Americans for Financial Reform
1825 K St NW, Suite 210, Washington, DC, 20006
202.263.4533

November 16th, 2010

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

Re: CFTC RIN 3038-AD01

Dear Mr. Stawick:

We appreciate the opportunity to comment on the above-captioned rulemakings of the Commodity Futures Trading Commission ("CFTC"), which is intended to implement Section 726 of the Dodd-Frank Financial Services Reform Act (the "Dodd-Frank Act"). This section directs the CFTC (the "Commission") to adopt rules to mitigate conflicts of interest, which may include numerical limits on the control of, or voting rights with respect to, derivatives clearing organizations ("DCOs"), clearing agencies that clear security-based swaps, swap execution facilities, security-based swap execution facilities, derivatives contract markets ("DCMs") that trade swaps, and national securities exchanges that trade security-based swaps.[1]

The rules authorized by Sections 726 may specifically restrict the ownership or voting rights of a bank holding company with total consolidated assets of $50,000,000,000 or more; a nonbank financial company supervised by the Board of Governors of the Federal Reserve System; an affiliate of such a bank holding company or nonbank financial company; a swap dealer; a major swap participant; or an associated person of a swap dealer or major swap participant (the "Enumerated Entities"). The rules adopted by the Commission must include such rules as are necessary or appropriate to improve the governance of, or to mitigate systemic risk, promote competition, or mitigate conflicts of interest, in connection with the conduct of business between swap dealers and major swap participants, and clearinghouses, SEFs, and exchanges.

The CFTC and the SEC should be congratulated for their incisive, and generally comprehensive, analysis of the many conflicts of interest that already exist in the over-the-counter derivatives markets and that can, in the absence of effective regulation, be expected to persist. The Commission correctly identifies the competitively unhealthy oligopoly that dominates the market, and its incentives to use control of market infrastructure to restrict access, limit competition, and thwart the Dodd-Frank Act's

[1] We refer to DCOs and clearing agencies collectively as "clearinghouses," swap execution facilities and security-based swap execution facilities collectively as "SEFs," DCMs that trade swaps and national securities exchanges that trade securities-based swaps collectively as "exchanges," and all such entities collectively as "market infrastructure."

objectives of mitigating systemic risk and promoting competition through greater use of clearing and transparent trading. We believe that the restrictions proposed by the Commission would provide limited benefits, however, and that much more needs to be done to address the risk and the shared self interest of the derivatives oligopoly – referred to by antitrust expert Robert Litan as the "Derivatives Dealers' Club"[2].

Conflicts of Interest in the Over-the-Counter Derivatives Market

The facts about this market that the Commission has placed in the rulemaking record should speak for themselves. The Commission cites Office of the Comptroller of the Currency data attributing 97% of derivatives trading to just five commercial banks, and further highlight the outsized revenues – $22.6 billion in 2009 – received by the banks that trade these instruments.[3] The Commission quotes testimony and cites studies by distinguished academics and knowledgeable market participants who draw some rather inescapable conclusions. The revenues are a function of the wide bid-ask spreads that prevail in this market due to what the SEC calls asymmetrical information, a charitable term for the ability to keep your counterparties in the dark and consistently buy from one at a much higher price than you sell to another. The system worked extremely well for the dealer banks for many years. When the banks' risk management models failed them in the 2008 financial crisis, they ran to the American taxpayer for a bailout, but since then, they have returned to business as usual, earning huge profits while the taxpayers continue to bear the risk of future failures.

The Dodd-Frank Act is supposed to bring real change to this market. Clearinghouses are supposed embrace large portions of the market and impose margin and capital requirements at levels that will safeguard the financial system against default. They are supposed to monitor exposure levels at their members to prevent excessive concentrations of risk. SEFs and exchanges are supposed to bring pre-trade and post-trade transparency and greater efficiency to the market, resulting in lower costs for end-users (who, after all, pay the fees that support billions of dollars in dealer profits). Swap dealers and major participants in the swap markets are supposed to register with the CFTC and SEC, and become subject to business conduct requirements to ensure fair treatment of their customers. All market participants are supposed to provide detailed information to the regulators, to allow them to monitor systemic risk and prevent the dangerous accumulations of risk and interconnectedness that helped to drag the world economy into a "Great Recession," whose devastating effects on American families are still being felt.

