SWAPS & DERIVATIVES MARKET ASSOCIATION

June 3, 2011

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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
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Re: Implementation of Conflicts of Interest Policies and Procedures by Futures Commission Merchants and Introducing Brokers (17 CFR Part 1) and Implementation of Conflicts of Interest Policies and Procedures by Swap Dealers and Major Swap Participants (17 CFR Part 23) (RIN 3038-AC96)

Dear Sir/Madam Secretaries,

The Swaps & Derivatives Market Association ("SDMA") appreciates the opportunity to provide additional comment on the (a) Implementation of Conflicts of Interest Policies and Procedures for Futures Commission Merchants ("FCM") and Introducing Brokers ("IB"), and (b) Implementation of Conflicts of Interest Policies and Procedures by Swap Dealers ("SD") and Major Swap Participants ("MSP"). These rules implement the structural and institutional safeguards mandated by sections 731, 732 and 764 of Title VII of the Dodd Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank Act") and are among the most important of all the rulemakings proposed by the Commodity Futures Trading Commission (the "CFTC" or "Commission"), because they ensure the independence of clearing members that is essential to nondiscriminatory, open access to clearing. The SDMA supports proposed rules (a) 1.71 *Implementation of Conflicts of Interest Policies and Procedures by Futures Commission Merchants and Introducing Brokers* and (b) 23.605 *Implementation of Conflicts of Interest Policies and Procedures.* The SDMA urges the Commission to move forward the proposed rules as written and not make any

revisions that dilute their effectiveness. This letter supersedes our January 24, 2011 letter regarding these proposed rules.

The SDMA is a non-profit financial trade group formed in 2010 to support the goals of the Dodd Frank Act. It believes that systemic risk of OTC derivatives can be mitigated through their regulation, the creation of central clearing, and by ensuring open and transparent access to greater competition, lower transaction costs and increased liquidity. The SDMA is comprised of many US and internationally based broker-dealers, investment banks, futures commission merchants and asset managers participating in all segments of the exchange-traded and over-the-counter derivatives and securities markets.

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.

## I. Introduction

Sections 731, 732 and 764 of the Dodd Frank Act correctly recognize the potential for conflicts of interest that arise from a dealer bank and its clearing subsidiary's business role to enhance shareholder value on one hand, and its prudential role, to ensure sound clearing practices as a clearing member, on the other. In the OTC derivatives markets, dealer banks may provide two types of services: execution and clearing. Execution services are provided by the dealer's trading desk, which provides liquidity to the markets as a "market maker". The dealer bank may also provide clearing services through its FCM or clearing member subsidiary. As a member of a clearinghouse, the clearing subsidiary typically submits customer derivatives trades for clearing in return for fees. To be sure, the dealer bank and its clearing member subsidiary have a fiduciary obligation to enhance shareholder value. To this end the dealer bank is always seeking to increase the profitability of its business.

Important to the broader market, the clearing subsidiary of the dealer bank also serves a more prudential role as a member of the clearing house. As a clearing member, the dealer's clearing subsidiary must ensure that customer trades are properly capitalized or "margined" subject to clearing house rules and relative to the risk that each trade adds to the system. In essence, the clearing member acts as a "gatekeeper" to the system. It keeps out bad trades or bad counterparties that might otherwise threaten

the clearing house systemically. In so doing, the clearing house's integrity is upheld and systemic risk to the financial markets is reduced.

It is these competing interests: (1) the dealer bank's obligation to enhance shareholder value (by both execution and clearing), and (2) the dealer bank's broader responsibility to provide open and fair market access to clearing, through its clearing member that creates a clear conflict. It is the tension between these two forces, where the dealer's clearing member may be required to provide access to models or firms that directly compete with its execution desk that is central to this paper's discussion and the success of clearing in the OTC derivatives market.

Such a conflict arises from potential profits. It is important to note that more profits lie in execution than clearing for the dealer bank. It was recently noted by the industry that, whereas revenues from OTC derivatives clearing was expected to generate an estimated $300 to $500 million in profits annually, dealer revenues from OTC derivatives market making currently generated a sizable $40 to $60 billion in annual profits.[1]

The Dodd Frank Act and the Commissions correctly notice that such conflicts of interest at dealer banks have the propensity to exist. Sections 731 and 732 of the Dodd Frank Act require that separation of trading and clearing exist at SDs, MSPs, IB's & FCMs. To comply with sections 731 and 732, FCMs, IBs, SDs and MSPs must establish "structural and institutional safeguards", similar to firewalls, to limit communication and interaction between their clearing and trading units. The SDMA believes that the firewalls are critical to reducing potential conflicts between the trading unit of an FCM, IB, SD or MSP and their clearing unit.

