Before the
United States Commodity Futures Trading Commission
Washington, D.C.

IN THE MATTER OF:
RIN 3038-AD01

Comments of the United States
Department of Justice

I. Introduction

The United States Commodity Futures Trading Commission ("CFTC") has requested public comment on a Notice of Proposed Rulemaking entitled Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest. The CFTC published this request in the Federal Register on October 18, 2010.

As the executive branch agency primarily responsible for protecting competition in the nation's markets, the United States Department of Justice ("Department") is pleased to have the opportunity to comment on the proposed conflicts of interest rules. The Department has significant experience in issues relating to the derivatives industry. It has conducted investigations into alleged anticompetitive conduct in the industry and studied the industry as part of its competition advocacy efforts. As a result, the Department has gained substantial knowledge with respect to promoting and maintaining competition in this sector. The Department also has broad experience in analyzing competition issues in the financial markets more generally, including the futures, fixed-income, foreign currency, equities, and options markets. It has conducted investigations and analyzed the likely impact of proposed mergers in these and other financial markets.

The derivatives industry is a critical component of the nation's financial system and of the broader economy. The derivatives markets, by any measure, involve a tremendous amount of capital. The Bank for International Settlements, for example, stated in a recent report that the notional amounts outstanding of over-the-counter derivatives reached $583 trillion at the end of June 2010.[1] Protecting competition in this sector thus is crucially important both for consumers and for the nation's economic health. Indeed, Section 726 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") specifically mentions promoting competition as one of the reasons to promulgate these conflicts of interest rules. The Department therefore strongly approves of the CFTC's efforts to improve governance

[1] Bank for Int'l Settlements, Triennial and Semiannual Surveys: Positions in Global Over-The-Counter (OTC) Derivatives Markets at End-June 2010, at 2 (Nov. 2010), *available at* http://www.bis.org/publ/otc_hy1011.pdf.

practices, reduce systemic risk, and promote competition in the derivatives sector through its proposed rulemaking.

The Department's comments are restricted to certain provisions of the proposed rules: the proposed ownership limits and governance restrictions on Designated Contract Markets ("DCMs") and Swap Execution Facilities ("SEFs") and the proposed governance restrictions on Derivatives Clearing Organizations ("DCOs"). The Department supports the imposition of individual ownership limits on DCMs/SEFs. However, the Department is concerned that because the proposed rule does not include an aggregate ownership cap on major derivatives dealers, preserving the opportunity for these powerful entities to achieve majority ownership of DCMs/SEFs, it may not sufficiently protect and promote competition in the industry. Further, the Department agrees that governance restrictions, in the form of minimum independent director participation requirements for boards of directors and committees, can help safeguard competition in this sector. But the Department believes that even stricter minimum requirements are appropriate to limit the possibility of anticompetitive conduct by DCMs, SEFs, and DCOs.

If modified as described in these comments, the CFTC's rulemaking has the potential to promote competition in several ways. To begin with, limiting aggregate ownership and imposing stringent governance requirements on DCMs/SEFs may prevent the emergence of a dominant trading platform controlled by major dealers to the detriment of other market participants. The creation of such a platform would be roughly analogous to the three or five largest airlines controlling all landing rights at every U.S. airport—the big carriers could use this control to disadvantage smaller carriers by restricting landing rights or raising their rivals' costs to access the airports.

In the derivatives context, participating dealers might use such a platform to exclude rival dealers or other market participants that would otherwise compete for trading volume. A dealer-controlled trading platform also might release less innovative data products or be less transparent than would an independent platform. Further, major dealers might use their control of a dominant trading platform to disadvantage rivals by refusing to trade their products or to continue trading over the counter even in instances where exchange trading is feasible. This latter issue might arise even though the CFTC has considerable authority to mandate central clearing of contracts. To the extent that dealers attempt to elude this authority by refusing to trade certain centrally cleared contracts in order to maintain markets in similar, over-the-counter contracts, aggregate ownership caps on Enumerated Entities and governance restrictions on DCMs/SEFs can serve as a backstop to protect competition.