But none of this will happen if the incumbent swap dealers and other large market participants are permitted to manage market infrastructure for their own benefit. Once again, the Commission correctly identifies why that is the case. The profitability of operating in an over-the-counter 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. But the Dodd-Frank Act entrusts clearinghouses, SEFs, and exchanges with the duty of determining which swaps must 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, and if no

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[2] 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).

[3] 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).

SEFs or exchanges offer to trade an instrument, it will continue to be traded in dark, inefficient single-dealer markets. Thus, dealers have every incentive to clear and exchange-trade as few contracts as possible, and if they are in control of market infrastructure, they will also have the power to bring about that result.

Dealer hostility to the goals of the Dodd-Frank Act is evident from the fact that prior to the financial crisis, there was literally no exchange trading or clearing of swaps in the U.S. If the dealers had shared the goals of effective risk management and transparency, then the credit default swaps that dragged down AIG might have been backstopped by a clearinghouse, with transparent pricing information available to support accurate margining of the instruments. Instead, when a drop in AIG's creditworthiness brought about margin calls that could not be met, the taxpayers ended up paying off AIG's swap counterparties at 100 cents on the dollar. Because the swap dealers had no interest in prudent risk management through a clearinghouse guarantee fund, the U.S. Treasury became the guarantee fund for this market. It is incumbent upon the Commission to ensure that this scenario never repeats itself, by demanding that everything that can be cleared will be cleared.

As the Commission identifies, conflicts of interest will also exist to the extent that dealer banks can control decisions about access to clearinghouses, SEFs and exchanges. Market participants that are denied direct access must rely upon dealers to provide intermediated access, and the dealers naturally collect hefty fees for providing such access. Direct access would provide additional institutions with the opportunity to compete with the largest incumbents in the market. Moreover, contrary to what some parties have alleged, broadened access to clearing and trading facilities does not pose systemic risks, because smaller institutions will bring positions into the clearinghouse that are commensurate with their size. It is the largest institutions whose default may prove economically devastating, and broadening the pool of members that contribute to the clearinghouse guarantee fund will serve to provide greater assurance of the safety and soundness of the clearinghouse, not less. While some may take comfort in the provisions of the Dodd-Frank Act that require fair access to market infrastructure, we believe that it is better to remove the conflict of interest altogether, rather than waiting for a fair result to emerge from litigation instituted by would-be participants that are forced to challenge exclusionary practices.

In the case of clearing, the Commission also points to lapses in risk management likely to occur if large market participants control clearinghouses. For example, one might expect to find a clearinghouse controlled by large dealer banks demanding that its members control extremely high levels of assets, so as to exclude smaller competitors, but then proceed to require low margin from admitted members, so as to release collateral for their own purposes. The result may be similar to our experience in 2008, where large institutions expected their counterparties to rely on the strength of their balance sheets rather than on posted margin to guarantee performance, until it became clear that the institutions were collapsing. Yet many of these same institutions continue to contend that their risk management expertise is needed in clearinghouse governance.

Finally, the Commission points to the conflicts occasioned when market infrastructure entities are required to regulate members that are also significant owners. This point is also well taken: the Commission's history of enforcement actions against exchanges has predominantly focused on their failure to enforce their rules against prominent members. Examples of these types of violations include 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, 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 on the Nasdaq Stock Market that had a strong voice in its governance. To address these concerns, the SEC has adopted restrictions on voting and ownership of exchanges, such as a 20% limit on ownership by any individual member, which seem to have reduced the prevalence of rule enforcement lapses. It is possible, however, that these regulatory improvements may also be traced to the extent to which exchanges are outsourcing regulatory obligations to the Financial Industry Regulatory Authority ("FINRA"), as an independent and unconflicted third party able to provide market oversight. Certainly, if exchanges failed to enforce rules against members when they were subject to a mutualized ownership structure, where every member had an ownership stake, it is reasonable to expect that similar lapses could occur if an exchange is owned by just five members. Thus, as discussed below, we believe that the SEC's own experiences should direct the Commission to impose more stringent limits than those proposed.

