." This lack of clarity, however, has been resolved in PFMI Principle 16, which provides that "An FMI should safeguard *its* [emphasis added] assets and minimise the risk of loss or delay in access to those assets, including assets posted by its participants [clearing fund deposits]. An FMI's investments should be in instruments with minimal credit, market, and liquidity risks". DTCC believes that the language of PFMI Principle 16 should be incorporated into Proposed Rule 17Ad-22(d)(3).

Accordingly, DTCC respectfully suggests that Proposed Rule 17Ad-22(d)(3) be revised as follows:

(d) Each clearing agency shall establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable:

* * *

[25] *See* Release, *supra* note 1, at 14,485.

> (3) Hold its assets in a manner whereby risk of loss or of delay in its access to them is minimized; and invest such assets in instruments with minimal credit, market and liquidity risks.

DTCC does not believe that any other changes are needed in Proposed Rule 17Ad-22(d)(3). The Proposed Rule, revised as suggested above, would conform to RCCP Recommendation 7 and PFMI Principle 16, cited above.

Proposed Rule 17Ad-22(d)(7): Links

Proposed Rule 17Ad-22(d)(7) provides as follows:

> (d) Each clearing agency shall establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable:
>
> * * *
>
> (7) Evaluate the potential sources of risks that can arise when the clearing agency establishes links either cross-border or domestically to clear trades, and ensure that the risks are managed prudently on an ongoing basis.

It appears from the Commission's discussion of Proposed Rule 17Ad-22(d)(7) that the "links" referred to in the Proposed Rule are links between clearing agencies and other clearing organizations (such as the DTC Canadian Link Service cited in footnote 68 of the discussion) rather than links between clearing agencies and any other entities that might be involved in the process of clearing trades (such as the arrangements that clearing agencies may have with data processors, pricing services, custodian banks, transfer agents and liquidity providers). For example, it is noted in the discussion that "by tying the clearing operations of different clearing agencies together, link arrangements potentially expose a clearing agency and its members to the risk management profile of another clearing organization and to the risk of financial loss if that clearing organization experiences a default or is otherwise unable to meet its settlement obligations".[26] The references in the discussion to Sections 17A(a)(1)(D) and (b)(3)(F) of the Exchange Act further demonstrate that the links which are the subject of Proposed Rule 17Ad-22(d)(7) are intended to be links between clearing agencies and other clearing organizations rather than links between clearing agencies and any other entities, *i.e.*, Section 17A(a)(1)(D) refers to "the linking of all clearance and settlement facilities", and Section 17A(b)(3)(F) refers to the rules of clearing agencies fostering "cooperation and coordination with persons involved in the clearance and settlement of securities transactions . . . ."[27]

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[26] *Id.* at 14,487-88.

[27] *Id.* at 14,487.

The text of Proposed Rule 17Ad-22(d)(7), however, unlike the Commission's discussion of the Proposed Rule, does not make it clear that the links which are the subject of the Proposed Rule are the links between clearing agencies and other central counterparties and central securities depositories rather than links between clearing agencies and any other entities.

Accordingly, DTCC respectfully suggests that Proposed Rule 17Ad-22(d)(7) be revised as follows:

> (d) Each clearing agency shall establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable:
>
> * * *
>
> (7) Evaluate the potential sources of risks that can arise when the clearing agency establishes links <u>with other central counterparties or central securities depositories</u> either cross-border or domestically to clear trades, and ensure that the risks are managed prudently on an ongoing basis.

DTCC does not believe that any other changes are needed in Proposed Rule 17Ad-22(d)(7). In particular, in response to a specific question from the Commission,[28] DTCC believes that, since any link that a clearing agency might establish with another central counterparty or central securities depository would have to be the subject to a filing pursuant to Rule 19b-4 and approved by the Commission, there is no need for the Proposed Rule to be any more specific than it is now. Proposed Rule 17Ad-22(d)(7), revised as suggested above, would conform to RCCP Recommendation 11, which provides, in relevant part, that "CCPs that establish links either cross-border or domestically to clear trades should evaluate the potential sources of risk that can arise, and ensure that the risks are managed prudently on an ongoing basis".

Proposed Rule 17Ad-22(d)(10): Immobilization and Dematerialization of Certificates

Proposed Rule 17Ad-22(d)(10) provides as follows:

> (d) Each clearing agency shall establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable:
>
> * * *
>
> (10) Immobilize or dematerialize securities certificates and transfer them by book entry to the greatest extent possible when the clearing agency provides central securities depository services.

[28] *See id.* at 14,488.

DTCC, of course, strongly supports the objective of Proposed Rule 17Ad-22(d)(10) to immobilize or dematerialize securities certificates.[29] However, while a CSD can promote the immobilization or dematerialization of securities certificates, it cannot do anything without the cooperation of, and coordination with, market participants and regulators. DTCC believes that the Proposed Rule should reflect the significant but not exclusive role of a CSD in the process of immobilizing and dematerializing securities certificates.

Accordingly, DTCC respectfully suggests that Proposed Rule 17Ad-22(d)(10) be revised as follows:

> (d) Each clearing agency shall establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable:
>
> * * *
>
> (10) [~~Immobilize or dematerialize~~] Promote the immobilization or dematerialization of securities certificates and transfer them by book entry to the greatest extent possible when the clearing agency provides central securities depository services.

DTCC does not believe that any other changes are needed in Proposed Rule 17Ad-22(d)(10). The Proposed Rule, revised as suggested above, would conform to RSSS Recommendation 6, which provides (without exclusive focus on the CSD) that "Securities should be immobilised or dematerialised by book entry in CSDs to the greatest extent possible".