Appropriate governance and ownership restrictions also might heighten competition among DCMs/SEFs themselves. For example, an aggregate ownership cap might lead to the creation of multiple DCMs/SEFs, each sponsored by a dealer or two, in competition with each other.

Such competition would benefit market participants in several respects: trading fees would likely decline, and price competition would likely be complemented by vigorous innovation, bringing market participants faster execution times and new data products.

Similar competitive benefits would likely flow from the imposition of governance and ownership restrictions on DCOs. Without such restrictions, access to clearing might be restricted by incumbents to limit competition among market makers, and a dealer-controlled DCO might resist clearing certain instruments in an effort to disadvantage rivals. Dealers might use their control over a DCO to resist the move to exchange trading by declining to clear contracts that are well-suited to central clearing but that the CFTC has not yet required to be centrally cleared. As with DCMs/SEFs, governance restrictions could serve as a backstop to the CFTC's authority to require that trades be centrally cleared.

II. The CFTC's Proposed Ownership and Governance Restrictions

The CFTC has proposed different ownership and governance restrictions for DCMs and SEFs on the one hand and DCOs on the other.

A. DCMs & SEFs

The CFTC proposes a 20 percent limitation on the voting equity or voting power that any single member may own or control of a DCM or SEF. However, the DCM/SEF proposal includes no limit on the aggregate voting equity or voting power that "Enumerated Entities" may own or control.[2] As a result, three Enumerated Entities together could own a controlling share of a DCM or SEF, and five Enumerated Entities could own a platform outright.

The CFTC's proposal also would establish governance restrictions on DCMs/SEFs by setting minimum membership requirements for independent directors on their boards of directors and management committees. Specifically, the CFTC would require that at least 35 percent of the members of a DCM/SEF's board of directors and executive and membership committees be independent, that 50 percent of a DCM/SEF's nominating committee and its chairperson be independent, and that 100 percent of a DCM/SEF's regulatory oversight

[2] The proposed rule defines Enumerated Entities as: "(A) A bank holding company (as defined in Section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841)) with total consolidated assets of $50,000,000,000 or more, (B) A nonbank financial company (as defined in Section 102 of the Dodd-Frank Wall Street Reform and Consumer Protection Act) supervised by the Board of Governors of the Federal Reserve System, (C) An Affiliate of such bank holding company or nonbank financial company, (D) A swap dealer (as defined in Section 1a(49) of the Act and any regulations promulgated thereunder), (E) A major swap participant (as defined in Section 1a(33) of the Act and any regulations promulgated thereunder), and (F) An associated person of a swap dealer or major swap participant (as defined in Section 1a(3) of the Act and any regulations promulgated thereunder)."

committee be independent. In addition to the 35 percent minimum, the rule would require that DCM/SEF boards of directors have no fewer than two independent directors.

B. DCOs

The CFTC's proposal offers two alternative ownership arrangements from which DCOs may choose. The first alternative sets a 20 percent limitation on the equity or voting power that any single member may own or control and a 40 percent aggregate limitation on the equity or voting power that Enumerated Entities may jointly own or control. The second alternative sets a 5 percent limitation on the equity or voting power that any DCO member or Enumerated Entity may own or control, but includes no aggregate restrictions on ownership or control by Enumerated Entities.

If a DCO believes that neither of the alternative ownership arrangements is appropriate for its particular situation, it may seek a waiver from the CFTC of the individual and/or aggregate ownership and voting rights limitations for "a reasonable period of time." The CFTC may grant the waiver if it determines that the ownership or voting rights limitations "are not necessary or appropriate" to achieve the purposes of the Dodd-Frank Act. Once granted, the CFTC may, at any time, revoke the waiver.

The CFTC rule also would impose governance restrictions on DCOs similar (but not identical) to those proposed for DCMs/SEFs. The CFTC would require that at least 35 percent of the members of a DCO's board of directors and executive and risk management committees be independent and that 50 percent of a DCO's nominating committee be independent. The rule also would require that a DCO's risk management and nominating committees be chaired by independent directors.