Another area of conflict is swap dealers' ability to direct business to entities that they control and thereby stifle competition. The SEC posits that allowing concentrated dealer ownership of trading facilities may not be problematic because 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 the securities markets. The SEC also notes that low barriers to entry for new trading facilities exist because they are relatively inexpensive to develop. 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, crucial. Because an oligopoly controls trading at present, it is in a position to determine how trading will develop in the new world, unless effective regulation prevents it from doing so. In other words, a SEF or exchange that is 100% owned by five dealers that control 97% of the market will also control the market for transactions. Similarly, if the same dealers join with others to form a utility clearinghouse, it will be impossible for others to compete.

The exercise in market power that we can expect in these markets has been observed elsewhere. 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.[4] The same system has announced plans for similar conduct in the Treasury security market.[5] Similar conduct in the derivatives markets – a Dealerweb for swaps – simply cannot be accepted as the outcome contemplated by Congress when it demanded rules to promote competition and mitigate conflicts of interest.

Solutions

Given the range and seriousness of the conflicts and structural deficiencies, we believe the restrictions should be stronger than those proposed by the Commission. In the case of clearinghouses, the Commission proposes an alternative test. Under the first part of the test, voting control is limited to 20% per stockholder, and limited to 40% in the aggregate for Enumberated Entities. . By themselves, these limits are consistent with the spirit of the Lynch Amendment, which would have placed a 20% limit on the voting interests of the largest of the Enumerated Entities, and which provided the intellectual

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4 "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).

5 "Dealerweb to Take on Icap and BGC in Electronic T-Bill Trading," Finextra (May 28, 2010) (available at http://www.finextra.com/news/fullstory.aspx?newsitemid=21442).

underpinnings for Section 726. Congressman Stephen Lynch and the other supporters of his amendment were the first to recognize the conflicts of interest that the Commission has now also detailed in its rulemaking, and 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 Commission can ensure that the problems present in the dealer market – concentration, anticompetitive conduct, poor risk management – are not extended into market infrastructure, and can thereby increase the likelihood that well-managed market infrastructure can bring about change at the dealer level. To achieve this, however, the limits must, at a minimum ensure that the dealers do not control the market infrastructure.

As the Commission recognizes in the rulemakings, there are various definitions of control, but within the context of the rulemakings themselves, 25% has been recognized as a significant threshold.[6] Accordingly, we would recommend a limit on voting control by Enumerated Entities in the aggregate at the 25% level. However, even such a limit at the 40% level, as proposed, would at least ensure that Enumerated Entities do not control a majority of the voting interests in a clearinghouse. This would provide independent owners, whose interests would lie solely in clearing contracts and maintain the solvency of the clearinghouse, with at least the possibility of directing clearinghouse decision making.

The Commission has, however, proposed an alternative standard that would impose no aggregate limits, as long as no single stockholder (together with its affiliates) owned more than 5%. We are concerned that this alternative will provide an opening for the creation of monopoly clearinghouse. This would be inconsistent with promoting competition, which is one of the stated goals of the rulemakings of Section 726. Thus, we believe that it would be flatly inconsistent with legislative intent to adopt a rule that includes this alternative.

The picture is even worse in the case of SEFs and exchanges, where the proposed rule would allow five dealers to own 100% of a SEF or exchange. Arguably, the competitive landscape in the derivatives markets is so poor that dealer banks should not be permitted to own any interest in a SEF or exchange, since they will inevitably favor the platform in which they own an interest. 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. However, imposing an aggregate limit that prevents dealers from controlling a SEF or exchange will at least 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. If the Commission is to fully realize the goals of the Dodd-Frank Act, however, they will also have to adopt rules to govern market structure and conduct, including rules governing matters such as pre-trade transparency, best execution, disclosure about risks, fees, and other material incentives in connection with a particular transaction, and most importantly, antitrust considerations, in addition to conflict of interest limitations.

We would also recommend that the Commission considers requiring that a majority of independent representatives serve on the boards of directors and key committees of clearinghouses, SEFs, and exchanges. As the SEC recognizes, 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.'" Requiring only that there be 35% independent representation

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6 See SEC Rulemaking at n.93.

would contradict best practices. Only by ensuring that independent directors comprise a majority of the board and key committees can the regulations also ensure that independent, unconflicted decision-makers carry the day when market infrastructure entities face difficult choices.