Proposed Rule 17Ad-22(d)(12): Timing of Settlement Finality

Proposed Rule 17Ad-22(d)(12) provides as follows:

> (d) Each clearing agency shall establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable:
>
> * * *
>
> (12) Ensure that final settlement occurs no later than the end of the settlement day; and require that intraday or real-time finality be provided where necessary to reduce risks.

[29] There are numerous disadvantages of physical securities certificates, including that (i) investors bear sole responsibility for safekeeping certificates, (ii) it is costly and time consuming to replace lost, stolen or damaged certificates, (iii) in order to effect a corporate action, investors must deliver certificates to the issuer or transfer agent (and this must often be done under tight deadlines), (iv) dividend payments may be misrouted and (v) customers often experience delays in effecting trade settlements.

DTCC is concerned that the second clause of Proposed Rule 17Ad-22(d)(12) – "and require that intraday or real-time finality be provided where necessary to reduce risks" – could be interpreted to impose an obligation on clearing agencies to provide intraday or real-time finality (i) beyond what the clearing agencies in the DTCC group currently provide and (ii) beyond what the clearing agencies in the DTCC group can provide without a significant change in their systems and processes and a related build. DTCC does agree with the goal of expanded intraday or real-time finality to reduce risks where possible and subject to industry and regulatory consensus.

Accordingly, DTCC respectfully suggests that, when the final rule is issued, the Commission make clear that the rule is not intended to impose on clearing agencies (i) any obligation to provide intraday or real-time finality beyond what they currently provide or (ii) any obligation to build such additional capability unless and until there is industry and regulatory consensus on whether and what additional capability to build and how to allocate the cost.

Proposed Rule 17Ad-22(d)(14): Controls to Address Participants' Failure to Settle

Proposed Rule 17Ad-22(d)(14) provides as follows:

> (d) Each clearing agency shall establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable:
>
> * * *
>
> (14) Institute risk controls, including collateral requirements and limits to cover the clearing agency's credit exposure to each participant exposure fully, that ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle when the clearing agency provides central securities depository services and extends intraday credit to participants.

Proposed Rule 17Ad-22(d)(14) is similar to, but varies in one critical respect from, RSSS Recommendation 9. RSSS Recommendation 9 provides as follows:

> CSDs that extend intraday credit to participants, *including CSDs that operate net settlement systems,* should institute risk controls that, at a minimum, ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle. The most reliable set of controls is a combination of collateral requirements and limits. [emphasis added]

Paragraph 3.42 of the RSSS Report relating to RSSS Recommendation 9 helpfully delineates (i) CSDs that have credit exposures to participants because they operate gross settlement systems and extend intraday credit to participants as principal and (ii) CSDs that have credit exposures to participants because they operate net settlement systems and are thereby deemed to extend credit to participants as agent for other participants in

the form of net debit positions (rather than actual credit extensions). Paragraph 3.42 of the RSSS Report provides, in relevant part, as follows:

> Where they are permitted to do so, CSDs often extend intraday credit to participants (either as principal or as agent for other participants) to facilitate timely settlements and, in particular, to avoid gridlock. In a gross settlement system, where credit extensions occur, they are usually extended by the CSD as principal and take the form of intraday loans or repurchase agreements. In net settlement systems these credit extensions are usually in effect extended by the CSD as agent for other participants and take the form of net debit positions in funds, which are settled only at one or more discrete, prespecified times during the process day.

DTCC fully supports the requirement of Proposed Rule 17Ad-22(d)(14) that a CSD institute risk controls to ensure timely settlement in the event that the participant family with the largest payment obligation is unable to settle. However, as a matter of technical and legal accuracy, since DTC operates a net settlement system rather than a gross settlement system, we believe that Proposed Rule 17Ad-22(d)(14) should be more closely conformed to RSSS Recommendation 9 to include in the Proposed Rule the reference to "net settlement systems" found in the Recommendation.

Accordingly, DTCC respectfully suggests that Proposed Rule 17Ad-22(d)(14) be revised as follows (including the change from "participant" to "participant family" in accordance with the change suggested in Proposed Rule 17Ad-22(a) above):

> (d) Each clearing agency shall establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable:
>
> * * *
>
> (14) Institute risk controls, including collateral requirements and limits to cover the clearing agency's credit exposure to each participant <u>family</u> fully, that ensure timely settlement in the event that the participant <u>family</u> with the largest payment obligation is unable to settle when the clearing agency provides central securities depository services and <u>operates a net settlement system or</u> extends intraday credit to participants.

DTCC does not believe that any other changes are needed in Proposed Rule 17Ad-22(d)(14). In particular, in response to a specific question from the Commission,[30] DTCC does not believe that a CSD should be required to be able to withstand a settlement failure by the two participant families with the largest settlement obligations (rather than the one participant family with the largest settlement obligation). Certainly, no historical or other empirical case has yet been made for any such change in the way

[30] *See* Release, *supra* note 1, at 14,492.

CSDs currently design their risk management controls, and no cost benefit analysis has been done on the impact of any such change on the operations and economics of CSDs and their participants. Accordingly, DTCC believes that there should be no change, by regulatory rulemaking, in existing practice. See also our comments on Proposed Rule 17Ad-22(b)(3) relating to CCPs on this issue.

