November 12, 2010

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

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 29549-1090

Re: Proposed Limits on Ownership or Voting Power of Derivative Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities; RIN 3038-AD01

Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps under Regulation MC; Exchange Act Release 63107

Dear Ms. Murphy and Mr. Stawick:

The Securities Industry and Financial Markets Association ("**SIFMA**")[1] appreciates the opportunity to comment on the Commodity Futures Trading Commission's (the "**CFTC**") and the Securities and Exchange Commission's (the "**SEC**"; the CFTC and the SEC are together referred to as the "**Commissions**") proposed rules regarding conflicts of interest with respect to derivatives clearing organizations ("**DCOs**"), designated contract markets, swap execution facilities, clearing agencies that clear security-based swaps ("**Clearing Agencies**"), security-based swap execution facilities

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

and national securities exchanges that post or make available for trading security-based swaps.[2]

The Commissions' proposals include structural governance requirements and limits on ownership and voting power. Our comments are focused on the proposed limits on ownership and voting power, and more specifically are focused on the proposed limits applicable to DCOs and Clearing Agencies.

I. Introduction

DCOs and Clearing Agencies are intended to reduce systemic risk by acting as highly creditworthy central counterparties that effectively manage the risk of swap transactions. But because they centralize risk, these entities could become significant sources of systemic risk themselves. As such, it is essential that DCOs and Clearing Agencies have robust governance and risk management. At the same time, DCOs and Clearing Agencies also must evolve to meet the needs of the innovative markets they serve. In order to accomplish these goals, DCOs and Clearing Agencies require access to capital and leading-edge risk and product expertise. The most likely sources of both are swap dealers, major swap participants, and the other financial institutions included in the definition of "enumerated entities," which are described in footnote three below.

The Commissions have proposed two alternative limits on the ownership of DCOs and Clearing Agencies. The first would impose a 20% limitation on the voting equity that any single member may own, and a 40% limitation on the voting equity that "enumerated entities"[3] may own in the aggregate, regardless of whether the enumerated entities are members. Alternatively, a DCO or Clearing Agency may choose to adopt a 5% limitation on the voting equity that any individual DCO or Clearing Agency member or enumerated entity may own.[4]

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[2] Proposed Limits on Ownership or Voting Power of Derivative Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities, 75 FR 63732 (Oct. 28, 2010) (the "**CFTC Proposal**"); Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps under Regulation MC, 75 FR 65882 (Oct. 26, 2010) (the "**SEC Proposal**").

[3] "**Enumerated entities**" means (i) a bank holding company with total consolidated assets of $50,000,000,000 or more, (ii) a nonbank financial company supervised by the Board of Governors of the Federal Reserve System, (iii) an affiliate of such bank holding company or nonbank financial company, (iv) a swap dealer, (v) a major swap participant, and (vi) an associated person of a swap dealer or major swap participant.

[4] The SEC's limitation on ownership would apply only to Clearing Agency participants (and their related persons).

As discussed more fully below, the proposed DCO and Clearing Agency ownership limits go beyond what is necessary to effectively mitigate conflicts of interest, and would have the effects of limiting access to necessary capital and stifling innovation. The Commissions' proposals would constitute barriers to entry for new DCOs and Clearing Agencies and thus would limit competition, rather than promote it as directed by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**").[5] We believe the Commissions' concerns regarding conflicts of interest can best be addressed by ensuring that DCOs and Clearing Agencies comply with the core principles enumerated in Dodd-Frank,[6] or, in the case of Clearing Agencies, their statutory equivalent.[7]

II. Discussion

A. It is Important to Mitigate Conflicts of Interest and Establish a Robust Structure for Clearing Swaps

In proposing the DCO ownership limitations, the CFTC stated that it seeks to mitigate the conflicts of interest that a DCO may confront when determining (i) whether a swap contract is capable of being cleared, (ii) the minimum criteria that an entity must meet in order to become a swap clearing member, and (iii) whether a particular entity satisfies such criteria.[8] In its separate proposal, the SEC described similar conflicts.[9] Addressing these conflicts is important to implementing the regulated market structure contemplated by Dodd-Frank because under the legislation swap contracts[10] meeting certain criteria are required to be cleared and swaps that are cleared are required to be traded on an exchange or a swap execution facility.[11] Thus, the ability to determine

[5] *See* Public Law 111-203, 111th Cong., 2d sess. (July 21, 2010) (hereinafter "**Dodd-Frank**"), §§ 726(b) and 765(b).