The following discussion considers examples of how conflicts of interest may have manifested themselves already in: (a) clearinghouse participant eligibility for membership, (b) clearinghouse governance, (c) customer eligibility for clearing services, (d) clearinghouse product eligibility for clearing, (e) clearing workflow, and (f) clearing documentation requirements.

[1] See CFTC SEC Governance Roundtable Transcript (Page 33, August 20, 2010).

## II. Clearinghouse Membership Requirements: Participant Eligibility

Participant eligibility for clearinghouse membership is the first situation where conflicts of interest may have arisen. The Dodd Frank Act correctly recognizes the potential for such conflicts and prohibits restrictive participant eligibility rules. Specifically, section 725 of the Dodd Frank Act amends section 5b(c) of the Commodity Exchange Act to create core principles for Derivative Clearing Organizations. Core Principle C: *Participant and Product Eligibility* requires that a clearinghouse shall establish "… appropriate admission and continuing eligibility standards ..." and that those requirements are objective, publically disclosed and permit fair and open access. This Core Principle addresses the concern that a clearinghouse may not use unreasonable capital or "sophistication" requirements to limit access to clearinghouse membership.

Since their inception, clearinghouses have played a vital role in the market by managing the default risk of counterparties and spreading that risk over the members of the clearing house. For over a hundred years, the listed derivatives marketplace has enjoyed considerable safety and soundness because its clearing membership constituency has been both large in number and diverse. It is well established in these markets, that no customer has ever lost money due to a clearing house or clearing member failure. From experience, it is fair to say that systemic risk has been properly mitigated when the clearing member constituency is large and uncorrelated.

By contrast, systemic risk is increased where a clearinghouse may be composed of a handful of dangerously correlated firms. In this instance, when one clearing member defaults there may be a greater chance that another member will default. In order to reduce systemic risk, the clearinghouse should be encouraged to have a large, non-correlated group of clearing members. This can only be accomplished through clearing membership standards that are based upon fair and open access.

### A. Minimum Capital Requirements

Some clearinghouses have attempted to impose minimum capital requirements of $1 billion. This requirement is unreasonable and is clearly aimed at restricting participant eligibility to clearinghouse membership. Moreover, a $1 billion capital requirement is no guarantee that a clearing member can meet their financial obligations. As the Global Financial Crisis of 2008 has readily shown, once there is a

loss of confidence in a financial institution, its capital evaporates rapidly. In fact, prior to the financial crisis, AIG, Bear Sterns and Lehman Brothers would have met the proposed $1 billion capital requirement.

The SDMA believes that capital requirements must be scalable and relate to the amount of risk a clearing member brings to the market, and not some arbitrary, discriminatory monetary threshold. The amount of risk the clearing member brings to the market must be calculated per trade and by the total value of the customer portfolios that it clears.

As the Commission correctly states in proposed rule 39.12(a)(2)(ii), capital requirements should be "…based upon objective, transparent, and commonly accepted standards that appropriately match capital to risk". Proposed rule 39.12(a)(2)(iii), provides that a clearinghouse "…shall not set a minimum capital requirement of more than $50 million for any person that seeks to become a clearing member in order to clear swaps." The SDMA agrees with CFTC Chairman Gensler's statement that the "proposed participant eligibility requirements will promote fair and open access to clearing."[2]

Proponents of such high capital thresholds fail to offer any empirical evidence or convincing argument to support that setting some nominally high capital thresholds somehow increases clearing house integrity. It is interesting to note that the proponents of such requirements are also dealer banks that may face competition from open access. The SDMA believes that such capital requirements may be unreasonable barriers to entry that are designed to protect against independent clearing members offering open access to clearing to firms and business models that would otherwise compete with such incumbent dealers interests.

The SDMA supports these rules and believes this level of capital would permit broad participation by clearing members and reduce systemic risk. Therefore, the SDMA respectfully recommends the Commission adopt proposed rules 39.12(a) (2)(ii) and 39.12(a)(2)(iii) as currently drafted.

