SDMA SWAPS & DERIVATIVES MARKET ASSOCIATION

January 24, 2011

David A. Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington DC 20581

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington DC 20549-1090

Re: Implementation of Conflicts of Interest Policies and Procedures by Futures Commission Merchants, Introducing Brokers, Swap Dealers, and Major Swap Participants Re: CFTC RIN 3038-AC96, 17 CFR (Federal Register) Parts 1 and 23 that address the proper separation of trading and clearing units.

Dear Sir/Madam Secretaries,

The Swaps & Derivatives Market Association ("SDMA") appreciates the opportunity to comment on the Implementation of Conflicts of Interest Policies and Procedures for Futures Commission Merchants ("FCMs"), Introducing Brokers ("IBs"), Swap Dealers ("SDs"), and Major Swap Participants ("MSPs"), as this subject matter is one of the most important of all the rulemakings to be undertaken.

The SDMA supports Title VII of the Dodd-Frank Law and commends the diligent, thoughtful, and exhaustive work that the teams at both the CFTC and the SEC continue to do with regard to promulgating rules necessary for the OTC derivatives market place to comply with the Act.

The SDMA is a financial markets trade group of United States and internationally based broker-dealers, futures commission merchants and investment managers participating in all segments of the exchange-traded and over-the-counter derivatives and securities markets. The SDMA was created as a nonprofit organization in January 2010 and today has over twenty member institutions representing all facets of derivatives execution and clearing.

I. Introduction

The SDMA agrees with the CFTC's proposals for the adoption of Regulations 1.71 and 23.605 for SDs, MSPs, and FCMs who dually register as SDs or MSPs which require these firms to establish "structural and institutional safeguards" and "appropriate informational partitions" between their in-house and affiliate trading and clearing units.

Undue influence on clearing units and competition by trading units and other interested parties contravenes the core principles of open access and business conduct standards described in the Dodd-Frank Act and supporting Regulatory proposals. Written procedures and policies approved and enforced by the Commissions will help ensure that the activities of any person within the firm providing clearing activities, especially in the area of accepting clearing customers, is removed from the review, pressure, or oversight of persons involved in pricing, trading or clearing who may prejudice their decision making.

II. Mandatory Organizational Separation of Trading and Clearing Units

A. Background and Legal Support

The core belief behind the Sarbanes-Oxley Act Section 501, NASD Rule 2711, and the Securities and Exchange Act of 1934 Section 15D that separates investment banking from research within the same firm by appropriate informational partitions mirrors the one that Congress, the Commissions, and other interested parties have correctly identified regarding conflicts of interest and antitrust considerations between OTC Derivatives trading and clearing units. As Dodd-Frank Act mandates in Title VII 124 STAT 1711:

> *"(5) CONFLICTS OF INTEREST.—The swap dealer and major swap participant shall implement conflict-of-interest systems and procedures that—"(A) establish structural and institutional safeguards to ensure that the activities of any person within the firm relating to research or analysis of the price or market for any commodity or swap or acting in a role of providing clearing activities or making determinations as to accepting clearing customers are separated by appropriate informational partitions within the firm from the review, pressure, or oversight of persons whose involvement in pricing, trading, or clearing activities might potentially bias their judgment or supervision and contravene the core principles of open access and the business conduct standards described in this Act; and "(B) address such other issues as the Commission determines to be appropriate."*

With respect to conflicts of interest, the proper separation of clearing and trading functions within SDs, MSPs, and FCM affiliate SDs or MSPs are necessary to ensure that the largest amount of products and users are included in a centrally cleared marketplace. To keep the market opaque and protect their profits, trading units can force products to remain un-cleared for arbitrary reasons such as volume thresholds, grandfathering and simply because it is their desire. Such reasoning dangerously increases systemic risk by keeping trades bilateral and reducing transparency. Additionally, showing favoritism to certain clients, clearing firms, and derivatives clearing organizations through overly subjective voting power, governance, and execution structures, as well as setting risk tolerances at suboptimal levels, jeopardizes the entire global financial system.

> *"(6) ANTITRUST CONSIDERATIONS.—Unless necessary or appropriate to achieve the purposes of this Act, a swap dealer or major swap participant shall not—"(A) adopt any process or take any action that results in any unreasonable restraint of trade; or "(B) impose any material anticompetitive burden on trading or clearing."*

With respect to antitrust considerations, the current artificial construct of tying clearing to execution and vice-versa within the same SD or MSP that exists in the OTC Derivatives market is anti-competitive. Therefore, proper organizational separation of trading and clearing units as well as the creation of independent competition through objective rulemaking are mandatory in order to increase fair and open access. We point to the non-existence of any independent swap dealer or clearing firm competitors in the current marketplace as evidence. Additionally, having trading units aware of customer and competitor positions through their clearing units gives them an informational advantage that is subject to abuse in the form of front-running and market manipulation.

Clearing House end-of-day pricing requirements can be met by joint ventures with third parties, independent swap dealers, and clearing firms, as well as the already mandated increased usage of swap execution facilities. Auction pricing requirements of distressed clearing firm portfolios can look to the highly correlated bond markets for guidance where daily billions are auctioned off efficiently by a multitude of participants that require an even higher commitment of capital. Furthermore, more participants in an auction simply make it a higher quality one.

