March 7, 2011

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

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

Dear Mr. Stawick:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned proposed rules (the "Proposed Rules") of the Commodity Futures Trading Commission ("CFTC"), the purpose of which (among other things) are (a) to impose certain substantive requirements on the resolution of conflicts of interest in order to further implement core principles applicable to derivatives clearing organizations ("DCOs), designated contract markets ("DCMs") and swap execution facilities ("SEFs")[2] and (b) to implement core principles for DCOs and DCMs concerning governance fitness standards and the composition of governing bodies, all as required by or pursuant to provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

Introduction

It must never be forgotten that derivatives markets have a history of anti-competitive, self-interested conduct that has only served the interest of the exclusive few at the expense of the many. Moreover, because of this dynamic, the system as a whole becomes riskier. If the Dodd-Frank Act was intended to accomplish anything in this area, it certainly was the eradication of such practices from these markets.

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

[2] DCOs, SEFs and DCMs are collectively referred to herein as "Market Infrastructure Providers".

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The Proposed Rules include a number of requirements which complement the CFTC's prior notice of proposed rulemaking on conflicts of interest (the "Conflicts of Interest NPRM").[3] Better Markets, Inc. submitted a comment letter in response to the Conflicts of Interest NPRM which is attached hereto (the "Conflicts of Interest Comment Letter"). In that comment letter, the history of formal and informal influence of a narrow oligopoly of dealers over the Market Infrastructure Providers is detailed and discussed. We would reemphasize that comment letter.

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

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

For example, Market Infrastructure Providers depend on fee income based on volume. That is the lifeblood of these markets and Market Infrastructure Providers live or die by volume. The extraordinary concentration of trading volume allows a very small group of dealers to determine the success or failure of Market Infrastructure Providers by directing their massive volume of transactions. The potential for anti-competitive advantages in exchange for volume and the increased cost to other market participants and, ultimately, the public are clear. It has also been commonplace for Market Infrastructure Providers to buy volume from dominant dealers by so-called commercial arrangements like revenue or profit sharing, liquidity rebates, or discounts. Again, the unfair access and inherent influence over the Market Infrastructure Providers imposes a substantial cost to the system.

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

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[3] 75 FR 63732 (October 18, 2010).

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

[5] 17 CFR Part 242, page 65887.

Additionally, lower-volume market participants require the liquidity that arises from higher-volume market participants, in particular market makers who wish to establish reliable bid/ask spreads. Thus, smaller market makers are effectively forced into the Market Infrastructure Providers used by the large dealers. This further ensures that only those trading systems and platforms used by a handful of high-volume market participants can survive. What's worse, the cost for use of a Market Infrastructure Provider's system is then allocated disproportionately to those participants with lower volume, who receive no discounts, rebates or revenue sharing benefits.

In many ways, these conflicts and influences are inherent to the derivatives marketplaces and distinguish them from other traded markets. While there are multiple and diverse derivatives markets, trading volume in each of them is highly concentrated. As a result, influence by dealers and other large trading entities over Market Infrastructure Providers has always been extreme. That is why the rules addressing conflicts must be both broad in scope and restrictive in application.

If the rules addressing conflicts of interest are not **sufficiently restrictive** or do not effectively limit the many **indirect methods** of exerting influence, a marketplace characterized by anti-competitive practices will continue. In addition, the transparent, competitive, fair and risk-reducing marketplace required by the Dodd-Frank Act will not be realized. Worse yet, concentrated risk-taking will actually be encouraged as the few participants that benefit from these arrangements work to maximize profits in markets overwhelmingly structured to favor them. Because of the level of risk inherent in derivatives, future failures caused by inevitable risk misjudgments by a few giant players could well be catastrophic. **Systemic risk is diminished by having more participants competing on a truly even playing field, not the other way around.**

Comments

The Proposed Rules provide an excellent and much-needed set of supplements to the Conflicts of Interest NPRM. In particular, the requirements that a DCO reports when its Board of Directors rejects a recommendation of its risk management committee ("RMC")[6] and that a SEF[7] or DCM[8] reports when its Board of Directors rejects a recommendation from its regulatory oversight or membership selection committee are important protections of the independent membership of significant committees as required by the Conflicts of Interest NPRM.

Similarly, the internal regulatory programs required by the Proposed Rules, and specifically the duty to establish and maintain procedures to make fair and non-biased

[6] Proposed Rules, Section 39.25(b).
[7] Proposed Rules, Section 37.19(d).
[8] Proposed Rules, Section 38.851(d).

decisions in the event of a conflict of interest, provide a reasonable firewall against conflicted decision-making.[9]

Annual reporting by regulatory oversight committees will enhance the transparency of the governance of SEFs[10] and DCMs.[11]

Finally, the requirement that DCOs must summarize and publically disclose all decisions ***not*** to offer a category of swaps or futures for clearing, among other key decisions, will greatly enhance the transparency of the process for clearing new products.[12]

Our further comments focus on to the proposal in the Proposed Rules, as explained in the NPRM, of a requirement for customer representation in the governance of DCOs. The CFTC is considering allowing an alternative of 10 percent customer representation on DCO Boards of Directors **or** to the 10 percent customer representation on RMCs, as required in the Conflicts of Interest NPRM.[13] This approach must be altered to (at a minimum) require 10 percent customer representation **on both** the Boards of Directors and RMCs.

RMCs are unique organizations. They control a great number of the key decisions of DCOs, including which contracts are cleared under what terms and membership standards and decisions. Because of the influence and specialized market knowledge of dealer members represented on RMCs, their control on the basic business of DCOs is extraordinarily strong. While they are structurally subordinate to Boards of Directors, the reality is that overruling their decisions is unlikely. On the other hand, Boards of Directors have authority over other key elements of DCO operation. Both are centrally important. ***Given the unique power and independence of RMCs and their susceptibility to influence by dealer members, membership requirements must apply at both levels, and application to either single level is insufficient.***

We advocated in the Conflicts of Interest Comment Letter a majority of independent (including customer) representation on RMCs, as well as on Boards of Directors. We reassert that comment.

Conclusion

The Market Infrastructure Providers are at the center of the market structure envisioned by the Dodd-Frank Act. The Proposed Rules, with the inclusion of the change proposed above, greatly add to the protection of the public from the extraordinary risks posed by conflicts of interest in the derivatives markets.

[9] Proposed Rules, Section 40.9(e).
[10] Proposed Rules, Section 37.19(b)(5).
[11] Proposed Rules, Section 85.851(b)(5).
[12] Proposed Rules, Section 40.9(d)(vii)(B).
[13] Proposed Rules. Section 39.26(b); NPRM at 729.

We hope these comments are helpful in your consideration of the Proposed Rules.

Sincerely,

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