Finally, there are core issues related to control of market infrastructure that we believe can only be addressed by implementing rules that prohibit SEFs, DCMs and DCOs from creating incentives for market makers to direct deal flow to their institutions. New SEFs, DCMs and DCOs will be competing for volume, which is the key to success among these institutions. Unless the Commission prevents them from doing so, it is likely that they will attract the market makers by giving them non-voting equity, revenue or profit shares or fee discounts. Market makers will want to coalesce because they want access to the broad customer base which will be attracted. This creates an oligopoly of market makers. In some markets, this can be as few as three firms. Once in place, the oligopoly can control decisions by the SEF, DCM or DCO. In order to effectively prevent conflicts of interest and ensure competition, we urge the Commission to prohibit SEFs, DCMs and DCOs from offering market makers incentives such as non-voting equity, revenue or profit shares or fee discounts in exchange in exchange for directing deal flow to their respective platforms.

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Congress has imposed on the CFTC and the SEC the heavily responsibility of adopting regulations that bring meaningful reform to the over-the-counter derivatives markets and help to prevent a repetition of the devastating financial crisis of 2008. While we congratulate the Commission for its thorough analysis of many of the problems associated with this market, we believe that their proposed rules do not fully address those problems. Accordingly, we urge the Commission to follow the direction of Congress by adopting across-the-board, aggregate limits on control of market infrastructure by Enumerated Entities, along with comprehensive requirements for independent majorities on boards of directors and key committees.

Sincerely,

Americans for Financial Reform

Following are the partners of Americans for Financial Reform.

All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.

- A New Way Forward
- AARP
- ACORN
- AFL-CIO
- AFSCME
- Alliance For Justice
- Americans for Democratic Action, Inc
- American Income Life Insurance
- Americans for Fairness in Lending
- Americans United for Change
- Calvert Asset Management Company, Inc.
- Campaign for America's Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
- Center for Justice and Democracy
- Center of Concern
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
- Common Cause
- Communications Workers of America
- Community Development Transportation Lending Services
- Consumer Action
- Consumer Association Council
- Consumers for Auto Safety and Reliability
- Consumer Federation of America
- Consumer Watchdog
- Consumers Union
- Corporation for Enterprise Development
- CREDO Mobile
- CTW Investment Group
- Demos
- Economic Policy Institute
- Essential Action
- Greenlining Institute
- Good Business International
- HNMA Funding Company
- Home Actions
- Housing Counseling Services
- Information Press
- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project

- International Brotherhood of Teamsters
- Institute of Women's Policy Research
- Krull & Company
- Laborers' International Union of North America
- Lake Research Partners
- Lawyers' Committee for Civil Rights Under Law
- Leadership Conference on Civil Rights
- Move On
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National Training and Information Center/National People's Action
- National Council of Women's Organizations
- Next Step
- OMB Watch
- Opportunity Finance Network
- Partners for the Common Good
- PICO
- Progress Now Action
- Progressive States Network
- Poverty and Race Research Action Council
- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer's for Common Sense
- The Association for Housing and Neighborhood Development
- The Fuel Savers Club
- The Seminal
- U.S. Public Interest Research Group
- United Food and Commercial Workers
- United States Student Association
- USAction
- Veris Wealth Partners
- Western States Center
- We the People Now
- Woodstock Institute
- World Privacy Forum
- UNET
- Union Plus
- Unitarian Universalist for a Just Economic Community

Partial list of State and Local Signers

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation (NY)
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG
- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina
- Community Resource Group, Fayetteville A
- Connecticut PIRG
- Consumer Assistance Council
- Cooper Square Committee (NYC)
- Cooperative Fund of New England, Wilmington NC
- Corporacion de Desarrollo Economico de Ceiba, Ceiba PR
- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA
- Empire Justice Center NY
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network
- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers
- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY

- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG
- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- Neighborhood Economic Development Advocacy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG
- New York PIRG
- New York City Aids Housing Network
- NOAH Community Development Fund, Inc., Boston MA
- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis M
- North Carolina PIRG
- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council
- Virginia Poverty Law Center
- War on Poverty - Florida
- WashPIRG
- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG