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<u>*Via Electronic Submission*</u>

October 6, 2022

Ms. Vanessa Countryman
Secretary of the Commission
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549–1090

Re: Clearing Agency Governance and Conflicts of Interest
Notice of Proposed Rulemaking
<u>RIN 3235–0695</u>

Dear Secretary Countryman,

I appreciate the opportunity to comment on the Securities and Exchange Commission ("Commission" or "SEC") proposed rules on "Clearing Agency Governance and Conflicts of Interest" ("Proposal").[1] In my scholarship, I have analyzed the implications of different ownership models on clearinghouses' risk profile;[2] I have looked at governance and financial mechanisms to more effectively align the economic interests and incentives of clearinghouses' owners to those of their participants;[3] and, more generally, I have studied the growing domestic and international regulation and role played by financial market infrastructures in the aftermath of the 2008 financial crisis.[4] I welcome the chance to share my findings and views with the Commission, I thank the Commission for citing and engaging with my work, and I remain

[1] Securities and Exchange Commission, Proposed Rule, *Clearing Agency Governance and Conflicts of Interest*, 87 Fed. Reg. 51812 (Aug. 23, 2022).

The views and opinions expressed in this letter are solely the author's and not those of George Mason University Antonin Scalia Law School.

[2] *See* Paolo Saguato, *The Ownership of Clearinghouses: When Skin in the Game is Not Enough: The remutualization of Clearinghouses*, 34 YALE. J. ON REG. 601, 633-34 (2017), available at https://digitalcommons.law.yale.edu/yjreg/vol34/iss2/5/ [hereinafter *The Ownership of Clearinghouses*].
[3] *See* Paolo Saguato, *Financial Regulation, Corporate Governance, and the Hidden Costs of Clearinghouses*, 82 OHIO ST. L. J. 1071 (2021), available at https://kb.osu.edu/handle/1811/101242 [hereinafter *The Hidden Costs of Clearinghouses*].; Paolo Saguato, *The Unfinished Business of Regulating Clearinghouses*, COLUM. BUS. L. REV. 449 (2020) https://journals.library.columbia.edu/index.php/CBLR/article/view/7219 [hereinafter *The Unfinished Business*].
[4] FINANCIAL MARKET INFRASTRUCTURE – LAW AND REGULATION (Jens-Hinrich Binder and Paolo Saguato eds., 2022).

available to further discuss them with the Commission.

The Commission's Proposal is an important step in the direction of addressing the incentives structure of clearing agencies and in supporting the development of robust governance arrangements that foster accountability, transparency, and resilience of clearing agencies. The considerations in this letter primarily focus on clearing agencies that provide central counterparty ("CCP") services. In supporting this Proposal, this letter focuses on three specific aspects of the proposed rules: *(i) board composition and requirements for independent directors - § 240.17Ad-25(b)* and *(f); (ii) nominating committee - § 240.17Ad-25(c);* and *(iii) risk management committee - 240.17Ad-25(d).*

While I commend the Commission's rule making initiative and support the current SEC's proposal to amend some provisions of the existing clearing agencies' regulatory regime,[5] I encourage the Commission to continue to assess the regulatory architecture of clearing agencies and their governance and financial resilience. In particular, the SEC should engage in a more comprehensive study that would further explore how different clearing agencies ownership models and organizational arrangements allocate incentives among owners and participants. Different ownership models might each require a special regulatory framework to support clearing agencies in fully aligning the incentives of clearinghouses' stakeholders and ultimately enhancing the accountability and resilience of these firms.[6] When a clearing agency mutualizes the risk it faces among its participants, a participant-owned clearing agency theoretically more efficiently aligns the incentives among the firm's main stakeholders. On the other hand, when the clearinghouse is investor-owned, and the clearing agency mutualizes risk among participants that are not owners – and thus do not have control rights over the clearing business – then the clearing agency faces a unique agency conflict that spills from the member-shareholder divide – or using the Commission's terminology, the participant-owner divide. This manifests in the separation of risk and control among participants and owners.[7] The Commission's Proposal moves in the direction of aligning the interests of clearing agency participants and owners by advancing governance arrangements that should give "voice," at the board level, to clearing agencies' different stakeholders – large and small participants, end-users and clients, etc. However, the Proposal could and should go further to align interests and enhance resiliency.

The Commission should continue in its mission to strengthen our national system for clearance and settlement of securities markets. To that end, and embracing the Proposal's focus on enhancing the alignment between owners' and participants' incentives, I respectfully urge a more comprehensive reassessment of the existing regulatory framework for clearinghouses' financial resilience, and recovery and resolution regime. Governance reforms alone, while they can result in more transparent and participative arrangements, cannot on their own enhance clearinghouses financial resilience, and ultimately support financial stability.[8]

(i) Board composition and requirements for independent directors - § 240.17Ad-25(b) and (f)

The Proposal would require registered clearing agencies to have a majority of independent directors and would define "independent director" as an individual who has no material relationship with the registered clearing agency, any affiliate thereof, or the holder of a controlling voting interest of the registered clearing

[5] Given that several clearing agencies are also registered with the Commodity Futures Trading Commission ("CFTC"), I encourage the Commissions to harmonize, whenever possible, their rules on clearinghouses.
[6] *See* Saguato, *The Ownership of Clearinghouses*, *supra* note 2, at 640-653 (discussing the costs and benefits of different ownership models).
[7] *See* Saguato, *The Hidden Costs*, *supra* note 3, at 1098-1108.
[8] *See* Saguato, *The Hidden Costs*, *supra* note 3, at 1132-1139 (offering policy option to align clearinghouse shareholders and members incentives in the firm capital structure, and in recovery and resolution proceedings).

agency.

