BETTER MARKETS
TRANSPARENCY · ACCOUNTABILITY · OVERSIGHT

November 17, 2010

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

Re: Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding Mitigation of Conflicts of Interest (CFTC RIN 3038-AD01)

Dear Mr. Stawick:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned proposed rules (the "Proposed Rules") of the Commodity Futures Trading Commission ("CFTC"), the purpose of which are to implement Section 726 of the Dodd-Frank Financial Services Reform Act (the "Dodd-Frank Act"). Section 726 directs the CFTC to adopt rules to mitigate conflicts of interest with respect to Market Infrastructure.[2] Also, Section 726 specifically, but not exclusively, also authorizes rules relating to potential conflicts of interest regarding Enumerated Entities.[3]

Introduction

As discussed in detail below, it must never be forgotten that the history of these markets is a history of anti-competitive, self-interested, predatory conduct that serves the interest of the exclusive few at the expense of the many and the system as a whole. If the Dodd-Frank Act was intended to accomplish anything in this area, it certainly was the eradication of such practices from these markets.

---

1 Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

2 Market Infrastructure refers to derivatives clearing organizations ("DCOs"), swap execution facilities ("SEFs"), and derivatives contract markets ("DCMs").

3 Enumerated Entities are bank holding companies with total consolidated assets of $50,000,000,000 or more; nonbank financial companies supervised by the Board of Governors of the Federal Reserve System; affiliates of such a bank holding company or nonbank financial company; swap dealers; major swap participants; or associated persons of a swap dealer or major swap participant.

1225 Eye St. NW, Suite 307, Washington, DC 20005
TELEPHONE (1) 202.481.8224
FAX (1) 202.682.6140
WEBSITE bettermarkets.com

To do that, both the formal **and** informal methods and means that are used to control and influence these markets must be eliminated or, at the least, reduced to as low a level as possible.

While the Proposed Rules would impose certain formal ownership and membership limits on certain types of entities, they fail to address the many informal ways that control over and influence of these markets are exercised. To truly tackle the many conflicts of interest that pervade these markets, strong limits on the formal and informal mechanisms and means of control and influence will be necessary. Moreover, the new structures created by the Dodd-Frank Act will actually give rise to additional opportunities for self-dealing and anti-competitive practices, which must be anticipated and prohibited before market participants take advantage of them.

There is ample authority for taking such actions. Specifically, the Dodd-Frank Act (in sections 727 and 735(B), among others) clearly authorizes a broader scope of rulemaking than contemplated by the Proposed Rules. Limiting the rules to the matters covered by the Proposed Rules simply does not address many practices that have proven to be as effective in establishing control and influence over providers of derivatives Market Infrastructure. To be effective, the rules must go further.

Our comments are based, in part, on the history, structure and prevailing practices in the derivatives markets. Unlike most markets, trading volume is highly concentrated in a small number of derivatives dealers in each of the derivatives markets. This has been true historically and it is true today. As the Comptroller of the Currency recently reported, merely "[f]ive large commercial banks represent 97% of the total banking industry notional amounts" of derivatives trading.[4] This report and other factors led the Securities Exchange Commission to also conclude correctly that "[t]rading in the OTC derivatives market is currently dominated by a small number of firms."[5]

Conflicts of interest have been pervasive in the derivatives markets. One reason has been the commonplace historic practice of dealer ownership of exchanges and clearinghouses. But, conflicts have also arisen from many less direct or apparent relationships, which, in these markets, have proven time and again to be equally effective mechanisms for control and influence.

For example, Market Infrastructure companies depend on fee income based on volume. That is the lifeblood of these markets and Market Infrastructure lives or dies by volume. The extraordinary concentration of trading volume allows a very small group of dealers to determine the success or failure of Market Infrastructure providers by directing their massive volume of transactions. It has also been commonplace for Market Infrastructure

---

4 OCC's Quarterly Report on Bank Trading and Derivatives Activities, Fourth Quarter 2009" (available at http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq409.pdf); hereinafter cited as "OCC's Quarterly Report"

5 17 CFR Part 242, page 65887.

providers to buy volume from dominant dealers by so-called commercial arrangements like revenue or profit sharing, liquidity rebates, or discounts.

In other areas, incentives for high volume are, by themselves, not problematic. However, in these markets, with high trading concentration, they are the grease that lubricates a conflict-ridden system of favors and predatory practices that perpetuate control by an oligopoly of firms. This "grease" enables the few dealers to pick and choose which Market Infrastructure thrives or withers away as volume is directed one way or the other.

Additionally, lower-volume market participants need the liquidity that arises from higher-volume market participants, in particular from market makers which establish reliable bid/ask spreads. Thus, they are effectively forced into the Market Infrastructure used by the large dealers. This further ensures that only those platforms used by a handful of high-volume market participants are the only platforms that survive. To add insult to injury, the cost for use of Market Infrastructure is then allocated disproportionately to the participants with lower volume, who receive no discounts, rebates or revenue sharing.

In many ways, these conflicts and influences are inherent to the derivatives marketplaces and distinguish them from other traded markets. While there are multiple and diverse derivatives markets, trading volume in each of them is highly concentrated. As a result, influence by Enumerated Entities over Market Infrastructure providers will always be intense. That is why the rules addressing conflicts must be both broader in scope and more restrictive in application than the Proposed Rules.

If the rules addressing conflicts of interest are not sufficiently restrictive or do not effectively limit the many indirect methods of exerting influence, a marketplace characterized by anti-competitive practices will continue. The transparent, competitive, fair and risk-reducing marketplace required by the Dodd-Frank Act will not be realized. Worse yet, risk-taking will actually be encouraged as the few participants that benefit from these arrangements maximize profits in markets structured to favor them. Because of the level of risk inherent in derivatives, future failures caused by inevitable misjudgments, over-reaching and structural flaws could well be catastrophic.

Regulators must not allow such a system to be perpetuated or permitted. Specifically, the thresholds in the Proposed Rules related to share ownership must be lowered and the percentages for independent membership on boards of directors must be increased. Market data should be made available by Market Infrastructure providers on equal terms: at the same times and at the same cost. And, importantly, the Proposed Rules must not be limited to formal ownership limits and membership percentages. The policy of the Dodd-Frank Act regarding conflicts of interest can only be fulfilled if volumetric incentives and other secret side payments to users or providers of Market Infrastructure are eliminated or severely constrained. Our specific proposals can be found below.

The Dodd-Frank Act Provides Very Broad Scope of Authority to Regulate

Section 726 of the Dodd-Frank Act provides, in relevant part:

> (a) IN GENERAL.—In order to mitigate conflicts of interest, not later than 180 days after the date of enactment.., the Commodity Futures Trading Commission shall adopt rules *which may include numerical limits on the control of, or the voting rights with respect to,* any derivatives clearing organization that clears swaps, or swap execution facility or board of trade designated as a contract market that posts swaps or makes swaps available for trading, by a bank ... a nonbank financial company... supervised by the Board, an affiliate..., a swap dealer, major swap participant, or associated person of a swap dealer or major swap participant.
>
> (b) PURPOSES.—The Commission shall adopt rules if it determines, after the review described in subsection (a), 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. [Emphasis Added]

The CFTC recognizes in the Proposed Rules that the authority to address conflicts of interest in Market Infrastructure also derives from Sections 735(b). Taken together, the sections of the Dodd-Frank Act dealing with conflict of interest provide broad authority to the CFTC to regulate practices involving Market Infrastructure. Importantly, the reference to voting rights is included to make clear that it is an area subject of regulation; it is not a limit on the scope of regulation.

The language set forth above clearly envisions rules that reach beyond formal voting share ownership. Indeed, the Proposed Rules (in footnote 77 for example) clearly state that ownership of non-voting equity could be limited. Further, the Proposed Rules pose a series of questions regarding scope:

- "Has the release correctly identified the conflicts of interest that a DCO, DCM or SEF may confront?
- Has the release accurately specified the possible effects on DCO, DCM or SEF operations? What are other possible effects?
- What other conflicts of interest may exist? What are the effects of such conflicts?"

This comment letter answers these questions (in addition to addressing many other issues). As detailed below, the answers to the first two questions are clearly no. In answer to the third question, many other conflicts exist with pernicious and unacceptable effects that will, in fact, undermine the letter and spirit of the Dodd-Frank Act.

Specifically, other commercial arrangements, which in the context and history of the derivatives trading business, create conflicts of interest or threaten risks to the system, are also appropriate subjects of regulation. In particular, revenue, profit sharing, fee discounts and rebates *may* be regulated and *must* be regulated. In addition, purchased preferential access to data or information, which can distort the market and favor one or a class of participants, must be prohibited.

The History of Derivatives Market Infrastructure is a History of Anti-Competitive Practices and Behavior

The history of major bank involvement with Market Infrastructure and current anti-competitive conditions provides a compelling case for a broad scope of regulations attacking and eliminating conflicts of interest.

Derivatives Market Infrastructure is a business with unique characteristics. Exchanges and clearinghouses evolved as membership organizations, providing the infrastructure which facilitated the trading businesses of their members. There was a good reason that this structure evolved. Exchanges emerged as venues for trading houses to meet and transact; and clearing was a shared, mutualized mechanism for efficient disposition and management of credit risk in transactions among members. The services provided by exchanges and clearinghouses were in the nature of utilities and common-carriers. However, a by-product of this structure was the ability to form an oligarchic market by limiting access to the infrastructure through restricted membership and trading procedures. This is exactly what the banks have done.

Significant competition in Market Infrastructure is a very recent phenomenon. It dates from the founding of the Intercontinental Exchange ("ICE") in 2000 by an initial investor group of Goldman, Morgan Stanley, BP, Total, Deutsche Bank, Shell and Societie Generale. The purpose was to displace bi-lateral energy trade matching by brokers with member-owned electronic matching, a new type of infrastructure for the market. Later, optional clearing of bi-laterally matched trades was added, a second level of new infrastructure. Clearing was initially outsourced to London Clearing House, but soon provided in-house. Clearing brought ICE into direct competition with the New York Mercantile Exchange.

In 2005, ICE shares were very successfully offered to the public. This IPO (co-managed by 2 of the owners, Morgan Stanley and Goldman) was quite unusual. Relatively little capital was raised by ICE. The vast majority of the offering consisted of the shares of the original investors. *They cashed out. Importantly, however, that did not end their influence.* The original investors retained great influence, not only because of relationships and historic alliances, but because of the market volume they controlled.

Volume is the lifeblood of ICE and all other Market Infrastructure businesses. Merely because the original investors cashed out and, thereby, gave up their ownership stakes, that did not reduce their influence. Especially the banks, as dominant market makers in the energy sector, still controlled and directed vast amounts of trading volume. And, importantly, fees are based on volume. Remember, there is very little cost associated with increased volume so the associated fees are almost entirely profit. Given the enormous sums of money involved, it cannot be denied that directing trading volume equals very significant influence.