III. Department Recommendations

The Department strongly supports the CFTC's efforts to create meaningful limits on ownership of DCMs, SEFs, and DCOs, as well as its proposed use of governance restrictions as a separate safeguard against conflicts of interest. However, the Department has two significant concerns with the proposed rule. First, the Department is concerned that the proposed ownership limits for DCMs and SEFs, which include individual share thresholds but no aggregate cap on ownership by Enumerated Entities, will not sufficiently reduce the risk that major dealers may control a DCM or SEF to restrict competition among dealers and other market participants. For example, major dealers might use their control of a DCM or SEF to exclude rivals, limit pre- and post-trade transparency, decline to trade certain contracts to disadvantage rivals, or try to evade exchange-trading requirements. In the Department's view, limiting both individual ownership shares and the aggregate shares held by Enumerated Entities would be the most effective structural approach to protecting competition in the derivatives markets. Further, the Department believes that an aggregate ownership cap may encourage some Enumerated Entities to sponsor new, viable DCMs/SEFs, leading to increased competition in this sector. Second, while the Department shares the CFTC's view that governance restrictions can help reduce the risk that DCMs, SEFs, or DCOs are used to stifle competition, the Department believes that these governance restrictions should be more stringent than those the CFTC has proposed.

A. DCM/SEF Ownership Limits

The CFTC's Notice of Proposed Rulemaking explains that the proposed 20 percent cap on individual member ownership of DCMs/SEFs is designed to ensure that no single entity can control a DCM/SEF by "dominating the decision-making process." The Department shares the CFTC's concerns that DCM/SEF members might exercise control over a trading platform to anticompetitively limit access to rival dealers or buy-side firms or to otherwise restrict competition in trading. The CFTC's Notice clearly identifies this risk, noting that conflicts of interest may cause a DCM "to (i) prioritize commercial interests over self-regulatory responsibilities; and (ii) restrict access or impose burdens on access in a discriminatory manner."

In the Department's view, however, it is not sufficient to impose restrictions only on individual ownership or control; an aggregate cap on ownership or control by Enumerated Entities also should be required. This is because the Enumerated Entities as a group likely share very similar incentives to limit access and to otherwise insulate themselves from competition. Accordingly, while the cap on individual ownership will eliminate the chance that a single entity could gain direct control over a DCM/SEF to the detriment of competition, under the CFTC's proposal, there is no barrier to a group of entities—major derivatives dealers, for example—working together to control a DCM/SEF to their combined competitive advantage. In addition to restricting access to competitors, these major dealers might limit the amount of pre- and post-trade transparency the DCM/SEF offers or the trades the platform will accept.

The Department has a great deal of experience analyzing the competitive impact of joint ownership of platforms like DCMs/SEFs and understands the potential for abuse in these situations. The Department believes that allowing three to five large participants in the derivatives sector to control a trading platform would greatly increase the risk that those entities will use their control to block or limit rival dealers' or buy-side firms' access to the platform, to choose not to support trading of instruments sponsored by other market participants, to impose undue burdens on rivals, or otherwise to limit competition in this sector.

One way to understand the issues raised by this scenario is to view this type of joint ownership arrangement as an over-inclusive joint venture. The Department will have concerns with a joint venture if it appears likely to harm competition by increasing incentives to raise price above or reduce output below what would prevail in the absence of the agreement.[3] A joint venture potentially can be problematic if it involves more competitors than necessary to achieve the joint venture's efficiencies. Airline alliances provide a useful example of this concept. The Department provides comments on applications for antitrust immunity submitted by participants in airline alliances to the Department of Transportation ("DOT"). Airline alliances can provide benefits to the public in the form of greater flight and ticketing options, improved access to services like frequent flyer programs, and reduced fares. However, the Department has recommended that certain immunity applications be limited when the public benefits of extending immunity to additional airlines are more than offset by reductions in competition among participants in the alliance. In 2009, the Department described these types of concerns regarding an application to expand Star Alliance.[4] When the DOT approved the application, it carved out certain routes from the grant of antitrust immunity, specifically citing the Department's concerns.[5]

In the current context, if the inclusion of an additional dealer in a DCM/SEF joint venture reduces dealers' incentives to compete with each other but is not necessary to ensure the DCM/SEF's viability, that joint venture may be over-inclusive. Aggregate limits on dealer ownership of DCMs/SEFs should prevent these platforms from including more dealers than is necessary to successfully sponsor a DCM/SEF and thus mitigate the potential for large dealers to use their control of a DCM/SEF to exclude their rivals, reduce transparency, or otherwise undermine competition. In addition, in the Department's experience, structural protections, like aggregate ownership limits, are likely to more effectively safeguard competition and require less oversight than relying solely on ongoing regulatory restrictions.