[2] Statement in Support of Dodd-Frank Rulemaking of Chairman Gary Gensler, Statement for the record regarding the proposed rules on Risk Management Requirements for Derivatives Clearing Organizations, made on December 16, 2010

B. Sophistication Requirements

Other clearing house membership requirements serve no legitimate purpose and may be construed as ways to limit clearing house membership by certain "sophistication" requirements. Certain clearing houses have attempted to impose a requirement that the clearing member must have a $1 trillion swaps portfolio. Such a requirement, which artificially links execution and clearing, directly limits membership and protects against new properly capitalized firms from ever qualifying as clearing members. Some have argued that this requirement is necessary because swaps are complicated transactions, and only a clearing member that has a portfolio of significant size has the "sophistication" necessary to clear swaps.

Proponents of such a requirement fail to show any empirical evidence or indeed offer any credible academic study that supports such a notion. The SDMA sees such a requirement as nothing more than a transparent attempt to thwart competition.

The Commission correctly recognizes in proposed rules 39.12(a)(iv) and 39.21(a)(v) that the clearinghouse should not require that a clearing member be a swap dealer, have portfolio size requirements, or meet any swap transaction volume size thresholds. Specifically, proposed rule 39.12(a)(iv) provides that a clearinghouse "shall not require that clearing members must be swap dealers", and proposed rule 39.12(a)(v) provides that a clearinghouse "shall not require that clearing members maintain a swap portfolio of any particular size, or that clearing members meet a swap transaction volume threshold". The SDMA agrees that any clearing house membership rule that artificially requires a clearing firm to have execution facilities or conversely an execution desk to have self clearing capability should be considered contrary to the express language of the Dodd Frank Act and be considered by the Commissions to be unlawful.

Clearing member eligibility requirements must focus upon the operational qualifications set out in proposed rule 39.12(a)(3), because they are the functions that clearing members traditionally provide. Specifically, proposed rule 39.12(a)(3) requires that clearing members have the ability to: (a) process expected volumes and values of transactions cleared by a clearing member in the required time frame; (b) fulfill collateral, payment, and delivery obligations imposed by the clearinghouse; and (c) reasonably participate in default management activities.

C. End of Day Pricing Requirements of Clearing Members

Some dealer owned clearing members may seek to limit clearing house membership by requiring fellow clearing members to contribute End of Day ("EOD") prices solely from their own dealer desks in the EOD process. In the absence of transparent exchanges where closing prices are readily available, the clearing house is right to request that clearing members provide EOD actionable swaps prices to the clearing house, so that it may properly price its book. To ensure clearing house integrity, it is even more critical that such prices be actionable on which the clearing house can execute. However, to require that these EOD prices can *only come from a clearing member's own execution desk* is an unreasonable requirement that again artificially links execution to clearing and limits competition.

Clearing members should be permitted to use third party dealers to provide actionable prices for submission in the EOD pricing process. For example, the clearing member can obtain prices from a dealer consortium or an execution platform. There is no evidence to suggest, as certain parties have argued, that a legal arrangement with a third party dealer somehow erodes the integrity of this pricing system. Obtaining actionable prices from third parties is common in the OTC markets and provides the clearing house a viable solution that both address their need to "mark their book" but also allow it to encourage broad clearing member participation, and by extension ensure clearing house integrity through more diversified constituents and importantly, comply with the law.

If no flexibility in obtaining end of day prices is offered, clearing house membership will be severely limited, the downside of which may certainly include a less rigorous and less diversified pool of clearing participants, but also restricted access to the clearing and trading of OTC derivatives.

The SDMA believes that a clearing member should not be required to provide end of day prices from its own dealer desk. Therefore, the SDMA respectfully recommends that the Commission amend 39.12(a)(1) to provide that a derivatives clearing organization shall either (a) not require that its clearing members provide end of day pricing from its own dealer desk, or (b) be permitted to obtain end of day prices from a third-party dealer.

D. Default Management: Liquidation of Clearing Member Portfolios

Other clearing member eligibility rules exist that require that a clearing member must use its own execution desk to participate in the default auction process.

A default auction's success is dependent upon the clearinghouse's ability to conduct an efficient default auction that neutralizes default risk of a distressed clearing member by selling off its entire portfolio. There are two key components to an efficient default auction process: (a) diversification of risk, and (b) obtaining the best price for the distressed positions.