Competition in Market Infrastructure initiated by the creation of ICE did not change the fundamental characteristics of the business. Market Infrastructure continues to serve market participants and its profitability is wholly dependent on volumes. As a result, the influence of members, especially market makers who transact large volumes of trades, is great whether the infrastructure provider is a SEF, a DCO or a DCM.

Volume commitments have often been secured by price concessions, revenue sharing[6] or other advantages. The potential for exclusionary and un-competitive arrangements in exchange for volume is extraordinary.

A relatively new feature of Market Infrastructure is that more elements are required as the transactions become more complex. This enables yet another form of influence by major market participants: the *pervasiveness* of influence through direct ownership or indirect commercial relationships along the chain of infrastructure providers.

An excellent example of this is the index credit default swap market. It is common knowledge in the industry that just three dealers dominate this entire market, reputedly Goldman Sachs, JP Morgan and DeutscheBank. This is strongly supported by the Office of the Comptroller of the Currency, which states that 98% of the notional amount of credit derivatives held by banks were held by just five institutions at December 31, 2009.[7]

Each of the following links in the Market Infrastructure chain was developed by or owned by major market participants:

- ICE Trust, which maintains a revenue sharing agreement with major dealers, provides clearing.
- Markit, which provides price data services and indexes, has substantial dealer ownership.
- DTCC, an industry-owned entity, which provides a swap data warehouse, is a service provider for the dealers with majority dealer representation on its board.

---

6 See Joint SEC-CFTC Roundtable to Discuss Swap Execution Facilities and Security-Based Swap Execution Facilities, Panel Two, September 15, 2010, Transcript, Colloquy commencing with question from Ms. Adriance on p. 130 and ending on p. 139.

7 OCC's Quarterly Report, Table: Notional Amount of Derivative Contracts, Top 25 Commercial Banks and Trust Companies in Derivatives, December 31, 2009.

- ICE now provides a SEF-like service for matching buyers and sellers. The original service provider was CreditEX, which was created with dealer sponsorship and ownership. It was later bought by ICE.

Interestingly, an alternative market structure offered by the Chicago Mercantile Exchange and Citadel was independent of dealer ownership and never even gained a toehold in the marketplace. The main differences with ICE were:

- Access to CME clearing was via a matching system, not initially offered by ICE.
- ICE Trust provided major dealers a 50% revenue share.

This suggests that *less* transparent pricing and *buying* volume from major dealers were the factors that determined which market survived and which did not.

The Derivatives Markets are Full of Conflicts That Must be Eliminated

The Proposed Rules do not sufficiently address the pervasive influence over "infrastructure" for the massive, diverse and complex derivatives markets by a narrow oligopoly of financial institutions. This oligopoly has been referred to by antitrust expert Robert Litan as the "Derivatives Dealers' Club."[8] Vertical integration of the system allows the Derivatives Dealers' Club to exclude potential competitors from market participation, avoid transparent and competitive pricing, and thwart the policy objectives of the Dodd-Frank Act. This is particularly troubling given the remarkably overt intent of many in the financial services industry to flaunt the will of Congress.[9]

The Proposed Rules are simply not nearly strong enough. They are also far too narrow in scope, given the tremendous influence of a handful of financial institutions on critically important markets. It must not be forgotten that these markets affect virtually every aspect of the economy and are directly related to the day-to-day welfare of American families.

The Office of the Comptroller of the Currency estimates bank derivatives trading revenues in 2009 of $22.6 billion, presumably 97% of which went to just five banks.[10] There is no disputing that a handful of financial institutions have derived staggeringly large profits from derivatives trading in recent years. That fact alone is evidence that the market is rife with uncompetitive influences.

These financial institutions deal with utilities, energy producers, state and local governments, transportation companies, agricultural companies, pension funds, asset

---

8 Robert E. Litan, "The Derivatives Dealers' Club and Derivatives Markets Reform: A Guide for Policy Makers, Citizens and Other Interest Parties," The Initiative on Business and Public Policy at Brookings (2010) (available at http://www.brookings.edu/~/media/Files/rc/papers/2010/0407_derivatives_litan/0407_derivatives_litan.pdf).

9 Bloomberg, October 27, 2010, "Wall Street Proprietary Trading Goes Undercover," Michael Lewis.

10 OCC's Quarterly Report.

managers and others as counterparties. The consistent massive profits of this oligopoly were earned largely at the expense of these counterparties in an uncompetitive market. These counterparties provide food, energy and financial security to the public, which bears the ultimate cost.

As pointed out above, the Comptroller of the Currency data attributes 97% of bank derivatives trading to just five commercial banks, highlighting their level of trading revenues.[11] Both the CFTC and the SEC quote testimony and cite studies by distinguished academics and knowledgeable market participants who reach an inescapable conclusion: the revenues are a function of the wide bid-ask spreads that prevail in these markets due to asymmetry.[12] Asymmetry means structural conditions which provide advantages to one class of market participants to the disadvantage of others. The SEC refers specifically to asymmetrical information, a charitable term for the ability to keep your counterparties in the dark and consistently buy from one at a much lower price than you sell to another.[13]

There are other forms of asymmetry, however, which yield similar results. One such form is asymmetrical access to Market Infrastructure because of exclusivity of membership and structures which favor the business strategies of a limited class of users. A properly functioning Market Infrastructure must reduce asymmetric information; and it must also reduce asymmetrical access and break down the oligopoly.

It is predictable that, in an asymmetrical and anti-competitive market, an oligopoly of banks will take on excessive market price risk: since the probability of success is high because of inherent advantages, greater market price risk is incentivized because it amplifies the result. The oligopoly predictably would earn disproportionate profits as long as the advantages function as anticipated. However, these advantages will inevitably fail them (for example, the superior information turns out to be flawed or an element of Market Infrastructure fails). When this occurs, because of the excessive risk-taking, the losses would be expected to be disastrous.

The system worked extremely well for the dealer banks for many years. But, the banks' anti-competitive practices ultimately led to the financial crisis of 2008, when the American taxpayers were forced to bail out the banks.

Those not favoring strong formal and informal limitations in effect seek to return to business as usual, earning huge profits in asymmetrical and anti-competitive market environments. This would perpetuate a market structure where large losses are inevitable. The details of the future market crisis are unknown, but it is almost certain to happen if asymmetry in information and access persists.

---

11 OCC's Quarterly Report.

12 See Darrell Duffie, Ada Li, and Theo Lubke, "Policy Perspectives on OTC Derivatives Market Infrastructure," Federal Reserve Bank of New York Staff Report No. 424, January 2010 as revised March 2010.

13 17 CFR Part 242 at page 65887.

Unfortunately, that is not all. The future market structures envisioned by the Dodd-Frank Act will actually open the door to additional forms of asymmetrical, anti-competitive, predatory and exploitive practices. These will again arise from conflicts of interest between Market Infrastructure providers and the large-scale users of their systems and everyone else.

Just one example, although a very important one, from the equity markets suggests the likely proliferation of problems to come: electronic markets have enabled a limited numbers of trading firms to be granted high-speed data access – for a price, of course. Purchased preferential access to rapid data feeds should be anticipated as volumes transacted through SEFs and DCMs increase. With extraordinary concentration of trading volumes by a narrow set of large firms, the new derivatives market structures will provide opportunities for asymmetrical information flows to develop into an enormous advantage for firms capable of algorithmic and high-speed trading.

The consequences could be disastrous; but, at a minimum, they will be anti-competitive and predatory. The CFTC must avoid focusing exclusively on the opaque over-the-counter markets of the past; the new rules under Sections 726 and 735(B) must anticipate and address the imminent exploitation of the information flows of the future.

The Dodd-Frank Approach to Anti-Competitive Derivatives Markets

The Dodd-Frank Act undertakes to curb anti-competitive practices by changing the structure of the markets. Use of SEFs and DCMs as mechanisms for matching buyers and sellers is intended to increase price discovery and transparency through the use of anonymous markets, free from influences extraneous to the basic transaction. The required use of DCOs is intended to increase the uniform and reliable post-trade management of derivatives credit risk and increase transparency. The Dodd-Frank Act envisions competition among providers of Market Infrastructure to achieve efficiently functioning markets, resulting in lower costs for end-users and the public. (It is the public, after all, which consumes the products of end-users, ultimately bearing the cost of asymmetry and conflicts of interest.)

Clearinghouses have never been free of control by members, even after their shares were sold to the public. They were always more like cooperatives, serving member interests, than unrestricted businesses. Clearinghouses were also entrusted with enforcement of regulations to give effect to public policy. Under the Dodd-Frank Act, an element of control has shifted away from the dealers to the public. The reality that new regulation is more of a shift in control and influence than the imposition of new constraints may not fit with the public image of major clearinghouses, but it is a fact. The same can be said of SEFs and DCMs.

The Proposed Rules' analysis[14] of the potential for conflicts of interest involving DCOs and Enumerated Entities fails to consider several less obvious, but very significant, factors. While the analysis concludes that there is potential for conflict, this potential is significantly understated.

The analysis focuses on the potential for restricting membership and resisting the scope of contracts cleared by a given DCO under the Dodd-Frank Act regulatory regime. These are critically important issues. However, DCOs deal with a far broader set of issues. For example, the methods of calculating margin based on volatility, liquidity and price correlations affect the quality of the clearing service. And compliance with and interpretation of Core Principles and other regulatory requirements is an ongoing process.

The analysis cites several factors that emerged from the CFTC study in preparation for issuance of the Proposed Rules which suggest that the potential for conflict is actually low.

- Statements by industry representatives that clearing is equally as profitable as bi-lateral derivatives trading and that there is no incentive to resist broad-based clearing.
- An observation that clearing members are incented to broaden membership to spread the risk of loss on a default.
- An observation that clearing members are incented to support conservative financial requirements for membership and management processes.

Financial institutions have asserted that they prefer cleared transactions to bi-lateral transactions because they are equally profitable.[15] The history of trading activity suggests otherwise, as does a Staff Report of the Federal Reserve Bank of New York cited in the Proposed Rule.[16] The CFTC is aware that the vast majority of derivatives volume has been transacted over-the-counter and has remained bi-lateral post trade. This is perfectly understandable in a market which is asymmetrical. Advantages are more easily exploited in markets characterized by (1) non-transparent pricing and (2) credit exposure management through (a) bi-lateral credit extension in lieu of collateral and (b) re-hypothecation.

The facts and logic demonstrate that the profitability of operating in an over-the-counter and bi-lateral environment is much higher than the profitability of trading in an efficient, transparent marketplace where participants have equal access to information and transaction costs are minimized through competition.

The observations that Enumerated Entities are incentivized to spread the mutualized risk of default and to support conservative membership financial standards are logical. However, they fail to consider the powerful, countervailing incentive of profit from controlling access to clearing services. Clearing members extract a toll from customers to

---

14 Proposed Rule, Supplementary Information, II. Conflicts of Interest, a. DCOs.

15 Proposed Rules, Footnote 22.

16 Proposed Rules, Footnote 28.

facilitate access. Fewer members means higher profits. And in many individual markets, members can effectively limit the emergence of competition by limiting access.

There is little doubt that the Enumerated Entities prefer to have the *option* to clear most types of transactions. Clearing can be a useful alternative to them where over-the-counter execution of bi-lateral transactions is difficult or impractical (for example, if a dealer has reached a limit on credit with a particular counterparty). Undoubtedly, there are some types of transactions and market conditions for which the efficiency of SEF/DCM trading and clearing exceed the value of asymmetry. But for many other transaction types, dealers should be expected to resist *mandatory* clearing because it will increase transparency and competition and, thereby, decrease their profits.

Required clearing is the policy lynchpin of the Dodd-Frank Act. Not only does the Act mandate the use of clearinghouse risk management, it moves trading into SEFs and DCMs as the required sources of trade flow into the clearing environment. However, the clearinghouses are the gatekeepers, determining which categories of swaps may be cleared and traded on SEFs or exchanges: if no clearinghouse offers to clear an instrument, it will remain a bilateral contract between a dealer and its isolated counterparties, traded in inefficient and risky single-dealer markets. Enumerated Entities' self interest and profit motive will cause them to influence the decision to clear new contracts and, if they are in control of Market Infrastructure, they will also have the power to bring about that result.

But the potential for continuing anti-competitive markets based on dealer influence is not limited to approval of swaps for clearing. It will serve the Enumerated Entities' interests if the market is structured to force transaction flow through the dealer oligopoly. Limiting access through key bottlenecks in Market Infrastructure will force transaction flow (and revenues) through a small group of members. Even worse, potential competitors can be frozen out of a market (as happened in the credit default swap markets) if no member of the oligopoly provides access to clearing. Arguments that unreasonably limit access to the largest dealers based on credit and transactional experience ignore the lessons of the recent past: *relying on a small number of entities, albeit with large balance sheets, will provide false security against calamitous market events when compared with broadening risk to a more diverse and less inter-connected group.*

Narrow membership is also an obstacle to diligent enforcement of standards. The history of regulatory enforcement actions against exchanges has predominantly involved the failure of the exchanges to enforce their rules against prominent members. A few highlights: a 2005 enforcement proceeding against the New York Stock Exchange for failure to adequately supervise the handful of specialists that controlled the bulk of its trading; and a 2000 action against U.S. options exchanges for, among other things, failing to enforce member rule compliance; and, a 1996 action against the National Association of Securities Dealers for failure to police anticompetitive practices by market makers (who had a significant voice in governance) on the Nasdaq Stock Market.

Whether through ownership, control or influence, when there are only a few, powerful members, market structures and rules will be bent to their advantage or broken outright.

Another area of conflict, requiring much greater attention in the Proposed Rule, is swap dealers' ability to direct business to SEFs and DCMs which they control or in which they have a substantial financial interest, stifling competition.

The SEC posits that allowing concentrated dealer ownership of Market Infrastructure may be less concerning in light of experience in the securities markets.[17] Broker-dealers are permitted to own alternative trading systems for securities and to have relatively concentrated ownership of securities exchanges, yet competition is vibrant in those markets.

The SEC also notes that low barriers to entry for new trading facilities exist because they are relatively inexpensive to develop.[18] The SEC goes on to note, however, that the derivatives markets have significant differences from developed securities markets, including the degree of concentration and the undeveloped nature of trading.

These differences are, in fact, decisive, rendering the analogy inapplicable. An enormous barrier to entry into derivatives Market Infrastructure is the ability to secure volume. Because an oligopoly controls trading at present (97% market share controlled by just five dealer banks) it is in a position to determine how trading will develop in the regulated environment. In other words, a SEF or DCM that is 100% owned by five dealers which control 97% of the bank market will also control the market for transactions. Similarly, if the same dealers jointly form a utility clearinghouse, it will be impossible for others to compete.

The exercise in oligopolistic power that we can expect in Market Infrastructure has been observed previously in the derivatives market and elsewhere. For example:

- In the first five years after the Commodity Futures Modernization Act of 2000 was passed, two SEFs competed in the OTC energy markets: ICE and TradeSpark, a system developed by Cantor Fitzgerald in conjunction with major energy firms. Although many factors influenced the relative success of ICE, the commitment of market-making by banks that owned ICE proved to be decisive. Lacking the capital to commit to market making, the energy companies, which were members of TradeSpark, could not match the ability of the banks to provide transactable prices.
- A dealer-owned trading system for bond trading known as Dealerweb succeeded in capturing 85% market share for mortgage bond trading within six weeks of its launch because its dealer-owners simply directed all their business to their own system.[19] The same system has announced plans for similar conduct in the Treasury

[17] 17 CFR Part 242, page 65894.
[18] Id.
[19] "ICAP Loses 85% of Mortgage Bond Trading to Dealerweb," Bloomberg (April 21, 2009) (available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aCxaCOeOAPBE).

security market, reportedly positioning Dealerweb for to move into the interest rate swaps market.[20] Similar conduct in the derivatives markets – a Dealerweb for swaps – is simply inconsistent with Section 726 of the Dodd-Frank Act.

Thus, there is simply no denying that whomever controls the trading volume will control Market Infrastructure and anti-competitive practices will result. This will defeat the purposes of the Dodd-Frank Act, unless the rules prevent it.