Proposed Rule 17Aj-1: Dissemination of Pricing and Valuation Information

The Commission states in its discussion of Proposed Rule 17Aj-1 its preliminarily belief that the pricing and valuation information generated by security-based swap clearing agencies that perform CCP services (hereafter "valuation information"), adds value beyond pre- and post-trade pricing sources, as well as information that may be available from firms that provide financial services data.[31] For this reason, Proposed Rule 17Aj–1 would require dissemination of valuation information by security-based swap clearing agencies that perform CCP services.[32] In particular, Proposed Rule 17Aj–1 requires each security-based swap clearing agency that performs CCP services to make available to the public, on terms that are fair, reasonable, and not unreasonably discriminatory, all end-of-day settlement prices and any other prices for security-based swaps that the clearing agency may establish to calculate its participants' mark-to-market margin requirements and any other price or valuation information with respect to security-based swaps as is published or distributed by the clearing agency to its participants.[33]
DTCC strongly supports the Commission's goal of bringing greater transparency to market participants by making trade pricing valuation information publicly available. While the Commission's goals are laudable, DTCC has concerns related to the necessity of Proposed Rule 17Aj-1, as well as its practical application and operation in the context of the Commission's previously proposed rules, particularly Regulation SBSR.[34] Further, Proposed Rule 17Aj-1 may have unintended consequences, such as data fragmentation and reduced market transparency.

It is unclear whether the "valuation information" addressed by Proposed Rule 17Aj-1 is, at least in some instances, the same type of data that already is required to be reported to and disseminated by a SDR under Regulation SBSR. Regulation SBSR requires SDRs to immediately publicly disseminate transaction reports upon receipt of the necessary trade information.[35] Section 901 of Regulation SBSR sets forth the data elements

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[31] *See* Release, *supra* note 1, at 14,530.

[32] *See id.* at 14,539.

[33] *See id.* at 14,530.

[34] *See* Regulation SBSR, Reporting and Dissemination of Security-Based Swap Information; Proposed Rule, 75 Fed. Reg. 75,208, at 75,286 (Dec. 2, 2010) (Proposed Section 902(d) imposes temporary restriction on the dissemination of trade data by entities other than SDRs) [hereinafter "Regulation SBSR"].

[35] *See id.* at 75,285.

required in such reports, including each product's "price" and "data elements necessary for a person to determine the market value of the transaction."[36] In addition, Section 901 requires that any "life cycle event data" also be reported, including "any event" that would result in a change in the information reported to a SDR.[37]

Both market participants and industry regulators recognize the importance of the valuation data Proposed Rule 17Aj-1 addresses. However, it is difficult to understand why this information should not be included in the information reported to, and disseminated by, a SDR. The Trade Information Warehouse currently receives similar event-based records and other data on valuation information. Based on these records, the Trade Information Warehouse maintains positions and publishes CDS market data. This data includes messaging and updating for successor and credit events, life cycle events, position updates, payment amount determination, and net settlement calculations and processing.[38]

DTCC is concerned that by relying on security-based swap clearing agencies that perform CCP services to collect and disseminate data separately from SDRs, there exists the potential for fragmentation of important market data. This will frustrate efforts to aggregate essential data and hinder the ability of SDRs to provide regulators a complete and accurate picture of the market.

Proposed Rule 17Ad-24: Exemption from Clearing Agency Definition

The Commission states in its discussion of Proposed Rule 17Ad-24 its preliminary belief that "[e]ntities that calculate net payment obligations among counterparties for security-based swaps and provide instructions for payments" (i) are likely acting as "an intermediary in making payments or deliveries or both in connection with transactions in securities"[39] and (ii) would therefore fall within the definition of a clearing agency and generally need to register.[40]

DTCC respectfully suggests that an entity such as WTC, which conducts only the limited activities described above, (i) should be exempt from registration as a clearing agency or, failing that, (ii) should be subject to a registration that imposes only limited requirements

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[36] *See id.* at 75,285.

[37] *See id.* at 75,285.

[38] *See* Comments from Mr. Larry Thompson, DTCC, Security-Based Swap Data Repository Registration, Duties, and Core Principles; Proposed Rule (Jan. 24, 2011), *available at:* http://www.sec.gov/comments/s7-35-10/s73510-12.pdf.

[39] This language comes directly from the definition of "clearing agency" in Section 3(a)(23)(A) of the Exchange Act.

[40] Release, *supra* note 1, at 14,495.

on the entity in recognition of the limited nature of activities that subject the entity to such registration.

The Commission asks with respect to Proposed Rule 17Ad-24:

> Should non-CCP security-based swap clearing agencies be subject to proposed Regulation MC, which the Commission proposed on October 14, 2010 to mitigate the potential conflicts of interest that could exist at certain entities, including security-based swap clearing agencies, through conditions and structures relating to ownership, voting, and governance of these entities? Why or why not? Should proposed Regulation MC apply to some but not all security-based swap clearing agencies that do not provide CCP services? If so, which ones?[41]

DTCC respectfully suggests (i) that a non-CCP security-based swap clearing agency should not be subject to the requirements of Regulation MC, (ii) that a non-CCP security-based swap clearing agency should instead be subject to the requirements of Proposed Rules 17A-d-22(d)(8) (Governance), 17Ad-25 (Procedures to Identify and Address Conflicts of Interest) and 17Ad-26 (Standards for Board and Board Committee Directors) and, in any case, (iii) that a security-based swap clearing agency owned by a financial market utility, whether or not it provides CCP services, should be exempt from the ownership and voting limitations of Regulation MC for the reasons set forth in the DTCC Comment Letter on Regulation MC.[42]

Proposed Rule 3Cj-1: Designation of Chief Compliance Officer

Proposed Rule 3Cj-1 provides as follows:

> (a) In general. Each clearing agency shall designate a chief compliance officer. The compensation and removal of the chief compliance officer shall require the approval of a majority of the clearing agency's board.
>
> (b) Duties. The chief compliance officer shall:
>
> (1) Report directly to the board of directors or to the senior officer of the clearing agency;
>
> (2) In consultation with its board, a body performing a function similar thereto, or the senior officer of the registered clearing agency, resolve any conflicts of interest that may arise;

[41] *Id*. at 14,496.

