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United States Senate
WASHINGTON, DC 20510

November 17, 2010

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

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

Re: RIN 3038–AD01, Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest

RIN 3235–AK74, 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

Dear Mr. Stawick and Ms. Murphy,

I write today to commend the Commodity Futures Trading Commission and Securities and Exchange Commission ("the Commissions"), individually and collectively, for their proposed rules to mitigate potential conflicts of interest in the operation of derivatives clearing organizations (DCOs), designated contract markets (DCMs), and swap execution facilities (SEFs).

The Commissions have taken a thoughtful, well-reasoned approach to the potential problems posed by conflicts of interest in the ownership structure of these organizations, particularly by establishing quantitative limits on voting ownership stakes in DCOs, DCMs, and SEFs. However, these rules could be augmented to address several areas of concern. Specifically, the Commissions should close the exception to the limit on aggregate voting; impose aggregate limits on DCMs and SEFs; adopt limits on incentives based upon trading revenue, profit, and volume; and removing the Commissions' authority to exempt institutions. It is important to ensure that any unscrupulous derivatives dealer cannot use any loopholes or exemptions to gain a financial advantage.

Centralized clearing is a critical element to stabilizing an over-the-counter derivatives market that has been called "a time bomb ticking away."[1] Dodd-Frank provides for mandatory clearing of swaps and security-based swaps for those trades that are eligible for clearing as determined by both the clearing houses and the regulators, unless the counterparty to the transaction is a corporate end-user.[2] Centralized DCOs, DCMs, and SEFs manage and spread the risk associated with currently opaque, bilateral derivatives contracts. However, if managed improperly, DCOs, DCMs, and SEFs have the potential to actually increase market instability, thereby increasing the likelihood of future taxpayer-funded bailouts.[3]

Central clearing can only serve its proper function if the DCOs responsible for clearing trades possess, in the words of CFTC Chairman Gary Gensler, "fair and open access criteria that allow any firm that meets objective, prudent standards to participate regardless of whether it is a dealer or a trading firm."[4] Regulators should be concerned about the inherent conflict of interest that exists when dealers act as gatekeepers to the trading facilities and clearinghouses in which they have a material economic interest. As Chairman Gensler has noted:

> Open governance would ensure that clearinghouses are not governed by parties that might have a conflict of interest or financial stake in particular transactions. Governance should be open to both dealers and non-dealers alike. As clearinghouses have an important say in which contracts are subject to a clearing requirement, it is essential that we remove potential conflicts of interest from that process.[5]

The five dealer banks that already control the vast majority of the derivatives market stand to profit from directing business only to those facilities they own. They also could enhance their profitability by influencing the facilities that they control to refuse to clear their swaps.[6] Allowing the dealers to control DCOs, DCMs, and SEFs would provide them with a mechanism by which they could circumvent the clearing, trading, and reporting requirements of the Dodd-Frank Act.[7] This would compromise the goals of the legislation to reduce systemic risk and increase transparency.[8]

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[1] David Segal, *Questions for Moody's and Buffett*, N.Y. TIMES, June 2, 2010 (quoting former Chairman of the CFTC Brooksley Borne).
[2] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, P. L. 111-203 § 723(a)(3) (2010).
[3] *See* Gretchen Morgenson, *Count on Sequels to TARP*, N.Y. TIMES, Oct. 2, 2010.
[4] Statement of Gary Gensler, Chairman, Commodity Futures Trading Commission Before the Senate Committee on Agriculture, Nutrition And Forestry, *Regulatory Reform and the Derivatives Markets*, June 4, 2009 at 5.
[5] Remarks of Chairman Gary Gensler, Over-the-Counter Derivatives Reform, Institute of International Bankers Washington Conference, March 1, 2010.
[6] *See* Robert Litan, *The Derivatives Dealers' Club and Derivatives Markets Reform: A Guide for Policy Makers, Citizens and Other Interested Parties* 36-37, Brookings Institution (Apr. 7, 2010).
[7] *See* Litan, *supra* note 5, at 37 ("As long as dealers have the ability and incentive to prevent or delay the maximum degree of derivatives clearing, exchange trading and transactions pricing (pre and post), systemic risk arising out of derivatives market activity will be higher than is socially optimal[.]").
[8] *See* S. Rep. No. 111-176 at 2 (2010) ("The primary purpose of [the] R[estoring] A[merican] F[inancial] S[tability] A[ct] is to promote the financial stability of the United States. It seeks to achieve that goal through multiple measures designed to improve accountability, resiliency, and transparency[.]").
in the financial systemresiliency, and transparency in the financial system.").

Dealers profit from over-the-counter transactions because their profit margins are greater in opaque markets than in fully transparent, regulated markets.[9] Conversely, investors and other counterparties benefit from the smaller spreads that result from the sort of clearing, trading, and reporting requirements that exist in the futures and securities markets.[10] Consequently, the DCOs, DCMs, and SEFs will directly affect the future profits of the derivatives dealers. The dealers would benefit financially from using their control of DCOs to refuse to clear certain contracts or make it more expensive for end-users to clear than to conduct bilateral trades.[11] To allow the few, largest dealer banks to control DCOs, DCMs, and SEFs would allow those dealer banks to effectively determine their own profit margins, potentially at the expense of financial stability.[12]

The dealers' intent to dominate such institutions was evident in a recent effort by certain stockholders of the European clearinghouse LCH.Clearnet to concentrate their ownership through a stock buyback. Dealer banks have a majority ownership stake in LCH.Clearnet – up to eighty-three percent – and LCH built its leading role in interest-rate swap clearing by only accepting trades done between the dealer banks.[13] U.S. clearing organizations create similar concerns.[14] For example, dealers reportedly exert influence over the Depository Trade and Clearing Corporation (DTCC), the data repository for derivatives,[15] and hold a significant

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[9] *See* Comments of Thomas Peterffy, Chairman and C.E.O., Interactive Brokers Group, Before The 2010 General Assembly Of The World Federation Of Exchanges 2, Oct. 11, 2010 ("The root of the problem, as always, is short-sighted greed on the part of the brokers ... They want to take more from their customers but without the customers seeing exactly what it is that they are paying. This is done by what is called internalization, which is easiest to illustrate with OTC products. The banks simply take the opposite side of the customers' orders at prices that leave the banks with undisclosed but huge profits."); *see also* Michael Lewis, *The Big Short* 201 (2010) ("No ordinary human being had ever heard of these credit default swaps or, if Morgan Stanley had its way, ever would. By design they were arcane, opaque, illiquid, and thus conveniently difficult to price."); *see also* Floyd Norris, *Being Kept in the Dark on Wall Street*, N.Y. TIMES, Nov. 2, 2007 ("Wall Street would normally resist proposals for shining light on the weird products it produces. Profit margins in such markets are much higher[.]"); *also* Litan, *supra* note 5, at 28.

[10] *See* Pub. L. No. 111-203, Legislative History of the Dodd-Frank Wall Street Reform and Consumer Protection Act, July 15, 2010 (statement of Sen. Blanche Lincoln) ("Speaking to the benefits of such a reporting requirement, the Committee could not ignore the experience of the U.S. Securities and Futures markets. These markets have had public disclosure of real time transaction and pricing data for decades. We concluded that real time swap transaction and price reporting will narrow swap bid/ask spreads, make for a more efficient swaps market and benefit consumers/counterparties overall."); *see also* Litan, *supra* note 5, at 29 ("[D]ealers are likely to resist, or at least not be as aggressive in promoting central clearing and exchange trading as, say, buy-side participants who want both low trading costs and the comfort of having central clearing to reduce their own exposures to systemic failures from non-performing derivatives counterparties.").

[11] *See* Litan, *supra* note 5, at 32.

[12] *See* Gretchen Morgenson, *It's Not Over Until It's in the Rules*, N.Y. TIMES, Aug. 28, 2010 at BU1 ("By controlling swaps clearinghouses, big firms have the power to decide which transactions can be cleared and which cannot. If the banks decide that certain contracts — usually intricately tailored financial arrangements sometimes known as "bespoke" agreements — can't be cleared, the deals are moved out of the clearinghouses and into private hands. This limits how transparent the pricing is for bespoke contracts, which is one of the reasons they remain among the most lucrative pieces of the derivatives market for Wall Street.").

[13] *See* Matthew Leising & Mary Childs, *LCH.Clearnet Sees U.S. "Battleground" for Rate-Swap Clearing*, Bloomberg, July 21, 2010; *see also* David Cowell, *LCH.Clearnet Sinks to Net Loss After Fee Cuts*, Reuters, Feb. 16, 2010.

[14] *See* Morgenson, *supra* note 12 ("A trading system that provides its customers with just a few bids and offers is far less transparent and significantly more costly to users than one presenting a long list of prices and participants ready to transact. To keep new participants out of the business of clearing trades, the established firms have rules requiring incoming members to hold a certain amount of net capital — in some cases $5 billion — and they want to keep these thresholds intact.").