Proposed Changes to the Proposed Rules

Strict limitations are required because of the undue influence arising from: (1) dealers directing volume to Market Infrastructure which serve their interest, (2) the concentration of market activity, (3) the continuing anti-competitive practices in the marketplace, and (4) the close association of the dealers with decision-making in Market Infrastructure as demonstrated throughout the history of the business. The Proposed Rules simply fail to address these realities.

In the case of DCOs, the CFTC proposes alternative tests. Under the first part of the test, voting control is limited to 20% per stockholder, and limited to 40% in the aggregate for persons whose influence over the clearinghouse may, the CFTC believes, require limitation. The 40% limit would apply to all members and Enumerated Entities. In the alternative, if no member or Enumerated Entity owns more than 5%, no aggregate limit applies. The Propose Rules impose a 20% limit on voting interest ownership by members of SEFs and DCMs; but no aggregate limit is imposed. The Proposed Rules further require that 35% of the members of the boards of directors of Market Infrastructure companies be independent. In addition, 35% independent membership is required on critical committees such as Risk Management at clearinghouses and Membership at SEFs and DCMs.

Congressman Stephen Lynch and the other supporters of his amendment were the first to recognize the conflicts of interest recognized by the CFTC in the Proposed Rules.[21] They understood that only structural limitations could bring about the structural reforms needed in this market. By placing meaningful restrictions on control of Market Infrastructure, the CFTC can assure that the Market Infrastructure is free from the issues of concentration, anticompetitive conduct and poor risk management.

To achieve this, however, the limits must, at a minimum, ensure that the dealers do not control the Market Infrastructure through a combination of ownership of voting shares and commercial influence.

---

20 "Wall Street–Backed Dealerweb to Offer Banks Treasury Trading," Bloomberg (March 24, 2010) (available at http://www.businessweek.com/news/2010-05-24/wall-street-backed-dealerweb-to-offer-banks-treasury-trading.html).

21 See Comment Letter on Proposed Rule, Congressman Stephen Lynch, October 18, 2010.

Aggregate Share Limit

As the CFTC recognize in the Proposed Rules, there are various definitions of control. As noted above, DCOs, DCMs and SEFs, as self regulatory entities are charged with an important public trust. But beyond this status, they are integral elements of the clearing process.

In the Dodd-Frank Act, "Congress determined that clearing is at the heart of reform...."[22] Given the enormous opportunity for influence and control beyond voting interests, the threshold for control in the context of derivatives markets must be low if the objectives of the law are to be achieved. Within the context of the statute's requirements to regulate conflicts of interest, 25% has been recognized by the SEC as a significant threshold (although its proposed regulations are in line with the Proposed Rules).[23] Accordingly, a limit on voting control by members and Enumerated Entities should be no more than 25% in the aggregate, regardless of the individual levels of ownership, in the case of DCOs.

While we believe that it should be no more than 25%, even such a uniform limit at the 40% level, as proposed in the first DCO alternative, would at least ensure that members and Enumerated Entities do not formally control a majority of the voting interests in a DCO. This would provide independent owners, whose interests would lie solely in clearing contracts and maintaining the solvency of the clearinghouse, with at least the possibility of directing DCO decision-making.

There is a very troubling suggestion regarding the other alternative of establishing a cap at 5% each, but no aggregate cap. The SEC states that it proposes allowing 5% individual ownership with no aggregate cap so as not to foreclose the development of "user-owned or user-controlled institutions that function as quasi-utilities." Remarkably, the SEC further notes that its "experience has been that the central clearing model in the securities markets historically has tended toward convergence to a single clearing agency...."

The suggestion is that the SEC does not wish to impede the emergence of a monopoly, member-owned clearinghouse. While a discussion of the merits of such a model in the securities markets is beyond the scope of this comment letter, we note that promoting competition is one of the stated goals of the Proposed Rules. This seems particularly wise in the context of mandated clearing in a market with a history of anti-competitive, oligopolistic behavior. Monopoly, member owned Market Infrastructure involves much greater potential for conflicts of interest where volume is highly concentrated. It would be entirely inconsistent with Section 726 of the Dodd-Frank Act to adopt any rule that in any way contemplates the elimination of competition.

---

22 Letter from Senators Christopher Dodd and Blanche Lincoln, respective chairs of the Senate Banking and Agricultural Committees, and Representatives Barney Frank and Collin Peterson, respective chairs of the House Financial Services and Agricultural Committees, dated June 10, 2010.

23 See 17 CFR Part 242 at n.93.

The concern is even greater in the case of SEFs and DCMs, where the proposed rule would allow five dealers to own 100% of voting interests. Competition in the SEF/DCM business centers on securing postings of prices by a relatively small group of market makers (no more than three firms, in some markets) which dominate volume. Cost and quality of service are secondary considerations.

Thus, while the cost of setting up a SEF may be low, the barriers to entry are all but insurmountable if the incumbent dealers can direct business exclusively to their own platform. The rationale for permitting dealer banks to own *any* interest in a SEF or DCM is difficult to ascertain, since they will inevitably favor the platform in which they own an interest. Use of Market Infrastructure should be based on cost and efficiency, not embedded self-interests.

If any such ownership is to be allowed, it is critical that an aggregate limit of no more than 25% be imposed. That at least would prevent dealers from controlling a SEF or DCM, which should result in independent governance, ensuring that decisions about listings, membership, and rule enforcement are not made solely to serve the narrow interests of a small set of powerful stockholders.

To fully realize the goals of the Dodd-Frank Act, however, other rules will have to be adopted. Those rules must include pre-trade transparency, best execution, disclosure about risks, fees and other material incentives in connection with a particular transaction, and antitrust considerations, in addition to conflict of interest limitations. The interaction between these rules and the Proposed Rules as finally promulgated will provide the comprehensive set of rules addressing conflicts of interest.