B. Clearing Activities and Undue influence on Counterparties and Competition

The table below summarizes the CFTC's areas of concern followed by SDMA market examples and suggested solutions:

SD & MSP Potential for Interference and Undue Influence on Clearing Services and Activities – Whether to:	**Examples that Increase Systemic Risk and Compromise Competition, Transparency & Open Access**	**Solutions**
Enter into Cleared or Un-cleared trade	Trading units could keep swaps un-cleared and executed away from Swap Execution Facilities or Designated Contract Markets arbitrarily to keep market opaque	Most OTC swap trades can be cleared
Refer Counterparty to a particular clearing firm for clearing	Linking execution to clearing and vice versa	SDMA CFTC Submission Paper dated 12/17/10 regarding ICE Trust DCO application
Send a cleared trade to a particular clearing house	Economic stakes and unbridled voting and governance power by enumerated entities at a clearing organization	SDMA CFTC/SEC Submission Paper dated 11/26/10 regarding Conflicts of Interest Voting Power and Governance limits
Offer clearing services and activities for customers	Denial of swap dealer, major swap participant or introducing broker competitors	"Execution Blind" access and pricing for all participants whether or not they are competitors
Accept a particular customer to clear derivatives for them	Customer could be denied at one clearing firm because of bad credit but is accepted at another firm because the trading unit does a lot of "good business" with them or conversely tying business	Objectively set standards for accepting clients for clearing
Set risk tolerances for particular customers	Zero or unnecessarily low margins for preferred customers because of other revenues they provide trading units or their counterparty rating e.g. AIG	Objectively set risk tolerance standards for all customers
Determine acceptable forms of collateral for particular customers	Accepting a form of collateral that is not a universally accepted correlation percentage to offset higher margin rates for a preferred customer	Objectively set collateral correlation percentages
Set fees for clearing services	Unnecessarily low margin rates to capture business and tying of "free clearing" to execution	Objectively set fee structures for clearing services not tied to execution

Clearing is a proxy war to protect the billions in profits made within the same firm or affiliate trading units. Currently, many clearing personnel are supervised, controlled, reviewed, and compensated by their in-house or affiliated trading units resulting in clearing decisions that are heavily influenced.

The written procedures and policies approved and enforced by the Commissions should also include language that provides for the inclusion of distant physical separation of trading and clearing units under the "appropriate informational partitions" and "structural and institutional safeguards" definitions. These same requirements should include language that appropriately separates clearing units into two divisions:

1) Self-Clearing Unit: one that clears for its internal SD or MSP
2) Customer Clearing Unit: one that clears for clients and competitors

C. Lessened Systemic Risk and Increased Liquidity from New Market Participants

Taken from the listed derivatives experience, successful derivatives clearing occurs when qualified FCMs, SDs, and MSPs and their affiliates offer clearing services to all eligible parties on a non-discriminatory, objective, and "execution blind" basis. The SDMA believes that central clearing will lessen systemic risk by providing a framework for regulators and market participants alike to assess interrelated and procyclical risk within the OTC derivatives market.

Limiting competition concentrates all the risk in "too big to fail" institutions that the US and international governments and taxpayers have to bail out in times of crisis. The system is better off with more uncorrelated qualified clearing firms to diversify the risk and more players to provide liquidity in a centrally cleared construct that has served many disparate marketplaces since the mid-1800s.

Increased competition in trading and clearing is one of the cornerstones of the Dodd Frank Act and its subsequent regulations. Combined, they will allow for a much needed structural change in the OTC Derivatives marketplace that decreases systemic risk and substantially increases liquidity by creating the following market participants:

1) Existing SDs and MSPs that execute and self-clear as well as externally clear new execution-only SDs, MSPs, IBs and Eligible Contract Participants ("ECPs");

2) New Execution-only SDs, MSPs, IBs and ECPs that are cleared by new and existing clearing firms;

3) New clearing-only FCMs that clear existing and new execution-only SDs, MSPs, IBs, and ECPs;

4) New FCMs that dually register as SDs or MSPs and self-clear their affiliates as well as clear other new execution-only SDs, MSPs, IBs, and ECPs;

5) New entrant Investor ECPs and MSPs: capital arbitrage, algorithmic, macro hedge funds, traditional credit and equity funds realizing the increased liquidity and transparency of the product as well as the zero need for bilateral agreements will adapt their strategies to take advantage of the potential for increased returns.

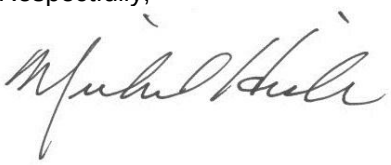
III. Conclusion

The SDMA agrees with the minimal additional cost findings by the CFTC for Regulations 1.71 and 23.605 by FCMs, IBs, SDs and MSPs to implement these structural organizational changes. Evidence is in the agency study and from the experience of SDMA members and other interested parties having being previously employed as OTC derivatives risk managers, line traders and clearing personnel at these institutions. Furthermore, a period of months, not years, is ample time for such a change.

The substantially increased benefits of central clearing, lessened systemic risk, competition in execution and clearing, transparency, liquidity and market integrity are exactly what Congress, the Commissions, international governments and their respective regulatory bodies, as well as the global financial system, are striving to achieve.

The SDMA fully supports these regulatory proposals and appreciates the opportunity to comment on these important issues. We look forward to working with the Commissions to help implement the Dodd-Frank Law and subsequent rules and regulations. If you have any questions or need additional information please contact the Swaps & Derivatives Market Association at mhisler@thesdma.com or visit our website at www.thesdma.org.

Respectfully,



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