I support this piece of the Commission's Proposal. All publicly listed corporations are required by stock exchanges rules to have a board comprised of the majority of independent directors, directors without ties to the management, who can exercise their independent business judgment over business affairs. Coupled with the provision in the proposed rule to establish a Nominating Committee that is tasked with nominating a slate of directors representative of the views of the different participants and end-users, the Proposal to create a majority independent board would allow the clearing agency to incorporate and address different perspectives in the governance of the clearing agency.

I respectfully believe that the distinction in board composition between participant-owned (required to have 34% of independent directors) versus investor-owned clearing agencies (required to have a majority of independent directors) is not necessary—nor is it actually justified by the premise of the proposed rule. From a practical standpoint, according to the economic analysis completed by the Commission, all clearing agencies that are participant-owned operate already with a board of directors that is composed of a majority of independent directors. In addition, if the rationale for an independent board is to oversee the management more effectively, then all clearing agencies deserve the same attention and the same treatment.

If, however, the subtle rationale that justifies the distinction is the assumption that (1) investor-owned clearing agencies deserve more regulatory attention due to the tension between the for-profit nature of the firm and the financial stability function of the clearing agency and (2) the fact that that risk bearing costs are allocated to the participants, but control rights over the firm business are allocated on their owners, then I would encourage the Commission to further develop the analysis and more explicitly adopt novel proposed rules that create a parallel regime for investor-owned and participant-owned clearing agencies. The potential tensions between participants and owners in investor-owned clearing agencies is a matter I have studied and that deserve particular attention by policymakers.[9]

On the matter of independent directors, I applaud the Commission's decision to expand the definition of independent directors to include directors who have material relationships with participants and their affiliates. Participants have substantial financial exposure and a commitment to the resilience of the firm, and, from a financial stability perspective, they are interested in a clearing agency that is financially stable and efficient.

Regarding the directors' "independence", the Commission states that "having a majority of independent directors reduced the potential misalignment of interests among directors and management, and among owners and participants, helping to ensure that a majority of directors are unattached to these dynamics." While I agree with this statement in the context of participant-owned clearing agencies, it is dubious whether that same conclusion can be reached for investor-owned clearing agencies. In investor-owned clearing agencies, the board and its members operate pursuing the legal purpose of maximizing shareholder value and directors, whether they are independent or not, owe to the corporation and its shareholders a duty to act in their interest. In light of these distinctions, the Commission should study the effect of different ownership structures and their effect on governance arrangements, and owners and participants incentives and consider adjusting its proposed rule to address those distinctions.

(ii) *Nominating Committee - § 240.17Ad-25(c)*

I support the proposal of the Commission to require each registered clearing agency to have a nominating committee, composed and chaired by independent directors and responsible for the selection and recommendation of candidates for director. This will ensure that board candidates possess expertise in matters

[9] *See* Saguato, *The Hidden Costs*, *supra* note 3, at 1029-1132; Saguato, *The Unfinished Business*, *supra* note 3, at 523-525 (offering an alternative solution on how to align the interests of clearing members and clearinghouses' shareholders via governance arrangements).

critical to clearing agencies' efficiency and stability, and they are representative of different stakeholders. However, I encourage the Commission to keep an open language in describing the function of the nomination committee and to clarify the meaning of "exclusive venue" as a necessary characteristic of the nominating committee. Many corporate boards establish nominating and corporate governance committee that address a broader range of corporate governance matters and that still consist of independent director.

(iii) *Risk Management Committee - 240.17Ad-25(d)*

I strongly support this provision of the proposed rule. Clearing agency should have one or more risk committee to support the board in its operation. Further, a majority of the committee should be composed of independent directors, given their detached position from the management and given their selection on the basis of their expertise in clearing and/or their relationship with clearing participants and end users.

In actuality, a dual level risk committee structure would be theoretically ideal as it would better incorporate inputs from the many constituencies of a clearing agency. In fact, there are benefits to having a board committee composed exclusively of directors, who are fiduciaries of the clearing agency, who can be held accountable, and who have a duty to act in the best interest of the clearing agency. On the other side, there are also benefits to having an external or advisory committee whose composition would not only be limited to current board directors, but that could be open to representatives of clearing participants, end users, etc. A clearing agency would be better served by establishing both types of risk committees, and I would recommend the Commission embrace such approach in the final rulemaking.[10] In addition, I strongly encourage the Commission to evaluate the merit of strengthening the decision-making process for risk management related matters. For instance, the Commission should consider the merit of requiring any clearing agency to promptly report to the Commission any decisions where the board decides *not* to follow the advice of the risk committee and to provide a comprehensive explanation for that decision.[11]

Thank you for the opportunity to comment on this important Proposal. If the Commission or staff have any questions and are interested in further discussing these issues, please do not hesitate to contact me at [redacted]. I look forward to continuing a dialogue with the Commission on clearing agencies and, more broadly, on clearance and settlement in securities markets.

Sincerely,

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[10] Adopting a "two tier" risk committee, with board committee made exclusively of directors, and an advisory committee where participants and end-users are represented would not simply create more effective risk management practices and policies, but also would align the SEC's Proposal to a recent CFTC Proposal on Governance Requirements for Derivatives Clearing Organizations, Commodity Futures Trading Commission, Proposed Rule, Governance Requirements for Derivatives Clearing Organizations, 87 Fed. Reg. 549559 (Aug. 11, 2022).

[11] *See* Regulation 648/2021 of the European Parliament and of the Council of 4 July 2012 on OTC Derivatives, Central Counterparties and Trade Repositories (EMIR), 2012 O.J. (L 201) 1, 70, Article 28 – Risk Committee; *see* Saguato, *The Hidden Costs*, *supra* note 3, at 1131.