Boards of Directors and Committees

There is simply no substitute for requiring that a ***majority*** of independent representatives be on the boards of directors and key committees of DCOs, SEFs, and DCMs. As the SEC recognizes,[24] independent directors and committee members "reduce the ability of non-independent directors to influence the operation" of Market Infrastructure "in favor of their own self-interests" and would "promote open and fair access, product eligibility, and sufficient risk management standards." The SEC also notes the consistency of such a requirement "with accepted corporate governance 'best practices.'"

This is exactly right: all the valid, non-self-serving arguments support a requirement that independent members be a majority. One argument made by opponents is that the expertise of non-independent members will be necessary. That is true, but that expertise will still be available when non-independent members comprise 49% rather than 65%. All the other arguments in opposition similarly lack merit.

---

[24] 17 CFR Part 242.

The Proposed Rules pose the correct question "[S]hould the Commission raise the percentage of [independent] directors to 51%?"[25] The only defensible answer is "yes." This is and has been long recognized as a best practice and, indeed, a key one that provides a substantial check on directors' conflicts of interest. Anyone, including industry representatives, who argue for only 35% independent representation are advocating "second-best practices." Only by ensuring that independent directors comprise a *majority* of the board and key committees can the regulations ensure that independent, un-conflicted decision-makers carry the day when Market Infrastructure entities face difficult choices.

In DCOs, the key committee is typically Risk Management. It is responsible for the critical elements of the business of clearing: the scope of contracts cleared, risk management algorithms and processes and membership criteria. In SEFs and DCMs, Membership Committees are equally central. Given the history of the derivatives markets, where time and again self-interest and profit maximization trumps all other considerations, it is critical that these committees be controlled in form and substance by independent decision-makers.

Commercial Arrangements for Volume and Influence

The CFTC (and SEC) dismissed the argument that non-voting equity and commercial incentives should be limited as well as ownership of voting interests. "In general, a shareholder would have influence over a DCO, DCM, or SEF Board of Directors *only if* the shareholder has the ability to exercise voting rights with respect to, *e.g.*, election, compensation, or removal of directors."[26] (Emphasis added) That is simply not true in the derivatives markets. History and logic demonstrate this.

When a SEF or DCM provides financial incentives based on volume of trades to a member, the cost of the service is shifted onto other members. The SEF or DCM is merely buying volume, and arranging for a class of its customers to pay for it. The obvious business plan for a SEF or DCM targeting a specific market is to strike a volume-for-cash deal with the market makers in the sector, regardless of the cost. Market participants must have access to market makers to reliably execute transactions and to discover bid/ask spreads. Market participants depend on the reliable price quotes provided only by market makers. *If the SEF or DCM can capture the volume of all or a substantial portion of the market makers, the rest of the market will be compelled to use the SEF or exchange regardless of the quality of service or cost (even though it is allocated disproportionately to them).*

Rebates and discounts for trading liquidity or volume result in variations in transaction value based on the particular fee concession that applies. Inevitably, prices will be distorted. With multiple SEFs, DCMs and DCOs, market participants will game the structure to take advantage of rebates and discounts to the detriment of the greater marketplace.

---

25 Proposed Rules. Page 63739.

26 Proposed Rules, footnote 77.

These behaviors and their consequences have already been experienced in the equities markets, which provide fair warning of potential issues as derivatives markets mature.[27] For example, equities markets have experienced activities such as fake quotes to take advantage of fee credits-for-quotes schemes and programmed direction of volume to various trading platforms to take advantage of liquidity rebates (known in the trade as "rebate harvesting algorithms").[28]

A group of market makers has every incentive to behave as an oligopoly. They are benefited by a marketplace (*i.e.*, a SEF or DCM) with broad participation by price takers. The composition of the oligopoly in any circumstances will be those market makers required to force volume through the trading venue, and no more. In this circumstance, the *control of a SEF or exchange by its shareholders is illusory. Quality and cost of service are far less important to the success of a SEF or DCM than the secure posting of transactable bid/ask prices. The market makers control without equity investment; and their incentive payments are borne by the captive market participants.*

With clearinghouses, incentives based on trade volume have the same effects, but the logical steps are somewhat more complicated. Through the years, the clearing member structure has enabled the members to restrict access to marketplaces by potential competitors as a by-product of rules designed (at least on the surface) to promote the creditworthiness of the clearinghouse. Today, observers and regulators are more sophisticated in their analysis of this justification. The banks themselves provided the ultimate teaching moment in the autumn of 2008.

The benefit of concentration of risks in a handful of institutions with large balance sheets is only *apparently* a sound concept. Breadth and diversity reduce inter-connectedness and risk. As with other Market Infrastructure businesses, clearinghouses need volume to be successful. In most cases, the mere threat by one or more significant clearing members of moving volume to a competitor is sufficient to determine business decisions. When a clearinghouse pays for volume with a volumetric fee discount or rebate or a revenue share, the members receiving the discount, rebate or revenue share become constructive partners in the enterprise. The cost is borne by the customers.

ICE Trust, established to clear credit default swaps, is an excellent example. ICE Trust and the Chicago Mercantile Exchange competed to provide the service so obviously needed in light of the financial crisis. ICE Trust has become dominant in the business, although CME accurately asserts that its offering provided stronger credit risk mitigation and was more transparent.