[42] *See* DTCC Comment Letter on Regulation MC, *supra* note 16.

(3) Be responsible for administering each policy and procedure that is required to be established pursuant to section 3C of the Act (15 U.S.C. 78c-3) and the rules and regulations thereunder;

(4) Ensure compliance with the Act and the rules and regulations thereunder;

(5) Establish policies and procedures for the prompt remediation of any non-compliance issues identified by the chief compliance officer; and

(6) Establish and follow appropriate procedures for the prompt handling, management response, remediation, retesting, and closing of non-compliance issues.

(c) Annual Reports.

(1) In general. The chief compliance officer shall annually prepare and sign a report that contains a description of:

(i) The compliance of the clearing agency with respect to the federal securities laws and the rules and regulations thereunder; and

(ii) Each policy and procedure of the clearing agency of the compliance officer (including the code of ethics and conflict of interest policies of the registered clearing agency).

(2) Requirements. An annual compliance report under this section shall:

(i) Accompany each appropriate financial report of the clearing agency that is required to be furnished to the Commission pursuant to the Act and the rules thereunder;

(ii) Include a certification that, under penalty of law, the compliance report is accurate and complete;

(iii)Be submitted to the board of directors and audit committee (or equivalent bodies) of the clearing agency promptly after the date of execution of the required certification and prior to filing of the report with the Commission; and

(iv)Be filed with the Commission in a tagged data format in accordance with the instructions contained in the EDGAR Filer Manual, as described in Rule 301 of Regulation S-T (17 CFR 232.301).

(v) Be filed with the Commission within 60 days after the end of the fiscal year covered by such report.

(e) For purposes of this rule, references to senior officer shall include the chief executive officer, or other equivalent officer.

Proposed Rule 3Cj-1 incorporates the duties of a chief compliance officer ("CCO") set forth in Section 763(a) of the Dodd-Frank Act now codified in Section 3C(j) of the Exchange Act, and includes certain additional requirements.

General Comments

DTCC agrees with the Commission that a robust internal compliance function plays a critical role in facilitating a clearing agency's monitoring of, and compliance with, the requirements of the Exchange Act and the rules and regulations thereunder applicable to clearing agencies. Requiring a clearing agency to designate a CCO is an appropriate way to further this goal.

DTCC currently has a CCO, an established compliance infrastructure for its businesses (including its three clearing agency subsidiaries), processes for establishing and implementing required compliance policies, procedures for overseeing adherence to those procedures and a mechanism for reporting, tracking, remediating and closing compliance issues, whether self-identified or identified through internal or external examinations. In light of this experience, DTCC offers the following comments on and suggested revisions to Proposed Rule 3Cj-1.

Duties of CCO

While DTCC fully supports the principle of a clearing agency designating a CCO, DTCC believes that some of the duties of the CCO specified in Proposed Rule 3Cj-1 require clarification in order to avoid an overly broad reading of those duties. DTCC believes that some of the duties of the CCO specified in the Proposed Rule go beyond those duties traditionally understood to be part of the compliance function. In DTCC's view, the CCO should be responsible for establishing relevant compliance procedures, and monitoring compliance with those procedures and other applicable legal requirements. The CCO should also participate in other aspects of the clearing agency's activities that implicate compliance or regulatory issues. However, the CCO cannot and should not be required to be responsible for all aspects of the clearing agency's business.

Similarly, the Commission should recognize that oversight of certain aspects of clearing agency activities are principally (and, as a practical matter, need to be) within the purview of risk management and operations personnel. Although there may be a regulatory or compliance aspect in determining whether a clearing agency is meeting, for example, its operational readiness, service level or data security responsibilities, principal oversight of those aspects of the clearing agency business should remain with the relevant business areas, subject to oversight by senior management and ultimately the

board of directors. While a CCO may have an important role to play in overall oversight and the remediation of problems, the Commission's rules should not impose on CCOs responsibilities outside their traditional core competencies.

The core competencies of CCOs have developed from responsibilities shared by CCOs under existing compliance regimes in the financial services industry, including those of investment advisers, funds, broker-dealers and banks.

Existing Compliance Regimes in the Financial Services Industry

Both investment advisers and investment companies, for example, are required to adopt written policies and procedures reasonably designed to prevent violations of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), and the Investment Company Act of 1940, as amended (the "Investment Company Act"), respectively, and to designate a CCO responsible for the administration of such policies and procedures.[43] Adviser and fund CCOs are also required to report at least annually on the adequacy and effectiveness of relevant compliance policies and procedures. Although Rule 38a-1 under the Investment Company Act arguably provides greater detail about a wider scope of responsibilities for fund CCOs (including reporting obligations with respect to the compliance programs of certain of the fund's service providers) than those applicable to their adviser counterparts, both systems were designed to enable adviser and fund CCOs to fulfill primarily administrative duties with a maximum of flexibility.[44]

The FINRA compliance rules applicable to broker-dealers share numerous features with those applicable to advisers and funds.[45] These include (i) an obligation to develop policies and procedures reasonably designed to achieve compliance with applicable laws;, (ii) appointment of a CCO, (iii) a requirement that the CCO be knowledgeable and vested with the requisite authority to fulfill his or her duties, (iv) mandatory review of the firm's compliance program at least annually, (v) a requirement that the compliance program be dynamic and (vi) CCO reporting (in the case of broker-dealers, to the firm's CEO). The broker-dealer compliance model, like that of advisers and funds, is not overly prescriptive with respect to the specific duties of the CCO.