Both components are directly affected by the number of participants in the default auction. A greater number of participants results in reducing the amount of risk each clearing member must assume. This, in turn, reduces the risk of additional clearing members defaulting. In an auction process, a larger number of participants also increases price competition and results in getting the "best price" possible for the swaps at auction. The default process will be more efficient, because it would increase the number of participants in the auction.

To somehow limit the auction process to only clearing members and not the broader market not only decreases the likelihood of obtaining "best price" in the auction but also promotes a market inefficiency that should be seen as nothing more that another discriminatory construct that links execution to clearing to restrict participation and limit membership.

Therefore, the SDMA respectfully suggests that the Commission amend 39.12(a)(1) to provide that a derivatives clearing organization may permit its clearing members to contract with a third party, (that meets objective, publically disclosed risk based default management standards), to handle default auction process on behalf of the clearing member.

The SDMA supports proposed rules 39.12(a)(iv), 39.12(a)(v) and 39.12(3), which recognize that clearing member eligibility requirements be based upon the operational functions that a clearing member traditionally provides in reducing systemic risk. Therefore, the SDMA respectfully recommends the Commission adopt proposed rules 39.12(a)(iv), 39.12(a)(v) and 39.12(3) but clarify that participation in the default management process should not require that a clearing member maintain an execution desk to provide end of day prices or participate in the liquidation auction process.

## III. <u>Clearinghouse Governance & Open Access</u>

A second area where conflicts of interest manifest themselves in the governance and ownership of clearinghouses. High ownership concentrations and exclusivity of membership create fertile ground for the creation of potential conflicts of interest. Those that clear swaps have attempted to use restrictive clearinghouse membership eligibility requirements to keep the number of their members low. This high concentration of ownership coupled with limited membership raises serious concerns about the dealer banks' ability to exert undue influence over the clearinghouses to support their own interests and stifle open access to clearing.

Dealers that own or are able to control significant concentrations of equity in a clearinghouse can attempt to enact policies and practices that enhance their own execution and clearing businesses. As a result, the potential for conflicts of interest between the dealers desire to enhance profits and the clearinghouse's obligation to provide nondiscriminatory clearing will have a significant impact on clearinghouse governance. How the clearinghouse is governed and who has the ability to participate in making key business decisions has a direct impact on vital aspects of the clearinghouse's business. These key areas are: (1) membership, (2) product eligibility, (3) acceptable collateral for margin, (4) proper risk models and default procedures, and (5) documentation.

The Dodd Frank Act and the Commissions proposed rules address the potential conflicts of interest by creating a governance framework that establishes standards for clearinghouse ownership, board composition, governance fitness standards and conflicts of interest rules. This framework starts with the Core Principles for Derivatives Clearing Organizations that relate to clearinghouse governance. These Core Principles are: (1) O: *Governance and Fitness Standards,* (2) P: *Conflicts of Interest*, and (3) Q: *Composition of Governing Boards*. The Commission has further defined the standards for the clearinghouse governance framework in the following proposed rules: (a) 39.13 *Risk Management;* (b) 39.24 *Governance Fitness* Standards; (c) 39.25 *Conflicts of Interest*; (d) 39.26 *Composition of Governing Boards*; and (e) 40.9 *Governance*.

This framework seeks to create an independent governance structure for clearinghouses and has several components. The first component is a limitation on clearinghouse ownership and voting rights. The second component is a mandate that the clearinghouse board of directors include market participants. Next, this framework requires that the clearinghouse establish and enforce fitness

standards. Finally, the clearinghouse must establish procedures for mitigating and resolving conflicts of interest. Each of these components is discussed below.

A. Limitations on Ownership and Voting Rights

Establishing limitations on ownership levels and voting rights is a key aspect of minimizing conflicts of interest. These limitations are addressed in both the Core Principles and the proposed rules. Core Principle P requires that a clearinghouse establish and enforce rules that minimize conflicts of interest. Proposed rule 39.25 provides two alternatives for limiting ownership and voting rights of clearinghouses.

