United States Senate

COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
WASHINGTON, DC 20510-6250

November 17, 2010

VIA EMAIL (dcodcmsefGovernance@cftc.gov)

Mr. David A. Stawick
Secretary
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, D.C. 20581

RE: RIN 3038-AD01: Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest

Dear Mr. Stawick:

The purpose of this letter is to express support for, and recommend enhancements to, the rules proposed to implement Section 726 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Alleviating conflicts of interest is central to the establishment of fair, economically sound, and effective trading and clearing operations which are, in turn, critical to safeguarding the U.S. financial system from risks associated with the multi-trillion-dollar swaps markets. The Commission should take strong measures to ensure that trading and clearing operations operate without the distortions that can result from decision making tainted by conflicts of interest.

BACKGROUND

The severity of the recent financial crisis was due in part to the interconnectedness between financial institutions, and the opacity of those connections,[1] including through over-the-counter (OTC) swaps that were explicitly exempted from federal regulatory oversight.[2]

---

[1] *See, e.g.*, American International Group, House Comm. on Financial Services, 111th Cong. (2010) (statement of Ben S. Bernanke, Chairman of the Federal Reserve Bank Board of Governors).

[2] *See* Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, § 1, 114 Stat. 2763, 2763A-366 (2000) (which explicitly exempted a broad category of products defined as "swaps" from federal oversight). In an attempt to eliminate that exemption, on May 4, 2009, I introduced with Senator Collins the Authorizing the Regulation of

To address this issue, Congress has overhauled federal regulation of derivatives, including by eliminating the prohibition on federal oversight of swaps.[3] Title VII of the Dodd-Frank Act provides a comprehensive new framework for regulating swaps, as well as the derivatives markets generally.

Title VII builds upon the premise that exchange trading and clearing operations are essential elements of financial reform. Its provisions are intended to: (1) increase fairness of trading for market participants by expanding pricing information and trading transparency; (2) reduce risk by ensuring adequate capital and margin requirements for firms that make trades; and (3) combat price manipulation and systemic risk by making trading information available to regulators.

A major concern, however, is that the current environment in which trading and clearing platforms are owned by large financial institutions that are also major dealers may lead to conflicts of interest and distorted decision making that may undermine the benefits of reform. Financial institutions that simultaneously trade swaps and own derivative trading and clearing operations, for example, may have incentives to: (1) limit access to the trading or clearing platforms by other firms in order to retain insider advantages, (2) limit public trading and clearing of some financial products in order to retain asymmetric information advantages and trading profits, and (3) specify artificially low capital and margin requirements in order to keep their trading expenses down. The proposed rules must enact strong safeguards to ensure such conflicts of interest do not endanger or distort the management of derivative trading and clearing operations.

STATUTORY PROTECTIONS AGAINST CONFLICTS OF INTEREST

Title VII of the Dodd-Frank Act requires the Commission to adopt rules limiting conflicts of interest in the operation of Derivatives Clearing Organizations (DCOs), Swap Execution Facilities (SEFs), and Designated Contract Markets (DCMs).[4]

While the Dodd-Frank Act allows these entities to remain subject to private ownership and market competition, it is incumbent upon regulators to ensure that conflicts of interest arising from market pressures do not keep the DCOs, SEFs, and DCMs from objectively performing their duties to manage and mitigate risks—both for individual firms and the financial markets. In other words, to the extent that DCOs, SEFs, and DCMs are entrusted with gatekeeping functions for U.S. derivative markets, the conflict of interest restrictions are essential to prevent the owners of these facilities from exploiting their positions for individual gain at the expense of other market participants and overall economic stability.

Swaps Act, which would have immediately repealed the statutory prohibition on regulating swaps. S. 961, Authorizing the Regulation of Swaps Act, 111th Cong. (2010). Action was not taken on that bill, and the prohibition was instead removed as part of the Dodd-Frank Act.

[3] Dodd-Frank Act, § 722.

[4] Dodd-Frank Act, §§ 725(c), 726, 733, and 735(b).