The established compliance regime for banks similarly acknowledges the need for flexibility in the development and administration of risk management policies and

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[43] 17 CFR 275.206(4)-7; 17 CFR 270.38a-1.

[44] In adopting Rule 206(4)-7, the Commission acknowledged that funds and advisers were too varied in their operations to impose a single set of universally applicable compliance requirements on the industry, and a wide range of CCO responsibilities and compliance programs specific to individual advisers has developed accordingly. *See* Compliance Programs of Investment Companies and Investment Advisers, 68 Fed. Reg. 74,714, 74,716 (Dec. 24, 2003) [hereinafter "IA/IC Compliance Release"]. The Commission also stated, in adopting Rule 38a-1, that it was designed to provide fund complexes with flexibility to apply it in a manner best suited to the organization of each complex. *See* IA/IC Compliance Release, at 74,717.

[45] FINRA (NASD) Rule 3010 and Interpretive Material 3010-1, FINRA (NASD) Rule 3012 and FINRA Rule 3030.

procedures for banking organizations.[46] In accordance with a compliance paper issued by the Basel Committee on Banking Supervision,[47] which is widely followed in the United States,[48] the core responsibilities of a banking organization's compliance function are to (i) provide advice, guidance and education, (ii) identify, measure and assess compliance risk, (iii) monitor and test compliance, (iv) oversee the compliance program, and (v) oversee any statutory responsibilities.[49] The bank model, like that of advisers, funds and broker-dealers, therefore establishes a role for CCOs that is evaluative, communicative, administrative and remedial in nature.

Duty to Administer Policies and Procedures

Section 3Cj-1(b)(3) of the Proposed Rule provides that the CCO shall be responsible for administering each policy and procedure that is required to be established pursuant to Section 3C of the Act. As a technical matter, DTCC believes the reference to Section 3C of the Act in Section 3Cj-1(b)(3) should be a more specific reference to Section 3C(j) of the Act, since the other parts of Section 3C only have relevance to a clearing agency for security-based swaps.

Duty to "Ensure" Compliance

Section 3Cj-1(b)(4) of the Proposed Rule imposes on the CCO the duty of "*ensuring* compliance with the Act and the rules and regulations thereunder" (emphasis added). Obviously, the requirement for a CCO to "ensure" compliance goes well beyond the existing financial services models described above – it is not a standard to which individuals with responsibility for supervising compliance programs would be held. Compliance with applicable laws is the primary responsibility of management and the relevant business units. It is the responsibility of the CCO to administer the policies and procedures that are designed to monitor such compliance with applicable laws by management and the relevant business units.[50]

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[46] *See* Board of Governors of the Federal Reserve System, SR 08-09 / CA 08-11, Compliance Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles (Oct. 16, 2008) [hereinafter "Fed Letter"].

[47] Basel Committee on Banking Supervision, Compliance and the Compliance Function in Banks (April, 2005) [hereinafter "Basel Committee Report"].

[48] *See* Fed Letter, *supra* note 46.

[49] Basel Committee Report, *supra* note 47, at 13-14.

[50] The supervisory responsibilities for compliance programs of broker-dealers and banks are vested in management, not compliance. *See* FINRA Rule 3130.07; Basel Committee Report, *supra* note 47, at 9-10; and FDIC Compliance Manual, Compliance Management System II2.1-II2.2 (June 2009). Further, the Commission noted, in adopting Rule 206(4)-7 under the Advisers Act and Rule 38a-1 under the Investment Company Act, that "[h]aving the title of chief compliance officer does not, in and of itself, carry supervisory responsibilities." *See* IA/IC Compliance Release, *supra* note 44, at note 73.

The imposition of this duty on a CCO, without any guidance, limitation or definition as to the meaning or scope of the CCO's responsibilities in this context, would result in an obligation that would be impossible to satisfy.

DTCC acknowledges that Section 3C(j)(2)(D) of the Exchange Act provides that the CCO shall "ensure compliance." However, DTCC believes that, in drafting this provision, Congress intended to require the CCO to oversee the implementation of compliance policies, procedures and programs that are reasonably designed to result in compliance with the Exchange Act and Commission rules and regulations promulgated thereunder, and to report to management when issues arise. DTCC does not believe Congress intended to require the CCO to guarantee absolute compliance or make the CCO a surety of absolute compliance by the clearing agency and every employee. No individual could conceivably achieve this. DTCC therefore respectfully submits that, in adopting Proposed Rule 3Cj-1 in final form, the Commission should replace the word "Ensure" in Section 3Cj-1(b)(4) of the Proposed Rule with the phrase "Be responsible for administering", a phrase which already appears in Section 3Cj-1(b)(3) of the Proposed Rule, or otherwise clarify that "ensure compliance" in this context means taking reasonable steps to establish, maintain, review, modify and test the effectiveness of compliance policies.