The first alternative proposes a single member limit and an aggregate limit. The single member limit caps a clearing member's (and their related persons) ownership level and exercise of voting rights at 20% (proposed rule 39.25(b)(2)(i)(A)). The proposed aggregate limit imposes a 40% cap on an Enumerated Entity's[3] (and their related persons) ownership and exercise of voting rights, regardless of whether the Enumerated Entity is a clearing member (proposed rule 39.25(b)(2)(i)(B)). The second alternative proposes a 5% limitation on the ownership and voting rights that a member or an Enumerated Entity (and their related persons) collectively own. (Proposed Rule 39.25(b)(2)(ii))

The SDMA supports Alternative 1, contained in 39.25(b)(2)(i), which limits (a) a clearing member ownership and voting rights to 20% of any one class of equity and (b) an Enumerated Entities' ownership and voting rights to 40% of any one class of equity. The SDMA does not support Alternative 2, contained in 39.25(b)(2)(ii), which limits a member's or an Enumerated Entities' ownership and voting rights to 5% of any one class of equity, as the SDMA does not believe this is adequate to limit conflicts of interest.

B. Board Composition

The SDMA believes that the Core Principles and the Commission's proposed rules regarding board composition strike the proper balance to ensure independent governance. Core Principle Q requires that each clearinghouse make certain that the composition of the governing board (or committee) includes market participants. The Commission has mandated the requirements of Core Principle Q in proposed

[3] Proposed rule 39.25(b)(1) defines Enumerated Entities as (a) a bank holding company with total consolidated assets of $50 billion or more, (b) a nonbank financial company supervised by the Board of Governors of the Federal Reserve System, (c) an affiliate of either of the previously described bank holding company or nonbank financial company, (d) a swap dealer, (e) a major swap participant, and (f) an associated person of a swap dealer or major swap participant.

rule 39.26 *Composition of Governing Boards*. Subsection (b) of proposed rule 39.26 requires that at least 10% of the clearinghouse's board of directors be customer representatives (proposed rule 39.26(b)). In addition, the Commission has mandated other board composition requirements in proposed rule 40.9. Proposed rule 40.9(b) requires that the board of directors must be composed of at least 35%, but not less than two, public members.

The SDMA believes that these composition requirements are not burdensome and strike a good balance between independent directors, clearinghouse members and customers. These requirements properly diversify the composition of the board of directors, promote broader participation in governance, and encourage diverse perspectives. The SDMA believes that the composition requirements mandated by the Core Principal Q and proposed rules 39.26 and 40.9 will help to reduce the potential for conflicts of interest. <u>Therefore, the SDMA respectfully recommends that the Commission adopt proposed rules 39.26 and 40.9 as drafted.</u>

C. <u>Governance Fitness Standards</u>

Governance fitness requirements also play an important role in mitigating conflicts of interest. Fitness standards for board members (and other governing committees) help to assure the integrity and independence of an individual to properly fulfill their fiduciary responsibilities. In addition, governance fitness standards should also encourage independent and transparent governance. The framework for governance fitness requirements are established by Core Principle O and proposed rules 39.24 *Governance and Fitness Standards* and 40.9.

Core Principle O mandates that each clearinghouse have transparent governance arrangements that (a) are in the public interest, and (b) "… permit the consideration of the views of owners and participants". In addition, Core Principle O requires that the clearinghouse must establish and enforce fitness standards for any (a) director, (b) disciplinary committee members, (c) clearinghouse members, (d) "… other individual or entity with direct access to the settlement or clearing activities …" of the clearinghouse, and (e) party affiliated with an individual or entity that has direct access to settlement or clearing activities.

Proposed rule 39.24 addresses governance fitness standard in two respects. First, proposed rule 39.24(a) mandates transparency of the governance process. This rule requires that each clearinghouse

make the description of "… the manner in which its governance arrangements permit the consideration of the views of its owners, whether voting or non-voting, and its participants, including, without limitation, clearing members and customers" available to the public. Second, proposed rule 39.24(b) provides that the clearinghouse must specify and enforce fitness standards for (a) members and affiliates, (b) persons with direct access to settlement and clearing activities, (c) persons that own 10% or more of any on class of equity and (d) their affiliates.

In addition, proposed rule 40.9(d) promotes transparency of clearinghouse governance by requiring that clearinghouses make all of the following items available to the public: (a) the clearinghouse charter, (b) the charter of the board of directors and each committee with the ability to amend or constrain the actions of the board, (c) the nominating process for the board of directors, (d) the names of the members of the board of directors and each committee with the ability to amend or constrain the actions of the board, (e) the names of all of the public directors, (f) the lines of responsibility and accountability for each operational unit of the clearinghouse, and (g) summaries of significant decisions implicating the public interest.