[15] *See Litan, supra* note 5, at 8.

financial stake in ICE Trust, the primary clearinghouse of credit default swaps in the United States.[16]

Strong limits on ownership concentration at clearing, trading, and reporting organizations will provide the following significant benefits for the United States' derivatives market.

Competition

Setting quantitative limits on controlling ownership of DCOs, DCMs, and SEFs will prevent the sort of oligopolistic concentration that has developed in the financial markets.[17] Specifically, the Office of the Comptroller of the Currency has noted that, "[d]erivatives activity in the U.S. banking system continues to be dominated by a small group of large financial institutions."[18] The five largest commercial banks account for ninety-six percent of the total banking industry's notional amounts and eighty-five percent of the industry's net credit exposure.[19]

This level of concentration forces end-users of derivatives to pay wide spreads and excessive fees. The banks' derivatives dealing profits frequently exceed $100 billion per year, often at the expense of their customers.[20] Allowing these institutions to dominate clearing and trading of these instruments will cement their hold on the derivatives market and make these institutions, already deemed "too big to fail," even larger.

There is precedent for setting quantitative concentration limits to promote competition and financial stability. The Riegle-Neal Act imposes a ten percent cap on one bank's share of nationwide deposits.[21] The Dodd-Frank Act imposes similar restrictions on a firm's share of liabilities in the financial system.[22] The Federal Credit Union Act imposes a cap on the share of commercial lending in which federally insured credit unions are permitted to engage.[23]

Codified activity restrictions helped to stabilize the financial system for decades. The McFadden Act and Glass-Steagall Act placed limits on the size and activities of commercial banks.[24] Contrary to the financial services industry's deregulatory arguments, repealing these important regulations created more, not less, instability in the financial system.

There is already a high level of concentration in this market, raising concerns about anti-competitive pricing and conduct. The dealers also occupy unique positions as both brokers and participants create bargaining advantages, informational advantages, and substantial conflicts of

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[16] *See id.* at 6.
[17] *See* David Cho, *Banks "Too Big To Fail" Have Grown Even Bigger*, WASH. POST, Aug. 28, 2009; Robin Sidel, *Bank Rally Leaves Out Small Lenders*, WALL ST. J., Sept. 9, 2010.
[18] Office of the Comptroller of the Currency, *OCC's Quarterly Report on Bank Trading and Derivatives Activities Second Quarter 2010* at 1 (2010). The five referenced banks are JPMorgan Chase, Bank of America, CitiGroup, Goldman Sachs, and HSBC.
[19] *Id.*, at 1.
[20] *See* Peterffy, *supra* note 9, at 2.
[21] *See* 12 U.S.C. § 1842(d).
[22] *See* P. L. 111-203 at § 622.
[23] *See* 12 U.S.C. § 1757a.
[24] *See* Andrew G. Haldane, Executive Director, Financial Stability, Bank of England, Remarks at the Institute of Regulation & Risk, "The $100 Billion Question" 7-9, Mar. 30, 2010.

interest.[25] The limits in the Commissions' proposed rules will provide open access to clearinghouses and exchanges, and help to address the challenges that excessive concentration and conflicts of interest create for buy-side investors and corporate end-users.

Risk Management

The excessive market concentration created when a handful of large financial institutions dominate over-the-counter derivatives markets creates the potential for systemic risk. The dealer banks nonetheless argue that parties should be permitted to own a stake in any DCO, so long as they have appropriate risk management expertise.[26] A decade ago, when legislation like the Commodity Futures Modernization Act and the Gramm-Leach-Bliley Act were passed, advocates of deregulation told policymakers that they could trust self-interested financial institutions to adequately manage their own risks.[27] Unfortunately, we have learned the hard way that this is not the case.

In reality, the largest banks' risk management abilities were woefully inadequate, failed to anticipate the financial crisis, and indeed, may have exacerbated the crisis. For example, AIG's counterparties were late demanding adequate collateral, and then sought quantities that the insurance company was unable to provide.[28] These same banks were also so undercapitalized that they required hundreds of billions of dollars of additional capital from Treasury, the Federal Reserve, and the FDIC. The Commissions would be repeating past mistakes if they allowed these same institutions to own or manage clearinghouses and trading facilities.

A well-run clearinghouse would prevent the accumulation of risk by consistently requiring any party that poses a risk to the clearinghouse to immediately post greater collateral to cover their trades.[29] A well-run clearinghouse would also stop a party that is unable to post collateral from trading, regardless of their industry.[30] A clearinghouse that is owned and dominated by a handful of financial firms might be less likely to demand collateral from its dominant owners, thereby increasing its risk level.