Non-Compliance Policies and Procedures

Section 3Cj-1(b)(5) of the Proposed Rule imposes on the CCO the duty to "establish policies and procedures for the prompt remediation of any non-compliance issues identified by the CCO". DTCC notes that Section 3Cj-1(b)(6) of the Proposed Rule imposes substantially the same duty on the CCO. Since the duties of the CCO in Section 3Cj-1(b)(5) are, for the most part, subsumed within the broader scope of Section 3Cj-1(b)(6), DTCC suggests that the material in Section 3Cj-1(b)(5) be combined with the material in Section 3Cj-1(b)(6) in a revised Section 3Cj-1(b)(5) and that Section 3Cj-1(b)(6) be deleted.

Consistent Use of Terminology

DTCC notes that Sections 3Cj-1(b)(2) and 3Cj-1(c)(1)(ii) of the Proposed Rule use the term "registered clearing agency" instead of the term "clearing agency" that is used in the other Sections of Proposed Rule 3Cj-1 (*i.e.*, Sections 3Cj-1(a), 3Cj-1(b)(1), 3Cj-1(c)(1)(i), the first part of 3Cj-1(c)(1)(ii), 3Cj-1(c)(2)(i) and 3Cj-1(c)(2)(iii)). For consistency with the other Sections of Proposed Rule 3Cj-1, DTCC suggests that Sections 3Cj-1(b)(2) and 3Cj-1(c)(1)(ii) of the Proposed Rule be revised to replace the term "registered clearing agency" with the term "clearing agency".

Conflicts of Interest

With respect to the requirement in Section 3Cj-1(b)(2) of the Proposed Rule that the CCO resolve conflicts of interest, DTCC requests that the Commission clarify what types

of conflicts of interest should be within the CCO's purview. Some issues, such as the permissibility of dealings with related parties or entities, are properly within the CCO's functions. Other issues, such as restrictions on ownership and access, may be fundamental for the board of directors and senior management to address. Furthermore, to the extent that Proposed Rule 3Cj-1 requires consultation with the board or senior management, some materiality threshold would be appropriate, as not every potential conflict of interest that might be addressed by a CCO (or his or her subordinates) would require such consultation. The determination of materiality should be within the CCO's purview to determine based on factors such as nature and scope of the issue and potential exposure.

Further, Section 3Cj-1(b)(2) of the Proposed Rule requires the CCO to "resolve any conflicts of interest that may arise." DTCC does not believe that, in inserting similar language in Section 3C(j)(2)(B) of the Exchange Act, Congress meant "resolve" in the executive or managerial sense such that the CCO alone would examine the facts and determine and effect the course of action. DTCC believes Congress intended "resolve" to mean to identify, advise, escalate as appropriate and assist senior management in resolving conflicts, and to require the establishment of reasonable procedures for the resolution of conflicts together with the executives of the clearing agency, not to require the CCO to resolve them alone. The authority to actually resolve conflicts, like the obligation to enforce compliance, resides principally with the clearing agency's senior executives and management.

Annual Compliance Report

DTCC suggests that the Commission make several clarifications and modifications to the requirement in Proposed Rule 3Cj-1 for the CCO of a clearing agency to prepare an annual report with respect to compliance. First, DTCC believes that any such report should be limited to compliance with the requirements of the Exchange Act and the rules and regulations thereunder applicable to the clearing agency rather than "the federal securities laws".

DTCC also believes that the annual compliance report should describe "the compliance policies and procedures" of the clearing agency, and not "each policy and procedure"[51] of the clearing agency, which would be beyond the subject matter expertise of the CCO and unduly burdensome and outside the scope of the duties and responsibilities of the CCO. DTCC does not believe it is appropriate to place the principal responsibility on a CCO to review such business matters as, for example, service levels, cost, pricing and operational reliability for purposes of preventing anticompetitive behavior. DTCC believes that other personnel teams, particularly in the risk management, operational or business areas, are best positioned to perform these functions. Of course, a CCO should be involved in remedying any noncompliance issues discovered during such review.

[51] Proposed Rule 3(C)j-1(c)(1)(ii).

Finally, DTCC firmly believes the annual report should be kept confidential by the Commission and not be subject to disclosure under the Freedom of Information Act. There is no requirement in the Dodd-Frank Act that the compliance report be made public. Given the level of disclosure expected to be required, DTCC believes that the report will likely contain confidential and proprietary business information. Such information should not be made available to the public or market participants generally.

Certification of Annual Compliance Report

DTCC acknowledges that Section 3C(j)(3) of the Exchange Act provides for the CCO to "annually prepare and sign a report" describing the clearing agency's compliance with the Exchange Act and its policies and procedures, and that Section 3C(j)(3)(B)(ii) of the Exchange Act provides for the report to "include a certification that, under penalty of law, the compliance report is accurate and complete." However, although Section 3C(j)(3) of the Exchange Act requires the CCO to prepare and sign the report, Section 3C(j)(3)(B)(ii) of the Exchange Act does not specifically state or mandate that the required certification must itself be made by the CCO, only that it be *included* in the report.

There is an obvious comparison to be made with the annual certification required under the broker-dealer model, where the certification is required to come from the CEO, because the CEO is the firm's senior officer and business manager and thus the person who ultimately should be responsible for any certification regarding firm compliance.[52] In fact, in approving the FINRA requirement, the Commission stated that the CEO certification requirement "will help motivate firms to keep their compliance programs current with business and regulatory developments,"[53] a clear statement that the best way to achieve the goal of robust, effective compliance programs is by making the most senior officer ultimately responsible.

Accordingly, DTCC would suggest that the Commission revise the language of Proposed Rule 3Cj-1 to require that the certification be made by the senior officer of the clearing agency, not the CCO.

