August 26, 2011

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

Re: Requirements for Derivatives Clearing Organizations, Designated Contract Markets. And Swap Execution Facilities Regarding Mitigation of Conflicts of Interest

Governance Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities; Additional Requirements Regarding the Mitigation of Conflicts of Interest

(RIN 3038 – AD01)

Dear Mr. Stawick:

Better Markets, Inc.[1] appreciates the opportunity to comment on matters identified in the above-captioned notices of proposed rulemaking ("NOPRs") of the Commodity Futures Trading Commission ("CFTC"), relating to proposed rules (the "Proposed Rules") which are intended, among other things, to mitigate conflicts of interest with respect to derivatives clearing organizations ("DCOs"), swap execution facilities ("SEFs"), and derivatives contract markets ("DCMs"). (DCOS, SEFS and DCMs are collectively referred to herein as "Market Infrastructure Providers".) Section 726 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") specifically, but not exclusively, authorizes rules relating to potential conflicts of interest related to Enumerated Entities.[2]

This letter supplements Better Markets' comment letters with regard to the NOPRs dated November 17, 2010 and March 7, 2011, respectively (the "Comment Letters"). For convenience, copies of the Comment Letters are attached hereto. This letter refers

[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] Enumerated Entities are bank holding companies with total consolidated assets of $50,000,000,000 or more; nonbank financial companies supervised by the Board of Governors of the Federal Reserve System; affiliates of such a bank holding company or nonbank financial company; swap dealers; major swap participants; or associated persons of a swap dealer or major swap participant.

1825 K Street, NW, Suite 1080, Washington, DC 20006 TELEPHONE (1) 202.618-6464 FAX (1) 202.618.6465 WEBSITE bettermarkets.com

specifically to matters discussed with CFTC staff in a meeting at the CFTC's offices on July 29, 2011.

As discussed, the interaction of existing market circumstance raise very serious concerns about how the new market infrastructure will work and whether it will be open, transparent, competitive, and serve the public interest. The issue boils down to whether the new rules will allow the current big bank oligopoly and market power to be replicated in the new markets, which would be inconsistent with the law and increase systemic risk, as demonstrated by the following facts:

- The business of derivatives trading is highly concentrated: the Comptroller of the Currency reports that "[f]ive large commercial banks represent 97% of the total banking industry notional amounts" of derivatives trading.[3] A more recent report of the Comptroller of the Currency finds that these conditions persist today.[4]

- Traders participating in the derivatives markets are divided into two groups: liquidity providers (often referred to as "market-makers") and liquidity takers (often referred to as "price takers"). Price takers are wholly dependent on liquidity providers for access to needed transactions and prices. In the highly concentrated derivatives markets, the number of liquidity providers is few; and, as a consequence, their individual market power is enormous.

- All Market Infrastructure Providers derive revenue from volumetric charges. It is abundantly clear that the use of a DCO, SEF or DCM by one or more liquidity providers compels price takers to use the same services. Therefore, liquidity providers (a very small number of derivatives dealers) each enjoy an embedded high level of influence over Market Infrastructure Providers.

- Especially relating to SEFs and DCMs, there are strong forces favoring oligopolistic behavior by liquidity providers in respect of Market Infrastructure Providers. As each liquidity provider attracts a class of price takers, the pool of price takers available to a single liquidity provider seeking to execute a trading strategy is broadened. The liquidity providers, as a result, are benefited if they act in concert and therefore are incentivized to do so. This behavior has been repeatedly manifested in the past.

The deleterious results of this oligopoly and abuse of market power are seen in many ways. For example, Market Infrastructure Providers routinely provide free service or

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[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).

[4] "The five banks with the most derivatives activity hold 96% of all derivatives, while the largest 25 banks account for nearly 100% of all contracts." OCC's Quarterly Report on Bank Trading and Derivatives Activities, Fourth Quarter 2010" (available at http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq410.pdf)

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or even pay the oligopoly for volume. Another example is revenue sharing arrangements which fundamentally align the interests of the liquidity-providing oligopoly with the Market Infrastructure Provider in opposition to the price takers. In effect, the price takers pay the entire cost of the service and, sometimes, even a "fee" to the oligopoly for the privilege of using the infrastructure service (the "fee" being in the form of increased costs of service to fund Market Infrastructure Provider's payment for liquidity).

Of greater concern are non-cash transfers of value from price takers to the oligopoly. Asymmetrical access to information and/or transaction execution, even if the advantages appear to be very small (measured in micro-seconds sometimes) can provide enormous value to the oligopoly. The source of this transfer of value, which is facilitated by the Market Infrastructure Providers, is no mystery: the price takers (who are quite often businesses that pass this cost on to the public) bear the cost of trading with counterparties who have an advantage.