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[25] *See* Lewis, *supra* note 9, at 185 ("The firms always claimed that they had no position themselves—that they were running matched books—but their behavior told him otherwise. 'Whatever the banks' net position was would determine their mark,' he said. 'I don't think they were looking to the market for their marks. I think they were looking to their needs.'"); *id.*, at 202-05.

[26] *See* Transcript of *Public Roundtable on Governance and Conflicts of Interest* at 50 (Aug. 20, 2010) [hereinafter *CFTC Transcript*] (statement of James Hill, Managing Director and Global Credit Derivatives Officer, Morgan Stanley, representing the Securities Industry and Financial Markets Association) ("These have to be risk-managed correctly, and you need clearing members who understand the risk. So we, again, are for complete open access to clearing membership in any clearinghouse as long as you have the capital to support it and as long as you have the risk-management tools to evaluate the risk of the products that are being cleared.").

[27] *See* Nelson D. Schwartz and Julie Creswell, *What Created This Monster?*, N.Y. TIMES, Mar. 23, 2008 ("Speaking in Boca Raton, Fla., in March 1999, Alan Greenspan, then the Fed chairman, told the Futures Industry Association, a Wall Street trade group, that 'these instruments enhance the ability to differentiate risk and allocate it to those investors most able and willing to take it.' ... 'Regulatory risk measurement schemes,' he added, 'are simpler and much less accurate than banks' risk measurement models.'")

[28] *See* Financial Crisis Inquiry Commission, "AIG/Goldman Sachs Collateral Call Timeline", July 1, 2010 *available at* http://www.fcic.gov/hearings/pdfs/2010-0701-Goldman-AIG-Collateral-Call-timeline.pdf.

[29] *See* Standard & Poor's, The Options Clearing Corporation: Full Analysis 6, Mar. 12, 2010 *available at* http://www.optionsclearing.com/components/docs/about/aaa_rating.pdf.

[30] *Id.*

Providing broad access to DCOs diversifies risk; allowing financial firms to dominate DCO ownership subjects DCOs to greater risk.[31] In theory, the largest financial institutions, with their various lines of financial business, should have the capacity to hedge against market volatility through diversification. However, all banks that are fully diversified effectively hold the same portfolio. Thus, the financial services industry is actually less diverse, subject to the same systemic risk factors, and more prone to generalized collapse.[32]

Non-financial companies and non-bank financial institutions make up an estimated sixty-nine percent of the notional value of the over-the-counter market derivatives market.[33] Allowing companies from the manufacturing, agriculture, and transportation industries to take financial and voting interests in clearinghouses would incorporate new perspectives, while diversifying the DCOs' risk exposure.

Liquidity

The financial services industry is arguing for a DCO membership regime that would favor the large dealer banks who currently dominate the over-the-counter derivatives market. The argument essentially goes that the largest actors – mainly the five or so dealer banks – must have unfettered access to DCOs because they are uniquely positioned to measure derivatives market risk and to absorb that risk and re-capitalize a DCO in the event that one of its members defaults.[34] This argument exclusively benefits the largest financial companies – the large dealer banks and investment banks – who hold the most capital.

Promoting open and diverse ownership will provide DCOs with more capital from more diverse sources. The largest industrial, agricultural, and transportation corporations in the United States certainly have ample financial resources with which to help capitalize DCOs. For example, the Options Clearing Corporation merely requires unsophisticated members to hold $4 million in capital and pay a $4,000 fee.[35] Open access would provide DCOs with liquidity from buy-side participants and corporate end-users with substantial financial resources, rather than tying the financial stability of DCOs to the financial stability of the large dealer banks.

In addition to bringing greater liquidity to clearinghouses, open and transparent central clearing and trading is likely to bring greater liquidity to the derivatives market as a whole. Individual investors and smaller institutional investors will flee markets that lack transparency and accountability.[36] Allowing greater access and competition benefits the market and increases

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[31] *See id.*, at 5.
[32] *See* Haldane, *supra* note 24, at 8.
[33] *See* Damian Paletta & David Wessel, *Business Rallies to Shape Finance Endgame*, WALL ST. J., June 21, 2010 (analyzing Bank for International Settlements data).
[34] *See CFTC Transcript* at 18 (statement of James Hill) ("[N]ot only do you need to have clearing members who have enough capital, you know, to recapitalize the clearinghouse if a member defaults, but they have to be able to … trade very large amounts of very highly complex illiquid OTC derivatives."); *see id.* at 70-71 ("[N]ot only do you have to be worried about someone's ability to fund the clearinghouse in a default scenario, but you have to be concerned that and focused on their ability to risk manage their customer relationships so that they don't put trades into the clearinghouse that could otherwise destabilize the clearinghouse.").
[35] *See* Standard & Poor's, *supra* note 29; *see also* The Options Clearing Corporation, Becoming a Member 5, Feb. 2010 *available at* http://www.optionsclearing.com/components/docs/membership/OCC_Becoming_A_Member.pdf.
[36] *See* Peterffy, *supra* note 9, at 4.

competition. Ensuring that there are liquid, transparent markets will ensure that there are market participants to step in and assume the position of a clearinghouse member that fails.[37]

Though the proposed rules in many ways address the issues inherent in dealer ownership and control of clearinghouses, the rules contain some potential areas of concern.