The proposed rules regarding the ownership and governance of these firms are critical components of the statute's conflict of interest safeguards. If the critical risk-mitigating functions are manipulated by large market participants the reforms of the Dodd-Frank Act will be frustrated.

Given the differing roles that DCOs, SEFs, and DCMs have in the new regulatory framework, the proposed rules for these facilities need to be examined separately.

Conflicts of Interest for DCOs

The relationship between a DCO and its members lays the foundation for effective management of risks. A DCO manages its risks by imposing capital requirements on its members, setting margin and capital requirements on its traders, and managing the guarantee fund. In the event of a default by any trader, the guarantee fund and ultimately the members will be required to bear any loss.

Because of the possibility of shared losses, DCO members are strongly vested in how well the DCO performs its functions. To ensure effective DCO operations, member firms may seek to exercise control over the DCO's decision making process in at least four ways. First, members may help the DCO develop its criteria for membership in the DCO, including capital requirements. Second, members may influence what trades the DCO accepts for clearing (in addition to what trades they may want to send to the DCO). Third, members may assist in the risk-assessment and valuation processes used by the DCO to assess the capital and margins that must be posted for trading positions, as well as help manage the size of the guarantee fund. Fourth, members may help the DCO develop the procedures to be used in cases of default, including how positions and losses may be allocated among the members and the guarantee fund.

The proposed rules would directly impact the amount of influence member firms may exert over the decisions of a DCO in these and other areas.

Membership Restrictions. DCO members may have incentives to keep membership in the DCO exclusive, not only to maximize profits from the DCO's operations, but also due to the benefits that may accrue from a member's insider status. Membership restrictions that advance legitimate concerns, such as ensuring that member firms are able to absorb losses in the event of a default, reduce risk and benefit both the DCO and the marketplace. Membership restrictions based upon improper considerations may lead to skewed rules that intentionally disadvantage particular firms or market participants, leading to market inefficiencies and greater risk.

Clearing Requirements. One of the key substantive decisions made by Congress in the Dodd-Frank Act was to mandate clearing for as many trades as possible. This clearing requirement is intended to remedy a fundamental problem that contributed to the recent crisis—perhaps best illustrated by the collapse of AIG—when firms did not have enough capital available to cover their losses. The statute also, however, created a limited exception allowing a DCO to refuse to clear a trade if it believes that type of trade cannot be adequately covered by the clearinghouse. This limited exception is intended to address the concern that some trades are inherently too risky to clear, and that forcing a DCO to clear such a trade may actually increase rather than reduce risk. This exception is intended to be narrowly construed, given that the vast majority of trades can be cleared using conservative capital and margining requirements.

Some DCO members may have an incentive, however, to pressure their DCOs to reject certain types of trades for clearing, not because they seek to better control the DCO's risks, but to promote their own self interests. Indeed, DCO members may have strong financial incentives for certain trades to not be cleared because the transparency in pricing that would likely result from public trading and clearing may significantly restrict their trading profits.[5] The Commission will need to be vigilant in ensuring that clearable trades are cleared, investigating why clearable trades are being rejected, and taking action to ensure those trades are, in fact, accepted for clearing.[6]

Capital and Margin Requirements. Another key substantive decision made by the Dodd-Frank Act was to favor the imposition of additional capital and margin requirements on dealers for swaps that are not cleared.[7] Members may have a financial incentive to minimize capital and margin requirements in order to minimize their trading expenses. But if members are allowed to pressure the DCO to impose, for example, artificially low margin requirements for clearing, then the potential risk-management gains from the clearing function may be lost, and risks may instead be concentrated. Inadequate capital requirements for members may even endanger the DCO's survival in the event of a major market break. The Commission should reinforce the capital and margin requirements imposed by DCOs for cleared trades by imposing correspondingly higher capital and margin requirements on dealers for trades that are not cleared. These higher capital and margin requirements will not only reduce the risk of default for the trades that are not cleared, but will also create incentives for dealers to support the clearing of more trades.

Governance Standards for DCOs

The proposed requirement that a DCO's Board be comprised of at least 35% "public directors" is a critical measure, as is the proposed requirement that a DCO's Risk Management Committee share a similar representation. Since the DCO's Risk Management Committee is likely to be primarily responsible for deciding which contracts can be cleared, it should be composed of a broad range of parties, including independent actors focused on the public objectives of systemic risk and fairness.

Similarly, the proposal to require at least 10% of the Risk Management Committee to be composed of the DCO's trading customers should help protect against the types of conflicts of interest just described, and should be adopted. Some may argue that because customers do not

---

[5] *See, e.g.*, DARREL DUFFIE ET AL., FED. RESERVE BANK OF NEW YORK, POLICY PERSPECTIVES ON OTC DERIVATIVES MARKET INFRASTRUCTURE, Staff Report No. 424 (2010) ("Thus, from the viewpoint of their profits, dealers may prefer to reduce the migration of derivatives trading from the OTC market to central exchanges.").
[6] See Dodd-Frank Act, § 723.
[7] *See generally*, Dodd-Frank Act, § 731 (amending the Commodities Exchange Act to authorize the Commission to impose additional capital and margin requirements for noncleared swaps).

contribute to the guarantee fund, they may be less concerned with the risk of default. To the contrary, inclusion of customers on the Risk Management Committee is critical to ensuring fair assessments. The 10% requirement is also sufficiently low so as to alleviate concerns of DCO members that their fates may be determined by those with less capital at stake.

The proposed rules would be further strengthened if they were to require each DCO to maintain and operate a Disciplinary Panel apart from the Risk Management Committee. Due to the self-regulatory nature of this panel's functions, the Disciplinary Panel has completely different concerns and functions from the Risk Management Committee, and should be comprised of 100% public directors.

This recommendation would require a change from current industry practice. But the current proposal that any member of a Disciplinary Panel would refrain from participating in the deliberations or voting on a disciplinary matter in which she or another member with which the member knowingly has a financial interest is simply unlikely to work as anticipated. There are simply too many interconnections in the U.S. financial system and too many variables. A Disciplinary Panel member could have business dealings with the target of a disciplinary action, for example, but claim it doesn't have a "financial interest" in the target. A Disciplinary Panel member could also be free of any existing business relationship, but still be influenced by the prospect of future business dealings with the disciplinary target. On the other end of the spectrum, a Disciplinary Panel could seek to overly penalize a competitor. These complex relationship issues support a simpler approach: that all Disciplinary Panels should be comprised of 100% public persons.

Ownership Standards for DCOs

With respect to direct ownership and voting controls, DCO member firms may have strong financial interests in the success of the DCO in managing risks, and may be well equipped to evaluate the financial risks and operational logistics attendant in operating a DCO.[8] But extremely concentrated ownership of a DCO by a handful of members raises serious conflict of interest problems.[9]

To mitigate the conflict of interest problems, the proposal outlines two alternative sets of voting equity ownership restrictions: (1) a single-member limit of 20% combined with an aggregate limit of 40%, or (2) a hard limit of 5% that applies irrespective of whether or not the firm is a DCO member. In addition, upon application by a DCO, the Commission may, for a

[8] *See, e.g.*, Statement of Jeremy Barnum, Managing Director of J.P. Morgan Chase, Commodity Futures Trading Commission and Securities and Exchange Commission Joint Roundtable, Aug. 20, 2010, Roundtable Tr. at 60-61 ("[T]hose are the folks that have the capital to support this innovation and the knowledge and expertise to move it forward."); *see also* Statement of Rick McVey, Chief Executive Officer of Market Axess, Commodity Futures Trading Commission and Securities and Exchange Commission Joint Roundtable, Aug. 20, 2010, Roundtable Tr. at 121-22 ("And rightly or wrongly, historically a tremendous amount of the capital for clearing, e-trading, data and affirmation hugs, has come from the dealer community, and I think it would be very dangerous to cut off an important source of capital that can lead to some of the market improvements that we're all seeking to achieve.").
[9] *See, e.g.*, 156 CONG. REC. H.R. 5217 (2010) (statement of Rep. Stephen Lynch). Indeed, as much as 97% of the swaps market may be controlled by only five banks.