Liability for Certification of Annual Compliance Report

DTCC is concerned with the language in Section 3Cj-1(c)(2)(ii) of the Proposed Rule that the annual compliance report be accompanied by a certification that, "under penalty of law," the compliance report is accurate and complete.

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[52] *See* FINRA Rule 3130(b).

[53] Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendments Nos. 1 and 2 Thereto by the National Association of Securities Dealers, Inc. Relating to Chief Executive Officer Certification and Designation of Chief Compliance Officer, Securities Exchange Act Release No. 34-50347 (Sept. 10, 2004) at 10.

While DTCC recognizes that Section 3C(j)(3)(B)(ii) of the Exchange Act contains identical language, given that, in the context of at least one other parallel rulemaking in respect of virtually identical provisions in the Dodd-Frank Act, another regulator has stated that the CCO could be subject to *criminal* liability for false, incomplete or misleading statements or representations made in the compliance report,[54] DTCC believes that the Commission should provide more specific guidance as to when, and under what standards, the CCO (or, as DTCC recommends, the senior officer) may be subject to penalty under law in respect of the certification.

DTCC recognizes that knowingly and willfully making a materially false or misleading statement to the government can, in appropriate circumstances, lead to civil or even criminal liability[55] but DTCC is concerned by the suggestion of possible criminal sanctions in the context of signing and certifying the compliance report and making any statement (and particularly incomplete statements or non-material statements) in the compliance report. There is no indication that Congress ever contemplated that CCOs would be subject to criminal liability under Section 3C(j) of the Exchange Act. Moreover, potential criminal liability for what in hindsight may be judged to be inappropriate or inadequate job performance will make it much more difficult, if not impossible, for clearing agencies to hire competent employees who will be willing to serve as CCO.

DTCC therefore suggests that the Commission clarify the standard for determining when the CCO (or, as DTCC recommends, the senior officer) has engaged in conduct that may subject him or her to liability, civil or criminal, and provide guidance with respect to which statutes (especially criminal statutes) may apply.

In doing so, DTCC asks the Commission to clarify that criminal sanctions would be sought, if ever, only in circumstances where it has been determined that the signer has knowingly and willfully made a materially false and misleading statement, and that it is not the Commission's intent to extend criminal liability beyond the existing statutory provisions that provide for criminal sanctions.

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[54] *See* Designation of a Chief Compliance Officer; Required Compliance Policies; and Annual Report of a Futures Commission Merchant, Swap Dealer, or Major Swap Participant, 75 Fed. Reg. 70,881, 70,884 (Nov. 19, 2010).

[55] *See, e.g.*, Title 18, Chapter 47, Fraud and False Statements. "§1001. Statements or entries generally: (a) Except as otherwise provided in this section, whoever, in any matter within the jurisdiction of the executive, legislative, or judicial branch of the Government of the United States, knowingly and willfully — (1) falsifies, conceals, or covers up by any trick, scheme, or device a material fact; (2) makes any materially false, fictitious, or fraudulent statement or representation; or (3) makes or uses any false writing or document knowing the same to contain any materially false, fictitious, or fraudulent statement or entry; shall be fined under this title, imprisoned not more than 5 years…"

Responses to Certain Specific Requests for Comment

In response to the Commission's specific questions in the Release accompanying the Proposed Rules, DTCC believes, as a general matter, that the Commission does not need to be overly prescriptive as to the specific compliance responsibilities of the CCO and that clearing agencies should have flexibility to implement the required compliance procedures in ways consistent with their current structure and business. DTCC believes that clearing agencies are best suited to determine the most effective way to implement the general requirements of the Exchange Act that are applicable to them.

The following are DTCC's responses to certain of the Commission's specific requests for comment:

Should the Commission include in its proposed rule a requirement that a CCO may only be removed by action of the board?[56]

DTCC does not believe that Proposed Rule 3Cj-1 should require that the CCO be removed only by board action. Rather, DTCC believes that the board or a committee of the board should be notified by management prior to any removal of the CCO and be given an opportunity to provide its consent or non-objection thereto. DTCC's audit committee is currently responsible for reviewing and endorsing management's appointment of a CCO and presenting that appointment to the board for approval. DTCC believes an analogous approach for removal is appropriate.

Should the Commission provide guidance in its proposed rules about the CCO's procedures for the remediation of non-compliance issues?[57]

DTCC does not believe that it is necessary for Proposed Rule 3Cj-1 to provide guidance about the CCO's procedures for the remediation of non-compliance issues. Because remediation of non-compliance issues is context and fact specific, the procedure should be left to the discretion of the CCO to reasonably implement an appropriate process for remediation.

Does requiring the compliance report to be filed annually with the Commission within sixty days after the end of the fiscal year covered by such report give a clearing agency enough time to prepare the report? Should the Commission consider a longer or short time frame? Please explain.[58]

DTCC believes that the proposed 60-day time period following the end of a clearing agency's fiscal year to file the compliance report is too short and should be at least 90 days. Moreover, DTCC believes that a clearing agency should be given up to 120 days

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[56] Release, *supra* note 1, at 14,400.

[57] *Id.*

[58] *Id.*

after the end of its fiscal year to file its first compliance report under Proposed Rule 3Cj-1; subsequent updates could then be subject to the 90-day period. Moreover, if the Commission determines that a clearing agency must make the compliance report public, a position with which DTCC strongly disagrees, then DTCC believes that a clearing agency should be given up to 120 days following the end of each fiscal year, not just the first, to file such report.