Further, the Department believes that an aggregate ownership cap on Enumerated Entities may facilitate competition by encouraging the creation of new DCMs/SEFs. If ownership by Enumerated Entities of individual DCMs/SEFs is capped at 40 percent, it is more likely that some Enumerated Entities will decide to sponsor new DCMs/SEFs, which, with this backing, will be able to compete alongside existing platforms. As the CFTC's Notice makes clear, one of the goals of the Dodd-Frank Act is "to create conditions favorable to sustained competition between DCMs and SEFs with respect to the same swap contract." Increased competition among DCMs/SEFs would likely result in lower transaction fees and increased

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[3] *See* U.S. DEPARTMENT OF JUSTICE & FEDERAL TRADE COMMISSION, ANTITRUST GUIDELINES FOR COLLABORATIONS AMONG COMPETITORS § 3.3 (2000), *available at* http://www.ftc.gov/os/2000/04/ftcdojguidelines.pdf.

[4] *See* Comments of the Department of Justice on the Show Cause Order, DOT-OST-2008-0234 (filed June 26, 2009), *available at* http://www.justice.gov/atr/public/comments/247556.htm.

[5] *See* Final Order, DOT-OST-2008-0234-0253 (filed July 10, 2009).

innovation, as has been the case with exchange competition in other financial markets. For example, studies have shown that increased competition among options exchanges in the listing of equity options resulted in lower transaction fees.[6] And, in the Treasury futures market, the entry of the BrokerTec Futures Exchange in 2000 led to a significant shift to electronic trading of Treasury futures contracts, an important innovation.[7] In the absence of an aggregate cap, however, there is a serious risk that the largest Enumerated Entities simply will join the same platform and control it to suit their own best interests.

It could be argued that economies of scale in trading are so pronounced that derivatives markets will best be served by a single trading platform. This claim would seem to be inconsistent with developments in other financial markets—for example, cash equities—where multiple trading platforms have flourished. However, even if economies of scale are pronounced in derivatives trading, competition to become the sole trading platform will benefit all market participants and is much preferred to simply allowing a handful of major dealers to establish a dominant platform that caters to their narrow self-interest.

In sum, an aggregate ownership cap would serve at least two important goals: it would greatly reduce the risk that major derivatives dealers controlling a DCM/SEF could impose anticompetitive access restrictions on competitors or engage in other anticompetitive conduct, and it would encourage Enumerated Entities to sponsor new, viable DCMs/SEFs, increasing competition among trading platforms.

B. Governance Restrictions

i. DCMs/SEFs

In addition to ownership limits, the CFTC's proposed rule would set minimum participation levels for independent directors on DCM/SEF boards of directors and various committees. The proposed minimum requirements are modest: only the nominating and regulatory oversight committees are required to have a majority of independent directors (the regulatory committee must be 100 percent independent). Boards of directors and executive and membership committees have to be only 35 percent independent. Under this arrangement, Enumerated Entities could both control a DCM/SEF's voting equity and, through a majority presence on the board, its management decisions.

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[6] *See, e.g.*, Patrick de Fontnouvelle, Raymond P.H. Fishe, and Jeffrey H. Harris, "The Behavior of Bid-Ask Spreads and Volume in Options Markets during the Competition for Listings in 1999," *Journal of Finance*, 58(6): 2437-2464 (2003); Stewart Mayhew, "Competition, Market Structure, and Bid-Ask Spreads in Stock Option Markets," *Journal of Finance*, 57(2): 931-958 (2002).
[7] *See* Comments of the United States Department of Justice in Response to the Department of the Treasury's Request for Comments on the Regulatory Structure Associated with Financial Institutions 11-12 (Jan. 31, 2008).