reasonable period of time, grant a waiver from either these restrictions, provided that impositions of the voting rights restrictions in that instance are not necessary or appropriate to improve the governance of the DCO, mitigate systemic risk, promote competition, mitigate conflicts of interest, and otherwise accomplish the purposes of the Act.

Given that current U.S. and global derivative markets are dominated by a handful of large firms, the conflicts of interest that entails, and their potential influence on the DCOs on which they will trade, the proposed rule does not go far enough. First, the restrictions ought to focus not only on equity voting interests, but also on general ownership of the DCO. Some suggest that general ownership interests should be subject to minimal, if any, restrictions, but that voting interest restrictions may be appropriate.[10] However, this analysis fails to recognize that a firm with a significant ownership interest will likely have significant influence over the decision making of the entity, whether or not the firm has actual voting interests.[11]

The proposed rule should be further enhanced by placing a 10% cap on any individual party's voting equity *and* general ownership interests, and then outline how the Commission may grant limited waivers from those restrictions. Further, the Commission should condition any such waiver on a finding that the DCO: (1) complies with best practices in governance standards, and (2) has no single owner (including related persons) with greater than a 20% ownership interest (voting or non-voting) in the DCO. Separately, the Commission's proposed aggregate ownership caps on firms need to be strictly enforced, with no waivers permitted. None of the proposed restrictions on voting equity or general ownership interests should be interpreted as precluding a DCO from soliciting risk management guidance, expertise, and systems from its members.

<u>Protections Against Other Forms of Improper Influence on DCOs</u>

Lastly, the Commission should be mindful that DCO member firms, as well as other firms, may exert influence over a DCO in a number of other ways, including through economic pressures. To the extent that multiple DCOs may compete with one another in a competitive marketplace, and a member firm or non-member firm may control a high percentage of a DCOs trading volume, such firms may put competitive pressures on a DCO by reducing (or threatening to reduce) their trading volumes on the DCO. Those pressures may bias a DCO in any number of ways, including by causing it to alter asset valuations and collateral requirements, assessments for the guarantee fund, or even decisions about which trades it will accept for clearing. To

---

[10] *See, e.g.*, Statement of Hal Scott, Nomura Professor of International Financial Systems and Director of Program on International Financial Systems, Harvard Law School, Commodity Futures Trading Commission and Securities and Exchange Commission Joint Roundtable, Aug. 20, 2010, Roundtable Tr. at 130-131.

[11] *See, e.g.*, Statement of Heather Slavkin, Senior Legal and Policy Advisor of AFL-CIO, Commodity Futures Trading Commission and Securities and Exchange Commission Joint Roundtable, Aug. 20, 2010, Roundtable Tr. at 153 ("I think most of us can imagine a situation where someone owns 5 percent of our company and asks us to do something. I don't think it matters if that person gets to vote for the board of directors, that person has real influence regardless of whether it's formal influence, there is going to be influence over the decision making, there's going to be influence over the strategy and innovation and the trajectory of the institution in general").

prevent this distortion of DCO decisionmaking and the increased risks that may follow, the Commission should explicitly bar such practices.

Conflicts of Interest for SEFs and DCMs

SEFs and DCMs are subject to somewhat different conflicts of interest than DCOs. Because SEFs and DCMs serve similar functions, the Commission's proposal to treat them similarly is appropriate. Further, like DCOs, their member firms may seek to prioritize their commercial interests over other risk and fairness concerns.