First, the proposed rules provide two alternative limits on aggregate ownership by dealers, large financial institutions, and major swap participants. One alternative would cap voting control by these enumerated entities at 40 percent. The other alternative would allow enumerated entities to control 100 percent of the voting stock of a clearinghouse, as long as the interest of each entity is limited to five percent. While this rule would limit the influence of any one dealer, it does not guard against a group of 20 like-minded dealers, investors, or other financial entities collaborating to the detriment of other market participants. In this market, the large banks have substantial shared economic interests, as described above. The Commissions should not provide an exception to the limit on aggregate voting control that big financial companies can exert over the clearinghouses.

Second, though the Commissions propose individual ownership limits, they have not proposed an aggregate limit on voting shares at DCMs or SEFs. It is unlikely that trade execution will be conducted in a way that benefits competition without an aggregate limit on the dealers' ownership stake in DCMs and SEFs. Right now there are essentially five access points to the derivatives market through the five dealers. The structure of this market will not change if there is one platform upon which trades are executed, and that platform is owned only by the five dealers. Trade information is vital to pricing in financial markets, and there are many ways that the five dealers might manage trade reporting to their advantage. For example, trades could be reported in a manner and at a time that benefits the big players; and special technology used by owners might provide them with an informational advantage.

Third, the rule focuses on direct control through on ownership and voting interest, but neglects other incentives based upon trading revenue, profit, and volume. It is important to remember that the authority to limit conflicts of interest is not necessarily confined to the influence that the dealers might exert through their ownership stakes.[38] The dealer banks' control an overwhelming majority of the market;[39] such market share is persuasive to any DCO, DCM, or SEF wishing to attract their business. While direct limits on ownership are important, the rules should also address the influence that market makers exert over financial market utilities based upon their market positions.[40]

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[37] *See id.*, at 6.

[38] *See* P. L. 111-203 at § 726(c) ("The Commission shall adopt rules if it determines ... that such rules are necessary or appropriate to improve the governance of, or to mitigate systemic risk, promote competition, or mitigate conflicts of interest in connection with a swap dealer or major swap participant's conduct of business with, a derivatives clearing organization, contract market, or swap execution facility that clears or posts swaps or makes swaps available for trading and in which such swap dealer or major swap participant has a material debt or equity investment.")

[39] *See* Morgenson, *supra* note 12 ("Ninety percent of swaps are traded through the 10 biggest banks, generating revenue of an estimated $60 billion a year for these institutions, according to the Swaps and Derivatives Market Association, a membership organization that consists of firms hoping to compete with the big derivatives dealers in these markets.").

[40] *See* CFTC transcript at 153 (comments of Heather Slavkin, Senior Legal and Policy Advisor, Office of Investment, AFL-CIO) ("I actually disagree with what the gentleman from JP Morgan said when he said that he doesn't think that having an economic stake without having a voting interest is a concern ... I do think we need to

Finally, the Commissions retain the authority to waive their ownership limits. It would be preferable not to leave future Commissions with the discretion to circumvent this provision. To the extent that there are specific scenarios in which the Commissions envision using this authority, the Commissions should lay out such conditions in advance. The criteria should provide guidance, with specificity, on the narrow set of market conditions that would have to be met before the rules could be waived. For example, the Commissions might believe that it is appropriate to adopt a monopolistic utility model for clearinghouses, but only where the market ceases to be competitive. Though we respect the Commissions' judgment that the rules' flexibility may be necessary and appropriate, laying out specific parameters for this authority would prevent potential future abuse.

The Commissions' rules take a balanced approach to the critical issue of DCO, DCM, and SEF ownership, with some potential areas for improvement. I commend your staff on its hard work, and look forward to working with you as you bring stability and transparency to the previously opaque over-the-counter derivatives market. Thank you for considering my views on this important matter.

Sincerely,

Sherrod Brown
United States Senator

look at ownership restrictions related to voting interests as well as related to economic interests even when they're not tied to actual voting shares.")