Pierpont SECURITIES

Pierpont DERIVATIVES

24 March 2011

Via Electronic Upload (http:/comments.cftc.gov)

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

**Re:** Proposed Rules under the Commodity Exchange Act, as amended, ("CEA") – **§ 1.71**, *Implementation of Conflicts of Interest Policies and Procedures by Futures Commission Merchants and Introducing Brokers*[1] ("Reg. 1.71"); **§ 23.605**, *Implementation of Conflicts of Interests Policies and Procedures*[2] ("Reg. 23.605"); & **§ 39.12**, *Participant and Product Eligibility*[3] ("Reg. 39.12" and together with Reg. 1.71 and Reg. 23.605, collectively, the "Proposed Releases")

Dear Mr. Stawick,

Pierpont Securities Holdings LLC on behalf of itself and its wholly-owned subsidiaries (including Pierpont Securities LLC, a privately-owned broker-dealer that is registered under the Securities Exchange Act of 1934, as amended, and is a member of the Financial Industry Regulatory Authority, and Pierpont Derivatives LLC ( collectively, "Pierpont")) is pleased to submit comments on the Proposed Releases as the Commodity Futures Trading Commission (the "Commission") establishes the regulatory framework in connection with the Dodd-Frank Wall Street Reform and Consumer Protection Act, particularly §§ 725, 731 and 732 thereof ("Dodd-Frank").

In submitting these comments, Pierpont acknowledges the herculean task with which the Commission has been charged and appreciates the Commission's adherence to certain core and guiding principles found in Dodd-Frank, including fair-and-open access ("all to all"), greater inclusiveness of and more competition among market participants, transparency, liquidity and reduction of systemic risk in the "swaps" market. By way of comparison to other institutions that have commented on the Proposed Releases, Pierpont is a new entrant to the swaps market and provides, it is hoped, another perspective for the Commission's consideration.

By amending the CEA to include the conflicts of interest provisions in §731 and §732, Dodd-Frank recognizes the potential for abusive practices in the trading and clearing of swaps and proposes the establishment of structural and institutional safeguards for any swap dealer ("SD") and major swap participant ("MSP") as well as any futures commission merchant ("FCM") and

[1] 17 CFR Part 1, 75 Fed. Reg. 70152 (Nov. 17, 2010), RIN 3038-AC96.
[2] 17 CFR Part 23, 75 Fed. Reg. 71391 (Nov. 23, 2010) RIN 3038-AC96.
[3] 17 CFR Part 39, 76 Fed. Reg. (Jan. 20, 2011) 3698, RIN 3038-AC98.

introducing broker. Pierpont agrees with the assertion that Reg. 23.605 and Reg. 1.71 should be applied in a consistent manner. More specifically, Pierpont contends that, where an FCM is an affiliate of, or dually registered as, an SD or MSP, the potential for anti-competitive or exclusionary behavior is ripe and that any customer that is itself an SD or MSP and that relies on an unaffiliated FCM to clear its swaps would be materially affected by such anti-competitive or exclusionary behavior.

By allowing large (or so-called "too big to fail") financial institutions to conduct some aspects of their over-the-counter ("OTC") swaps business in pre- Dodd-Frank ways, the new regulatory regime will reinforce the status quo, and the net effect will be a reduction of market access and choices and the hindrance of transparency of pricing and liquidity for swaps. In this regard, Pierpont supports Reg. 23.605 and Reg. 1.71 as drafted, in particular the requirements that no direct or indirect interference or influence be permitted by personnel of an affiliated SD, MSP, FCM or business trading unit on the clearing unit as to (i) whether clearing services will be provided and (ii) how clearing fees will be set. These requirements address two of the more significant "barriers to entry" for any new entrant in the swaps market – *i.e.*, fair access to clearing services and fair and identical pricing for such clearing services for all customers, not just those who enjoy "preferred status". Put plainly, the denial of clearing services to a perceived competitor and the setting of disparate pricing for similar services by large financial institutions, are anti-competitive barriers by design and create an unreasonable restraint of trade not only for any SD or MSP without an FCM to clear its swaps but also for any customer who seeks to diversify its trading partners and to conduct robust pre-trade price discovery.