Governance Standards for SEFs and DCMs

With respect to Boards and Committee composition controls, because access to a SEF or DCM will likely have significant competitive advantages, it makes sense to require SEFs and DCMs to have at least 35% public directors on the Membership or Participation Committee. This broader membership will address the conflict of interest concerns identified earlier. Similarly, the proposed prohibition against the Membership or Participation Committee restricting access or imposing burdens of access in a discriminatory manner makes sense.

Another aspect of the proposal, which would require a Membership or Participation Committee to reject any staff denial of admission to a firm that meets the relevant application standards, seems to go too far. Staff denials under these circumstances are likely to be rare and may involve special circumstances. For example, there may be applications that technically meet the requirements for admission, but for which the staff reviewer has legitimate grounds for denial. Accordingly, rather than require automatic rejection, a better approach might be to subject the denial to an accelerated review process. If the Membership or Participation Committee upholds the denial, notice and an explanation must be provided to the Commission which can then take further action as warranted.

SEFs and DCMs also have obligations as self-regulatory organizations. It is critically important for SEFs to mimic the DCMs in having a Regulatory Oversight Committee that is comprised of 100% public persons. Regulatory oversight should operate independently from the day-to-day operations of the business, and business considerations should not be allowed to compromise a SEF's or DCM's regulatory obligations.

This argument also holds true with respect to the composition of the required Disciplinary Panels. Rather than just requiring at least one public participant, including the chair, as the proposed rules would, the Commission should require all panel members to be from the public. Indeed, the Commission has already recognized the importance of public participation on these disciplinary bodies.[12] It should expand those benefits to the entirety of the disciplinary bodies, and remove the actual and potential conflicts of interest that arise when firms are asked to discipline their peers and likely future business partners.

---

[12] *See, e.g.*, Conflicts of Interest in Self-Regulation and Self-Regulatory Organizations ("SROs"), 72 Fed. Reg. 6936, 6937 *et seq.* (Feb. 14, 2007) (adopting a final rule regarding DCM core principle 15, which reflected the potential conflicts of interest when a DCM acts as an SRO).

Ownership Standards for SEFs and DCMs

With respect to ownership and voting interest controls, SEFs and DCMs are subject to the same dangers as DCOs that a small oligopoly of firms will dominate their markets to the detriment of other market participants and the public. As with DCOs, the Commission should enhance the proposed rules by providing a 10% cap on voting equity *and* general ownership interests, subject to limited waivers that may be granted by the Commission. The Commission should condition any such waivers on a finding that the SEF or DCM: (1) complies with best practices for governance standards, and (2) has no firm (including related persons) that owns greater than a 20% ownership interest (voting or non-voting) in the SEF or DCM. Separately, the Commission's proposed aggregate ownership caps on firms should be strictly enforced, with no waivers permitted. Again, these restrictions on voting equity and general ownership interests should not be interpreted as precluding a SEF or DCM from soliciting risk management guidance, technical support, and expertise from its members.

Protections Against Other Forms of Improper Influence on SEFs and DCMs

As with DCOs, the Commission should strengthen the SEF and DCM proposed rules by barring firms from exerting improper pressure on the SEF or DCM, irrespective of the member's ownership or voting interests. Like DCOs, SEFs and DCOs may compete with one another for firms with capital, expertise, and high trading volumes. Such firms, whether or not members, may put pressures on a SEF or DCM by, for example, reducing or threatening to reduce their trading volumes. Similarly, these firms could increase the risks to a SEF or DCM by, for example, asking it to price services in a way that disadvantages other market participants. To prevent these risks, the Commission should explicitly bar such practices at SEFs and DCMs.

Conclusion

One of the great lessons of the financial crisis was that firms did not have enough capital on hand to cover their trading losses, forcing taxpayers to pick up the tab to avoid a total economic collapse. These proposed rules that are intended to mitigate the conflicts of interest in DCOs, SEFs, and DCMs will have a significant impact on ensuring that taxpayers are never again forced to bail out firms that cannot cover their bad trades.

Thank you for the opportunity to comment on these proposed rules.

Sincerely,

Carl Levin

Carl Levin
Chairman
Permanent Subcommittee on Investigations