How could that happen? The difference in outcome is difficult to justify based on quality of service and cost. In large part it was because ICE Trust provided a massive financial

27 See New York Stock Exchange discussion of payment for order flow by the CBOE in comment letter on SEC Release No. 34-62445, available at: http://sec.gov/comments/s7-21-09/s72109-163.pdf.

28 Fred Federspiel and Alfred Berkely, High Frequency Trading and the Evolution of Liquidity in US Markets, August 25, 2009 available at http://www.advancedtrading.com/exchanges/219401479?pgno=1

incentive to members equal to approximately half of revenues. Until a dominant position in the market was established, senior management of ICE Trust came from a major investment bank (part of the oligopoly), not from ICE management.[29] CME subsequently provided incentives to members, but it was too late. The volume had gone to ICE (which paid 50% for it) and, once there, it stayed there.

We are aware that the Dodd-Frank Act requires access to Market Infrastructure. However, exclusionary behavior has been a pernicious, embedded part of this sector for much of its history. Market practices and commercial realities, as well as rules which appear to serve the interest of sound credit practices, mask anti-competitive realities.

Asymmetric Access to Transaction Data Must Be Prohibited

The rules must also clearly address asymmetric access to transaction data. The increased use of SEFs and DCMs to facilitate transactions opens the door to rapid market data availability, which actually increases certain trading advantages, particularly related to algorithmic and high frequency trading. Purchased preferential access to rapid data feeds, for instance, should be anticipated.

Any form of unequal access constitutes an anti-competitive advantage passed from Market Infrastructure providers to selected market participants that are in a position to use it to secure a trading advantage. Given the extraordinary concentration of trading volumes in a narrow set of large firms in the derivatives market, the potential for conflicts of interest and predatory behavior is great.

Securing participation of market makers and obtaining their volume is critical for SEFs and DCMs. As stated above, it is the most important factor in determining success or failure, not quality of service or cost. Preferential access to trade data is a powerful incentive to offer market makers. Indeed, it is even more valuable than revenue or profit sharing, which are based on fee income. Preferential access enables a market maker to profit from all of its trading activity, based on an advantageous market position. Thus, if allowed, there is no doubt that Market Infrastructure providers will offer such preferential treatment, regardless of the many harmful market distortions that will inevitably result.

Therefore, especially in the highly concentrated derivatives trading markets, such preferential access to data must be prohibited.

Conclusion

We have described the historic and current un-competitiveness caused by derivatives markets which are asymmetrical in terms of information and access to Market Infrastructure. We have also described how such practices actually encourages risk taking,

---

[29] Press Release, Intercontinental Exchange, Inc., "ICE Trust to Begin Processing and Clearing Credit Default Swaps March 9," March 6, 2009.

magnifying the consequences when misjudgments and structural flaws inevitably lead to catastrophic failures. If the rules addressing conflicts of interest are not sufficiently restrictive or do not effectively limit indirect and informal methods of exerting influence, an anti-competitive marketplace characterized by self-dealing will continue. The seeds of the next financial crisis will have been sown.

Any claimed benefits from looser rules on formal corporate governance or from disregard of the practical significance of selling trade flow for revenue incentives and price concessions, must be carefully scrutinized and rejected. These self-serving claims are illusory and even counter-productive.

While the Proposed Rules focus on voting interest limitations and membership on boards of directors and key committees, Sections 727 and 735(B) of the Dodd-Frank Act clearly authorize a broader scope of rulemaking. Limiting the rules implementing these sections to the matters covered by the Proposed Rules ignores long-standing practices that have proven to be highly effective in establishing control and influence over providers of derivatives Market Infrastructure.

In summary, the following additions and changes to the Proposed Rules are necessary:

- Aggregate formal ownership of voting shares by members and Enumerated Entities in clearinghouses must be capped at no more than 25% regardless of the size of individual share ownership.

- Aggregate formal ownership of voting shares by members in a SEF or DCM must be capped no more than 25% regardless of individual share ownership.

- Membership on Boards of Directors of all Market Infrastructure companies must be at least 51% independent directors.

- Membership on the following committees must be at least 51% independent directors:
    - Risk Management Committees of DCOs.
    - Membership Committees of SEFs and DCMs.

- Ownership by Enumerated Parties and members of non-voting equity in Market Infrastructure must be treated the same as voting interests. Given the multiple strategically important means for influencing decision-making by Market Infrastructure providers (direction of volume, influence over membership and risk management committees and others), the formal voting right is not determinative of a conflict of interest.

- Revenue and profit sharing of any type and however denominated by Enumerated Entities and Market Infrastructure providers must be prohibited. These practices are central to the practice of acquiring volume from market makers and other dominant market participants. They reduce competitiveness in the provision of Market Infrastructure. In a market in which trading is so concentrated, the practice opens the door to forced use of Market Infrastructure and undue influence by a narrow group of participants. It allocates the costs inequitably to less influential users and it becomes a breeding ground for anti-competitive practices.

- For similar reasons, fee discounts and rebates of any type and however denominated to Enumerated Entities and others for liquidity and volume must be prohibited.

- Preferential access to Market Infrastructure trade or other data or information of any type and however denominated must also be prohibited. This should include, but not be limited to, direct feeds and co-location of systems.

We hope these comments are helpful.

Sincerely,

Dennis M Kelleher

Dennis M. Kelleher
President & CEO

Wallace C. Turbeville
Derivatives Specialist

Better Markets, Inc.
Suite 307
1225 Eye Street, N.W.
Washington, D.C. 20005
(202) 481-8224
dkelleher@bettermarkets.com
wturbeville@bettermarkets.com

www.bettermarkets.com