These governance fitness standards are important for a number of reasons. First, they mandate transparency. Transparency ensures that the governance process is followed and that decisions are made only by those authorized to do so. Second, they give clearing members and market participants the right to know about and the ability to participate in decisions that affect them. Third, fitness standards ensure the independence of the board members. These governance fitness standards are necessary to prevent self-interested parties from exerting undue influence.

The SDMA strongly believes that governance fitness standards are needed to promote independent and transparent governance, and it supports the standards established by proposed rules 39.24 and 40.9. Therefore, the SDMA respectfully suggests that the Commission adopt proposed rule 39.24 and 40.9 as drafted.

D. Customer Eligibility For Clearing Services

The need to stifle competition in order to increase profits may also manifest conflicts of interest regarding customer eligibility for clearing services. To enhance profits, members of the trading desk may seek to influence the decision of the clearing unit with respect to its decision to accept a particular customer for

clearing services, or compel the linkage of execution and clearing services. The execution desk's undue influence over the clearing unit may also adversely affect the clearing unit's decisions regarding margin levels and risk limits. As a result, clearing services may not be provided on an equal basis to all customers.

The SDMA believes that the Commission has correctly addressed this issue in proposed rule 39.12(b)(3) which requires that clearinghouses provide for non-discriminatory clearing of swaps and proposed rules 1.71(d) and 23.605(d), which implement the separation of clearing and execution services. These rules enable clearing units to evaluate customer eligibility for clearing services based upon objective standards, and not based upon pressure from the execution desk. As a result, the clearing units will offer clearing services to eligible customers on a non-discriminatory and "execution blind" basis. Publicly available, uniform and objective standards for acceptance of clients across all customer groups into clearing, and fee structures not tied to execution, will greatly increase the odds of central clearing being a success. Therefore, the SDMA respectfully suggests that the Commission adopt proposed rule 39.12(b)(3) as drafted.

E. Product Eligibility For Clearing

A fourth area where conflict of interest may arise is in the clearinghouse's determination of what products should be eligible for clearing. An independent clearinghouse acting in its own economic self-interest would want to increase their profits by clearing as many products as possible. However, this is not be possible if the clearinghouses are controlled by self-interested parties acting for their own benefit in determining what products are eligible for clearing.

Nearly all credit default swaps ("CDS") and interest rate swaps ("IRS") are eligible for clearing. Most CDS have well defined economic terms, legal documentation, market definition and trade protocols. SDMA members who are daily participants in this market estimate that at least 80% of CDS trades are standardized and ready to be cleared. Approximately half of these are index products, and half are standard single name CDS swaps that make up the indices. All index and single name constituents are liquid, easily priced and should be centrally cleared. Arbitrarily making CDS names ineligible from clearing could adversely affect liquidity and distort the market by affecting the bid ask spread.

In addition, a large majority of interest rate swaps are eligible for clearing. IRS are extremely liquid instruments focused over a finite set of maturity points along a single curve. IRS instruments possess well defined economic terms, legal documentation, market definitions and trade protocols.

Despite the fact that CDS and IRS are ready to be cleared today, some clearinghouses suggest using volume thresholds and grandfathering to determine whether products are eligible for clearing. They argue that volume thresholds are an appropriate measure in determining product eligibility because volume creates price transparency serving two purposes: (a) it provides more accurate information for better risk management, and (b) the ability to price positions for clearing. However, this argument -- that only high volume products can be priced -- is a red herring. Prices in the credit markets are a not based upon volume. Prices are a function of the yield curves[4] as well as perceived and actual fluctuations in credit ratings. Grandfathering is used as a method of blocking existing swaps from eligibility for clearing. Under grandfathering the clearinghouse would determine only new trades as being eligible for clearing and seek to exempt the clearing of existing swaps.

The Dodd Frank Act correctly recognizes the potential for conflicts of interest created by allowing self-interested parties to determine product eligibility for clearing and addressed this issue in Core Principle C *Participant and Product Eligibility*. Core Principle C requires that each clearinghouse will have "… appropriate standards for determining the eligibility of agreements, contracts, or transactions submitted to [the clearinghouse] for clearing." The Commission has outlined an objective, comprehensive approach to determining product eligibility in proposed rule 39.12(b)(1).