[6] *Id.* at § 725(c).

[7] The SEC is authorized to adopt rules governing Clearing Agencies under Section 17A of the Securities Exchange Act of 1934 (the "**Exchange Act**"), as amended by Dodd-Frank. *See id*. at § 763(b).

[8] CFTC Proposal at 75 FR 63733.

[9] SEC Proposal at 75 FR 65885.

[10] Please note that in this letter we refer to swaps and security-based swaps collectively as "swaps."

[11] Dodd-Frank §§ 723 and 763.

which contracts they will accept for clearing provides DCOs and Clearing Agencies with significant influence over both clearing and the manner in which a swap contract can be executed.

The CFTC noted in its proposal that certain entities that are active in the over-the-counter ("**OTC**") swap markets earn significant revenues from this line of business and are at risk of experiencing a decrease in this revenue if swap contracts in which they deal were to be cleared with a DCO and executed on a designated contract market or swap execution facility.[12] Thus, the CFTC is concerned that these entities would have an incentive to influence a DCO's decision making with respect to the matters identified above. In essence, the CFTC is seeking to ensure that the profit-seeking interests of certain DCO members do not adversely influence DCO decision making in a way that undermines the intent of Dodd-Frank and increases systemic risk. The SEC makes a similar point in its proposal.[13]

Although we agree with and strongly support the goal of reducing risk, we believe the proposed ownership limits are unduly and unnecessarily restrictive and would be an impediment to achieving the intent of Dodd-Frank to create a robust market structure for the clearing and trading of swaps.

B. Swap Dealers Have Incentives to Clear Their Transactions and the Commissions' Concerns about Conflicts of Interest Are Fully Addressed by the Statutory Requirements Applicable to DCOs and Clearing Agencies

Although swap dealers earn significant revenues that possibly could be decreased to some degree with respect to swap contracts that are required to be cleared and exchange traded, they also realize significant benefits from clearing that create a countervailing incentive to clear their transactions. Clearing reduces individual counterparty risk and systemic risk, and dealers, along with other market participants, benefit from that risk reduction. Moreover, clearing facilitates trade compression (elimination of offsetting transactions) which further reduces dealers' risk exposure. That dealers have an incentive to clear is demonstrated by the fact that even before the Dodd-Frank clearing requirements have been implemented, dealers have been clearing

[12] CFTC Proposal at 75 FR 63735.

[13] SEC Proposal at 75 FR 65887 ("A participant in a security-based swap clearing agency might, however, derive greater revenues from its activities in the OTC market for security-based swaps than it would from sharing in the profits of a security-based swap clearing agency in which it holds a financial interest. As a result, the increased use of central clearing may be contrary to the economic interests of some participants to a security-based swap clearing agency").

a substantial portion of their inter-dealer interest rate swaps. They are not required by any law or regulation to clear these transactions, but do so because of the risk-reduction benefits they realize. To the extent that uncleared swaps will be subject to an incremental capital requirement, the cost of additional capital will be another reason for dealers to clear. Moreover, if clearing and exchange trading provide substantial benefits for swap end users as regulators and legislators intend, market activity could grow substantially and dealers will benefit from that as well.

Not only is it doubtful that dealers have an incentive to avoid clearing, but Dodd-Frank also adds new statutory provisions that address possible conflicts of interest in a manner that will not impair competition in the market for clearing services. Dodd-Frank amends the Commodity Exchange Act (the "**CEA**") to add new core principles applicable to DCOs and Clearing Agencies.[14] In particular, a core principle is added to the CEA that requires DCOs to establish and enforce rules to minimize conflicts of interest in the decision-making process of a DCO, and to establish a process to resolve any such conflicts that may arise. In addition, Dodd-Frank adds or amends core principles regarding risk management and product and participant eligibility, which, among other things, require membership requirements to be objective, publicly disclosed and to require fair and open access. They also require DCOs to establish "appropriate standards for determining the eligibility of agreements, contracts, or transactions . . . for clearing."[15] The SEC has authority to adopt and enforce similar conflicts of interest rules under Section 17A of the Exchange Act, as amended by Dodd-Frank.[16] Complying with these core principles will ensure that the legislative mandate to clear swap transactions is achieved.