The Department believes that a requirement that boards of directors and all committees have a majority of independent directors, and that nominating committees be 100 percent independent, would reduce the risk that DCMs/SEFs will erect anticompetitive access barriers to competitors or otherwise limit competition in this sector. These increased requirements would make the CFTC's proposal consistent with the SEC's proposed conflicts of interest rule for the derivatives markets, which includes these heightened governance restrictions.[8] Consistency between the CFTC's and SEC's conflicts rules may be valuable for market participants who initially offer swaps trading but later expand into security-based swaps trading, as they would be able to do so without reorganizing.

ii. DCOs

The Department's concerns about governance restrictions on DCOs stem from the role that DCOs play in the Dodd-Frank Act framework, as described in Section 723 of the Act. Because the Dodd-Frank Act requires contracts that must be cleared with a DCO to be executed on a DCM or SEF, the CFTC has noted that "a DCO has unprecedented influence over the manner in which a swap contract can be executed." If certain Enumerated Entities have a financial interest in trading swaps on a bilateral basis, rather than on a DCM or SEF, those entities have an incentive to ensure that such swaps are not cleared by a DCO. This conflict of interest could result in a DCO controlled by Enumerated Entities declining to clear certain swaps or not submitting swaps to the CFTC for review to determine if clearing should be required.

The Department also is concerned about ensuring access to DCOs. Allowing Enumerated Entities to control a DCO's operations could result in their restricting access to new clearing members in an effort to insulate themselves from competition in making markets (even though these new members would contribute to the DCO's guarantee fund). These actions against potential new clearing members could be explained away, for example, by expressing risk management-related concerns. Further, a DCO controlled by large dealers could resist clearing certain kinds of instruments in an effort to disadvantage rivals.

In its Notice of Proposed Rulemaking, the CFTC states that it is "seeking to mitigate potential conflicts of interest that may influence a DCO regarding (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." The Notice asks whether "the 35 percent requirement [is] sufficient to ensure that the private, competitive interests of certain DCO members do not capture DCO risk assessments with

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[8] Securities and Exchange Commission, 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 Fed. Reg. 65882 (proposed Oct. 26, 2010) (to be codified at 17 CFR pt. 242).

respect to both products and membership? Or should the Commission increase the required percentage of public directors to 51%?" The Department agrees with the CFTC's framing of these issues and concludes, based on its experience analyzing the competitive issues that can arise when access to a platform is necessary to participate in a market, that DCOs choosing the ownership alternative with no aggregate cap on ownership by Enumerated Entities should be required to have a majority of independent directors on their board.

Similarly, the Department believes that increasing the minimum percentages of public directors required on the nominating, risk management, and executive committees would further reduce the risk that captured committees could serve as a mechanism for attempts to restrict competition among dealers or other market participants. Accordingly, the Department supports increasing the required minimum percentage of independent directors to 100 percent for the nominating committee and to a majority for the risk management and executive committees for DCOs choosing the no aggregate cap option. The Department's proposals match the minimum percentages required by the SEC in its proposed rule for scenarios where there is no cap on aggregate ownership. Specifically, the SEC would require that if a DCO chooses the option which caps individual ownership at 5 percent, but has no aggregate cap, the DCO's board of directors and executive and risk management committees must have a majority of independent directors and its nominating committee must have only independent directors.

IV. Conclusion

The Department shares the CFTC's concerns about the potential for conflicts of interest in ownership and governance of DCMs, SEFs, and DCOs. The Department also generally endorses the CFTC's approach to reducing the risk that these conflicts of interest will harm competition. However, the Department urges the CFTC to enhance its proposed ownership and governance limitations, as described in these comments. The Department believes that an aggregate ownership cap on Enumerated Entities for DCMs and SEFs, along with more stringent minimum requirements for independent director membership on DCM, SEF, and DCO boards of directors and committees, will reduce the likelihood that members of these organizations will be able to control these platforms to limit access or otherwise harm competition in the derivatives sector. The Department also believes that an aggregate ownership cap on DCMs and SEFs will lay the groundwork for the development of new, viable DCMs and SEFs, resulting in increased competition in these markets.

Respectfully submitted,

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December 28, 2010