Proposed rule 39.12(b)(1) requires that clearinghouses have the appropriate standards for determining product eligibility for clearing that consider the clearinghouse's ability to manage the risks associated with clearing those products. In addition, proposed rule 39.12(b)(1) provides a list of factors the clearinghouse should consider in determining product eligibility. These factors are: (a) trading volume, (b) liquidity, (c) market participants ability to use portfolio compression, (d) the clearinghouse's and clearing members' ability to access the relevant market to create and liquidate positions, and (e) the operational capacity of the clearinghouse to address any unique risk characteristics of the product.

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[4] A yield curve is a line that plots, at set points in time, the relationship between the interest rate and the time to maturity of a debt for a borrower in a particular currency.

The SDMA believes that there should be objective, publically available standards for determining product eligibility for clearing. The SDMA believes that the Commission has correctly addressed this issue in section 39.12(b)(1) requiring clearinghouses to adopt product eligibility standards which consider clear and objective criteria relevant to the clearing of transactions. Therefore, the SDMA respectfully suggests that the Commission adopt proposed rule 39.12(b)(1) as drafted.

F. Clearing Workflow

Conflicts of interest also manifest themselves through the asymmetrical workflows that currently exist in the clearinghouses that clear swaps. These clearinghouses may be utilizing workflows designed to protect the profits of self-interested parties by favoring a particular type of trade execution process or forcing indirect access to clearing.

The current workflow at these clearinghouses for clearing swaps transactions has many steps. Upon trade execution the dealer submits the trade to the customer via an electronic affirmation platform for the customer to affirm or reject. If the customer affirms the trade, the dealer will submit the trade to the clearinghouse for clearing. Once the clearinghouse receives the trade it will determine whether to accept it for clearing. Last, the clearinghouse notifies the parties whether or not the trade has been accepted for clearing. This workflow currently takes anywhere from four hours to one week to complete.

There are a number of problems with this workflow. First, by inserting additional unnecessary steps into the clearing process, there is a slower, inefficient clearing process that impedes liquidity and increases risk. Once the trade is executed it should be immediately sent to the clearinghouse. Instead the trade is only sent for clearing after (a) dealer submits the trade to the customer for the customer to affirm or reject and (b) the customer affirms that trade. This affirmation process delays the submission of the trade for clearing by several hours. In addition, the trade counterparties still have to wait for notification from the clearinghouse to find out whether the trade will clear.

Second, this work flow forces indirect access to clearing. The customer is denied direct access to clearing, because the dealer submits the trades on their behalf creating a restriction on trade. In addition, the electronic affirmation system sits between the counterparties and the clearinghouse.

Indirect access to clearing is limiting and dangerous because it prevents trade anonymity, which greatly increases the risk of front-running orders. Additionally, it prevents competition since the dealers

control the customer's access to clearing. Finally, indirect access means that buy side firms cannot trade directly with each other, which reduces competition and increases execution costs.

The SDMA recommends that clearing workflow be efficient and symmetrical. At the time of execution the sell side and the buy side of the trade must be sent directly to the clearinghouse simultaneously regardless of whether the trade was executed on a request for quote or central limit order book platform. This allows for prompt and efficient clearing via straight through processing that does not require middleware to affirm a trade.

The Commission correctly recognizes the importance of workflows in achieving prompt and efficient clearing and has proposed a number of rules to address this issue. It is clearly written that a transaction executed on a SEF must be confirmed upon execution (proposed rule 37.6(b) *Enforceability)*, and immediately accepted for clearing (proposed rule 39.12(b)(7)(ii)). Proposed rule 39.12(b)(4) mandates that clearinghouses shall not require that in order for the swap to clear one of the executing parties must be a clearing member. Proposed rule 23.506(a)(2) requires each SD and MSP to coordinate with the clearinghouse to facilitate prompt and efficient swap transaction processing in accordance with the requirements of 39.12(b)(7). Therefore, the SDMA supports proposed rules 37.6(b), 39.12(b)(7)(ii), 39.12(b)(4), 23.506(a)(2) and respectfully suggests the Commission adopt the rules as drafted.