Should the Commission require submission of the CCO compliance report to the board before or after submission to the Commission? How would submission of the compliance report to the board before or after submission to the Commission effect the board's review of the compliance report?[59]

DTCC believes that, in accordance with appropriate corporate governance requirements, the compliance report should be submitted to the board before it is submitted to the Commission.

Should the Commission prescribe any specific method of review by the board with respect to the CCO compliance report? For example, should the Commission require that (i) the CCO compliance report include, as appropriate, recommended actions to be taken by the clearing agency to improve compliance or correct any compliance deficiencies, (ii) the board review any such recommendations and determine whether to approve them, and (iii) the clearing agency notify the Commission if the board declines to approve such recommendations, or approves different actions than those recommended in the CCO compliance report? What are the advantages and disadvantages of such an approach? Should clearing agencies be required to have the CCO report directly to the board instead of also permitting reporting to a senior officer of the clearing agency? What would be the advantages and disadvantages of requiring the CCO to report to the board?[60]

DTCC does not believe it is appropriate to require the report to include a discussion of recommendations for material changes to the policies and procedures of the clearing agency as a result of the annual review (or the rationale for such recommendations and whether the policies or procedures will be modified as a result of such recommendations). DTCC believes that the inclusion of a description of any material changes to the clearing agency's policies and procedures, and any material compliance matters identified, in each case, since the date of the preceding compliance report, provide comprehensive information. In DTCC's view, requiring the CCO to detail recommendations for material changes (whether or not accepted) may chill open communication between the CCO and other clearing agency management (including the board of directors) regarding improvements to the compliance policies and procedures. Such an approach could have the undesirable effect of making it less likely for

[59] *Id.*

[60] *Id.*

management or the CCO to propose improvements to compliance policies and procedures.

Suggested Changes in Proposed Rule 3Cj-1

DTCC respectfully suggests that Proposed Rule 3Cj-1 be revised as follows:

(a) In general. Each clearing agency shall designate a chief compliance officer. The compensation [~~and removal~~] of the chief compliance officer shall require the approval of a majority of the clearing agency's board.

(b) Duties. The chief compliance officer shall:

(1) Report directly to the board of directors or to the senior officer of the clearing agency;

(2) In consultation with its board, a body performing a function similar thereto, or the senior officer of the [~~registered~~] clearing agency, assist in resolving [~~resolve~~] any material conflicts of interest that may arise;

(3) Be responsible for administering each policy and procedure that is required to be established pursuant to section 3C(j) of the Act [(15 U.S.C. 78c-3(j))] and the rules and regulations thereunder;

(4) [~~Ensure~~] Be responsible for administering compliance with the provisions of the Act and the rules and regulations thereunder applicable to the clearing agency;

[~~(5)Establish policies and procedures for the prompt remediation of any non-compliance issues identified by the chief compliance officer;~~] and

[~~(6)~~] (5) Establish and follow appropriate policies and procedures for the [~~prompt~~] timely handling, management response, remediation, retesting, and closing of non-compliance issues.

(c) Annual Reports.

(1) In general. The chief compliance officer shall [~~annually~~] prepare and sign [~~a~~] an annual compliance report that contains a description of:

(i) The compliance activities of the clearing agency with respect to the [~~federal securities laws~~] provisions of the Act and the rules and regulations thereunder applicable to the clearing agency; and

(ii) [~~Each policy and procedure~~] The compliance policies and procedures of the clearing agency [~~of the compliance officer~~]

(including the code of ethics and conflict of interest policies of the [~~registered~~] clearing agency).

(2) Requirements. [~~An~~] The annual compliance report under this section shall:

(i) Accompany [~~each appropriate~~] the annual financial report of the clearing agency that is required to be furnished to the Commission pursuant to the Act and the rules and regulations thereunder;

(ii) Include a certification of the senior officer of the clearing agency that, under penalty of law, the [~~annual~~] compliance report is accurate and complete;

(iii)Be submitted to the board of directors and audit committee (or equivalent bodies) of the clearing agency promptly after the date of execution of the required certification and prior to filing of the report with the Commission; [~~and~~]

(iv)Be filed with the Commission [~~in a tagged data format in accordance with the instructions contained in the EDGAR Filer Manual, as described in Rule 301 of Regulation S-T (17 CFR 232.301).~~] on a confidential basis; and

(v) Be filed with the Commission within [~~60~~] 90 days after the end of the fiscal year covered by such report, except that the first annual compliance report filed by a clearing agency under this section shall be filed with the Commission within 120 days after the end of the fiscal year covered by such report.

[~~(c)~~] (d) For purposes of this rule, references to senior officer shall include the chief executive officer, or other equivalent officer.

Phase-In Period for Proposed Rule 3Cj-1

If DTCC's suggested changes in Proposed Rule 3Cj-1 are not accepted by the Commission, clearing agencies (i) will be required to conduct a complete re-evaluation of the roles and responsibilities of the CCO and the resources needed by the CCO to perform the duties set forth in the Proposed Rule and (ii) may be required to restructure their entire compliance function accordingly to comply with such Rule. It is difficult to assess at this time the additional cost and time commitment that such re-evaluation and restructuring will entail, but it will undoubtedly be substantial. Therefore, DTCC recommends that, if Proposed Rule 3Cj-1 is implemented as currently proposed, the final rule should be subject to a significant phase-in period to allow adequate time for clearing agencies to comply.

CONCLUSION

We appreciate the opportunity to comment on the Proposed Rules and provide the information set forth above. Should you wish to discuss these comments further, please contact me at 212-855-3240 or lthompson@dtcc.com.

Sincerely yours,

Larry E. Thompson
General Counsel