These practices cause market distortions, anti-completive behavior and systemic risk under the current regulatory regime. It should go without saying that, under the Dodd-Frank Act mandate of SEF/DCM execution and DCO clearing, these practices are intolerable.

Given the enormous market power of the major bank dealers, and their demonstrated propensity to use it to extract profits for the oligopoly by controlling Market Infrastructure Providers:

- ***formal methods of control (ownership interests, board seats, control of committees etc.) must be severely restricted; and***
- ***informal sources of market power must be eliminated.***

In Better Markets' recent meeting with CFTC staff, we related several reports of activities by the large dealer banks in relation to the implementation of Dodd-Frank Act requirements which indicate that they are focused on maintaining and increasing their oligopolistic power over the derivatives markets by controlling the means of trade execution and clearing. Assuming that the reports accurately reflect the facts, this is especially troubling since the oligopoly would be using the Dodd-Frank Act requirements and the implementing regulations to undermine the very purposes of the law and regulations.

The most widely known event is the development of the tri-party clearing annex to the FIA-ISDA form derivatives agreement which would funnel a large part of the over-the-counter market through a few large banks. The CFTC has wisely acted to check this practice in a recent proposed rule.[5]

[5] CFTC Notice of Proposed Rulemaking, Customer Clearing Documentation and Timing of Acceptance for Clearing, 76 FR 47530.

However, there are other similarly problematic activities related to Market Infrastructure Providers which have been reported:

- Prospective SEFs need access to clearing and need to secure it prior to the effective date of Dodd-Frank Act provisions to be available at the same time as their competitors. The oligopoly might be expected to secure advantages for SEFs owned or controlled by them or owned by clearing entities which the oligopoly can influence. This could include placing obstacles in the way of less-favored SEFs by delaying access to APIs, insisting on unreasonable business terms and similar behavior. If reports of such actions are accurate, it is deeply concerning as a continuation of the large bank oligopoly.

- In a multiple SEF/DCM marketplace with mandated clearing, the ability to ascertain clearing credit availability for each counterparty at the time of execution is crucial. Otherwise, there is no assured execution until the clearing process is completed. A central source for this information, at which credit availability can be decremented as trades are executed at multiple venues, is the only solution which allows SEFs not dominated by the oligopoly to compete on equal terms. It is reported that the large dealers are, instead, insisting that credit availability be apportioned by the counterparties, including the process which is set forth under the tri-party annex, described above. The incentive would be to apportion only to large dealers who can provide the greatest liquidity. If accurate, this development could severely impair open and fair access.

- The CFTC's proposed rules on membership address the problem of extraordinary capital requirements for Market Infrastructure Provider membership which bear little or no relevance to risk. They serve instead to restrict membership and the powers over the Market Infrastructure Provider which flow from membership. It has been reported that some Market Infrastructure Providers have moved to align direct capital requirements with the proposed CFTC rules, but imposed large customer usage-related capital requirements which are disproportionate to credit concerns, but serve to limit membership. If accurate, this would constitute a cynical evasion of the CFTC's intent for its proposed rule.

The mandates of the Dodd-Frank Act will be fulfilled and the public will be protected only if trading is anonymous and transparent and if access to Market Infrastructure Providers is equitable. History and commonsense lead inexorably to a single conclusion: this can only be achieved if the oligopolistic control of Market Infrastructure Providers is severely restricted by regulation and enforcement.

The formal and informal oligopolistic means and methods of control simply cannot be viewed as separate phenomena. They are synergistic: adding, reinforcing and solidifying the effectiveness of each other. There will always be new opportunities for informal control, at least until the market concentration of trading activity is eliminated.

However, formal means of control can be more effectively curbed. Because of the characteristics of the derivatives markets, and the behavior of the large dealer banks that is a continuing problem, these formal controls must be strict so as to reinforce other regulation, such as open access requirements. We refer you to the specific proposals set out in the Comment Letters to address these matters.

CONCLUSION

The elimination of conflicts of interest and the formal and informal means and methods of controlling Market Infrastructure Providers are crucial to the reforms mandated by the Dodd-Frank Act. Strong formal limits on share ownership, board seats and committee membership of Enumerated Parties must be adopted in final rules to buttress tight rules on informal practices that perpetuate oligopolistic market power.

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

Sincerely,

Dennis M. Kelleher
President & CEO

Wallace C. Turbeville
Derivatives Specialist

Better Markets, Inc.
1825 K Street, NW
Suite 1080
Washington, DC 20006
(202) 618-6464

dkelleher@bettermarkets.com
wturbeville@bettermarkets.com

www.bettermarkets.com