G. Clearing Documentation Requirements

Lastly, conflicts of interest manifest themselves through give-up documentation used to limit competition in execution and clearing services. These "tripartite" or "trilateral" agreements are nothing but a bilateral wolf in the proverbial sheep's clothing and they unreasonably restrict trading and competition. In the bilateral world one counterparty to the trade is the self-clearing dealer, providing both trading and clearing services, and the other counterparty is typically a customer. In the trilateral world the parties to the agreement are (1) the dealer's trading desk, (2) the dealer's clearing member and (3) the customer. These trilateral agreements assume that one side of every trade is a dealer, and, if the trade does not clear permits the dealer to determine, on its own, any breakage amount. This documentation does not permit anonymous trading or symmetrical workflows. In addition, these documents (a) restrict customer choice of execution venue (as they are designed for request for quote venues and do not allow for execution on a central limit order book), (b) seek to supersede the rules of execution venues, and (c) negate trade anonymity.

The SDMA strongly believes that if a give-up agreement is used in the post Dodd Frank swap market it should have similar give up documents that have been successfully used in other markets. Specifically, these give up agreements should only be used to decide the rights and obligations between the: (1) executing broker and the customer; (2) clearing member and the execution broker; and (3) clearing member and the customer. The SDMA respectfully suggests that the Commission amend proposed rule 39.12 to prohibit any documentation that attempts to supersede SEF or clearinghouse rules.

## IV. Prohibition of Conflicts of Interest is Essential to Open Access to Clearing

The Dodd Frank Act correctly recognizes that open access to clearing requires that clearinghouses and clearing members be independent. Creating an environment that enables clearinghouses and clearing members to be independent has two components. First, the clearinghouse must have a governance structure that is autonomous and transparent. Second, the clearing members should not be subject to interference or undue influence from the trading units of their firm.

As discussed above, the Commission has proposed a number of rules to regarding the independence and transparency of clearinghouse governance. The proposed rules that implement the mandate the separation of trading and clearing complement the rules regarding clearinghouse governance by ensuring the independence of its clearing members.

Proposed rules 1.17(d) and 23.605(d) provide clear standards for preventing conflicts of interest between the trading and clearing units of a firm. These rules mandate that the FCM, IB, SD and MSP establish and maintain a firewall between their trading and clearing units through the use of informational partitions. In addition, these rules mandate that FCM, SD and MSP shall not “directly or indirectly interfere with or attempt to influence” the personnel of their clearing unit (proposed rule 1.71(b)) and or affiliated clearing member (proposed rule 23.605(d)) with respect to six key decisions. Specifically, these decision points are: (1) what clearing services and activities will be offered to customers; (2) who will be accepted as a customer; (3) which clearinghouse will clear a particular transaction or group of transactions; (4) determining customer risk limits; (5) determining acceptable forms of collateral; and (6) determining fees for clearing services. In addition, proposed rule 23.605(e)

requires SDs and MSPs to establish written policies that require the disclosure of any material incentives or conflicts of interest to their counterparties regarding that counterparty's decision where to execute and clear their transactions. These rules correctly address the key areas where conflicts arise.

Clearing members play an essential role in the operation and governance of the clearinghouse. Independence of clearing members ensure that both (a) the clearinghouse adopts appropriate standards for membership eligibility standards, governance, customer eligibility, product eligibility, workflow and documentation; and (b) clearing members accept customers, provide clearing services, submit transactions, set risk limits, determine acceptable forms of collateral and set fees in a manner that promotes open access to clearing.

## V. Conclusion

Proposed rules 1.71 and 23.605 are among the most important rules issued by the Commission, because they provide standards to ensure the independence of the clearing units of FCMs, IBs, SDs and MSP. Independence of clearing members is essential to the Dodd Frank Act's goal to provide nondiscriminatory, open access to clearing.

The SDMA supports proposed rules 1.71 *Implementation of Conflicts of Interest Policies and Procedures by Futures Commission Merchants and Introducing Brokers* and 23.605 *Implementation of Conflicts of Interest Policies and Procedures* because they ensure the independence of clearing members, which is essential to nondiscriminatory, open access to clearing. Therefore, the SDMA respectfully suggests that the Commission adopt proposed rules 1.71 and 23.605 as drafted and not make any revisions that dilute their effectiveness.

Sincerely,

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