To lessen the potential for anti-competitive behavior in this respect, informational partitions within any large financial institution between its business trading unit and its clearing unit must be established and maintained as to all personnel, not just supervisory personnel, and the penalties for any breach of such informational partitions must be meaningful. As the Swaps & Derivatives Market Association suggested in its 24 January 2011 letter to the CFTC and Securities and Exchange Commission, clearing units should be physically separated into two groups – a self-clearing unit for purposes of house or affiliate trading and a customer clearing unit. Bolstered by informational partitions, the physical separation of the two clearing units within any large financial institution from one another and from the business trading unit would assuage some concerns around anti-competitive and exclusionary behavior.

While much attention has been paid to large financial institutions and their conduct in the OTC swaps market, the fact remains that such large financial institutions will continue to exert, either directly or through interests in clearing houses and trade associations, too much influence in the cleared swaps market. Put another way, large financial institutions have too much at stake to embrace the core and guiding principles of Dodd- Frank.[4] For example, two of the largest

[4] In the *OCC's Quarterly Report on Bank Trading and Derivatives Activities, Fourth Quarter 2010*, it was noted: "Derivatives activity in the U.S. banking system continues to be dominated by a small group of large financial institutions. Five large commercial banks [*i.e.*, JPMorgan Chase Bank NA, Citibank National

clearing houses, the CME Group and LCH.Clearnet, have set the financial requirements at a level that not only deters direct access to clearing membership but also, as a consequence, gives even greater prominence to any existing FCM that is a clearing member of CME Group or LCH.Clearnet. The CME Rulebook requires that a non-bank interest rate swaps clearing member must "maintain minimum adjusted net capital of $1 billion"[5] and make no less than a $50,000,000 contribution to the CME's IRS Guaranty Fund.[6] LCH.Clearnet sets as a minimum for its SwapClear clearing membership net capital of $5 billion[7] and minimum contribution of £2,000,000 to the SwapClear Fund Amount.[8]

As the OTC swaps market learned after the default of Lehman Brothers in 2008, no amount of capital is a panacea against default, unless such capital is ring-fenced or otherwise legally segregated as to actual liabilities. In fact, it is the pledging of collateral and its management (including equitable initial and variation margin requirements imposed on all professional market participants based on actual risk) that should occupy discussions about clearing membership. Pierpont supports the proposal made in Reg. 39.12 that a derivatives clearing organization ("DCO") not set a minimum capital requirement of more than $50,000,000 for any applicant to become a clearing member; moreover, an argument can be made to scale DCO participation further so that a lesser minimum would be applicable for applicants based on identifiable and objective criteria (*e.g.*, product type, frequency, currency and tenor of the swaps traded and exposures created thereby).

Finally, the swaps risk posed by large financial institutions continues to be systemic and concentrated. Based on publicly available information as of the date of this letter, a comparison of CME Group dealer-clearing firms and LCH.Clearnet SwapClear FCMs illustrates that of the twelve (12) clearing members in each of the CME Group and LCH.Clearnet offerings eleven (11) are the same or affiliates of the eleven overlapping members. The names of most of these eleven clearing members have been repeatedly identified as the largest OTC swap dealers and as those having a stranglehold over the OTC swaps market. A sobering conclusion can be drawn from these facts: while centralized clearing will reduce risk to a significant extent, the swaps risk of "too big to fail" financial institutions will nevertheless remain systemic but now concentrated in a few clearing houses whose governance and efficacy are left to these same large financial institutions.

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Assn, Bank of America NA, Goldman Sachs Bank USA and Wells Fargo Bank NA] represent 96% of the total banking industry notional amounts and 86% of industry net current credit exposure.

[5] CME Group, CME Rulebook, Chapter 8G, Interest Rate Derivative Clearing, Rule 8G04, *IRS Clearing Member Obligations and Qualifications.*

[6] CME Group, CME Rulebook, Chapter 8G, Interest Rate Derivative Clearing, Rule 8G07. *IRS Financial Safeguards and Guaranty Fund Deposit.*

[7] LCH.Clearnet, Clearing House Procedures, Section 1, Clearing Member, Dealer, EquityClear and EDX NCMS (Non-clearing members), § 1.9, *Net Capital Requirements.*

[8] LCH.Clearnet, http://www.lchclearnet.com/membership/ltd/ "Costs".

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On behalf of Pierpont, my colleagues and employees, I thank you for the opportunity to submit comments on the Proposed Releases. Please do not hesitate to contact me should you have any questions or require further information.

Sincerely,

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