C. Aggregate or Extremely Low Limits on Enumerated Entities' DCO and Clearing Agency Ownership Would Stunt the Development of a Robust Market Structure

Swap dealers, in particular, are among the most likely equity investors in new DCOs and Clearing Agencies. There are two reasons for this. First, swap dealers (and their clients) are among the primary beneficiaries from the risk reduction achieved through central clearing. Dealers that are clearing members also are exposed to significant risk (they provide significant amounts of funds and guarantees to back-up DCO and Clearing Agency obligations). Because they benefit from clearing and because they

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[14] *See* Dodd-Frank § 725(c).

[15] *Id*.

[16] *See* Dodd-Frank § 763(b).

are exposed to substantial risk, dealers have a legitimate interest in having a voice in clearing house operations, particularly with regard to risk management. Second, swap dealers have both the capital and expertise needed to establish a DCO or Clearing Agency. Few, if any, others do.

If swap dealers are precluded from having a meaningful ownership interest – individually or in concert – in DCOs and Clearing Agencies, they are less likely to contribute their expertise or investment capital to establishing and operating such an entity. As a result, fewer DCOs and Clearing Agencies will be established and there will be less competition in the provision of efficient clearing services. In fact, we believe this is exactly the result that some proponents of ownership limits intend.

D. Allegations of Anti-Competitive Behavior by Swap Dealers Are Misleading and Incorrect

During congressional action leading up to passage of Dodd-Frank, proposals were made to impose strict limits on swap dealer ownership and control of DCOs and Clearing Agencies. An amendment to impose an aggregate 20% limit on swap dealer ownership was offered by Representative Stephen F. Lynch on the House floor and adopted by a vote of 228 to 202.[17] The Senate version of the bill, however, did not contain that provision and the same is true of the final version of the legislation that was approved by Congress and signed by the president. We believe the Commissions' proposals resurrecting this concept are contrary to the intent of Congress.

One of the principal arguments offered in support of a strict aggregate limit was that a small number of dealers dominate the swap markets[18] and will do so with respect to DCOs and Clearing Agencies if their ownership is not limited. For example, Rep. Lynch has asserted that five banks control "upwards of 95% of the order flow on the existing over the counter derivatives market."[19] This claim, which is repeated in a

[17] 155 Cong. Rec. H14730-H14731 (daily ed. Dec. 10, 2009) (vote on amendment offered by Rep. Lynch). *See also* H.R. Rep. No. 111-370, at 188 (2009) (amendment text).

[18] This contention was made, for example, in a letter from Rep. Lynch to CFTC Chairman Gary Gensler and SEC Chairman Mary Schapiro dated October 18, 2010. Letter from Representative Stephen F. Lynch to Chairman Mary Schapiro, SEC, and Chairman Gary Gensler, CFTC (Oct. 18, 2010), *available at* http://www.sec.gov/comments/s7-27-10/s72710-3.pdf (the "**October 2010 Lynch Letter**").

[19] October 2010 Lynch Letter.

slightly different form in a letter from Representative Michael E. Capuano,[20] as well as in the CFTC's proposal[21] and the SEC's proposal,[22] is misleading and incorrect. These commenters and the Commissions are relying on statistics on U.S. bank swap activity that are published quarterly by the Comptroller of Currency.[23] The statistics do in fact show that five U.S. banks account for more than 95% of the swap business ***conducted by U.S. banks***. But U.S. banks do not make up the entire market. These statistics do not include the activity of non-U.S. banks that are major swap dealers, such as Barclays, BNP Paribas, Credit Suisse, Deutsche Bank, Nomura, RBS, Societe Generale, and UBS, among others. When non-U.S. bank swap dealers are included in aggregate market data, the market share of the five largest U.S.-based swap dealers is only 37%[24] and the market share of the five largest swap dealers overall is 45.6%.[25] Based on the combined market share of the five largest firms, the swap market is less concentrated than the markets of wireless telecoms, web browsers, book publishing, automobile manufacturing, and healthcare insurance, among many others.

The United States Department of Justice, in evaluating antitrust issues, uses the Herfindahl-Hirschman Index ("**HHI**"), a commonly accepted measure of market concentration. The Department of Justice considers a market with an HHI of more than 1,800 to be concentrated, a market with an HHI between 1,000 and 1,800 to be moderately concentrated, and a market with an HHI below 1,000 to not be

[20] Letter from Representative Michael E. Capuano, to Chairman Mary Schapiro, SEC, and Chairman Gary Gensler, CFTC (Oct. 28, 2010) ("It is painfully clear that clearing and trading will be monopolized unless the agencies put stronger collective ownership limits in place.").

[21] CFTC Proposal at 63733, fn. 5 (quoting Rep. Lynch as saying "95 percent of all of the clearinghouses in this country are owned by just five banks").

[22] SEC Proposal at 65887 ("Trading in the OTC derivatives market is currently dominated by a small number of firms").

[23] *See, e.g.*, *id*.

[24] ISDA Market Survey Results (Oct. 25, 2010), *available at* http://www.isda.org/ (follow hyperlink to "ISDA Provides Concentration Statistics on OTC Derivatives Activity and Publishes Mid-Year 2010 Market Survey Results" under "Latest News"). ISDA's market survey also notes that the fourteen largest international dealers represent 82% of the swaps market.

[25] Information provided by ISDA.

concentrated.[26] The HHI for a number of OTC markets is listed below, based on recent data from the Bank for International Settlements.[27]

Product	HHI
USD interest rate swaps	940
OTC FX products	570
OTC equity forwards/swaps	700
OTC equity options	1,500

The markets for swaps and other OTC products, according to the measure preferred by the Department of Justice, are largely not concentrated, and are in fact highly competitive. It would be inappropriate and wrong to conclude from OCC statistics covering only a portion of the market that a small number of dominant players have the intention or ability to dominate and control swap market activity or clearing of swaps.

E. The CFTC and SEC are Not Required to Adopt Rules Mitigating Conflicts of Interest Regarding DCOs

In its proposal the CFTC expresses the view that "the Dodd-Frank Act requires [it] to promulgate rules to mitigate conflicts of interest in the operation of certain DCOs" and other entities.[28] The SEC expresses the same view.[29] We believe the Commissions have considerable discretion in deciding whether to adopt rules in this area and to decide on the form those rules might take. Although sections 726 and 765 of Dodd-Frank begin with a general statement to the effect that the Commissions "shall adopt rules" to mitigate conflicts of interest in connection with DCOs and Clearing Agencies, the legislation further defines the Commissions' duties in this regard. Subsections 726(b) and 765(b) make it clear that the Commissions' duties are ***conditional***, stating that the Commissions "shall adopt rules ***if*** [they determine], after the review described in subsection (a), that such rules are necessary or appropriate".[30] For the reasons outlined above, we do not believe that the proposed strict limits on aggregate

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[26] *See* http://www.justice.gov/atr/public/testimony/hhi htm.

[27] Bank for International Settlements, Detailed tables on semiannual OTC derivatives statistics at end-December 2009, *available at* http://www.bis.org/statistics/derdetailed htm.

[28] CFTC Proposal at 75 FR 63732.

[29] SEC Proposal at 75 FR 65904.

[30] Dodd-Frank §§ 726(b) and 765(b) (emphasis added).

ownership by swap dealers and other enumerated entities meet this test. Concerns expressed by the Commissions regarding conflicts of interest arising from swap dealers' ownership interests in DCOs and Clearing Agencies can be fully addressed by the core principles and other statutory requirements applicable to DCOs and Clearing Agencies. We do not believe there is a sufficient basis for the Commissions to conclude it is necessary to adopt rules that would impose aggregate ownership limits that are substantially similar to those that were proposed by Rep. Lynch – and which he now urges upon the Commissions – but rejected by Congress.

III. Conclusion

In conclusion, we believe the Commissions' proposals would have the unfortunate effect of limiting the availability to DCOs and Clearing Agencies of capital and expertise and limit competition in the market for clearing services. We believe that any concerns about conflicts of interest can be addressed through the core principles for DCOs and statutory requirements applicable to Clearing Agencies. If the Commissions, nevertheless, determine it is necessary and appropriate to impose limits on DCO and Clearing Agency ownership by swap dealers and other enumerated entities, those limits should be substantially higher than the proposed 5% limit and there should be no aggregate limit on ownership by swap dealers and other enumerated entities.

Respectfully yours,

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