BETTER MARKETS
TRANSPARENCY · ACCOUNTABILITY · OVERSIGHT

September 30, 2011

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

Re: Customer Clearing Documentation and Timing of Acceptance for Clearing (RIN 3038 – AD51)

Dear Mr. Stawick:

Better Markets, Inc.[1] appreciates the opportunity to comment on matters identified in the above-captioned notice of proposed rulemaking ("NOPR") of the Commodity Futures Trading Commission ("CFTC"), relating to proposed rules (the "Proposed Rules") addressing a customer and a futures commission merchant ("FCM") and the timing of acceptance or rejection of trades for clearing by a derivatives clearing organization ("DCO"), pursuant to and in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") amendments to the Commodity Exchange Act ("CEA").

Introduction

The Proposed Rules are unique among the vast rulemakings undertaken previously under the Dodd-Frank Act. In the Proposed Rules, the CFTC addresses developments in the evolution of market structures to accommodate the Dodd-Frank Act regulatory regime.

Importantly, the NOPR recognizes an even broader issue. The market power of large financial institutions will continue to be a decisive force as the new derivatives trading infrastructure emerges under the Dodd-Frank Act. Such direct and indirect influence over this new infrastructure by these entities is a direct threat to the transparent, fair and prudently managed marketplace envisioned by the Dodd-Frank Act, as Better Markets has detailed previously.[2]

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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 Better Markets Comment Letter, Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding Mitigation of Conflicts of Interest, November 17, 2010

Make no mistake about it: without clear and careful regulation and oversight, these large financial institutions will seek to mold the new trading infrastructure to preserve their control of 96% of the current OTC market.[3] Their current direct and indirect means and methods of control and influence, which enabled them to lock up that 96%, must not be allowed to seep into the new infrastructure.

If there was any doubt of the existence of this danger, the activities which prompted the Proposed Rules demonstrate that it is real and will persist. The derivatives trading business can be immensely profitable in the short run to sophisticated market participants who exercise market power through infrastructure which provides advantages over others. We now know that embedded in these seductive short term private profits are enormous systemic risks that can threaten the entire financial system as well as the viability of the economy as a whole.

The job of the CFTC will not be completed when the rules required by the Dodd-Frank Act are completed and promulgated. Continuing vigilance will be required. The incentives to accrue and exercise market power are so large that market participants will continue to try to tip the marketplace in their favor. Stronger rules which limit direct and indirect influence can help, and Better Markets has offered comments and suggestions intended to achieve this end. [4]

However, it is impossible to anticipate every possible leverage point that the powerful financial institutions will seek to exploit as the marketplace evolves. The activities discussed in the NOPR tell us that the CFTC and others who have the legal and moral responsibility to protect the public's interest must be proactive in anticipating, monitoring and guarding the new market infrastructure.

Importantly, these are not theoretical concerns. There are already a number of concrete, real world examples, some of which Better Markets discussed with the CFTC staff at a meeting on July 29, 2011.[5] At that meeting, we pointed out some worrisome developments regarding the post-Dodd-Frank Act market infrastructure and potential factors which might tilt the playing field. These must be viewed as merely a limited set of early examples which must be addressed by the CFTC, but which will have to remain on

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(available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26475&SearchText=Better%20Markets). Better Markets Comment Letter, Governance Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities; Additional Requirements Regarding the Mitigation of Conflicts of Interest , March 7, 2011 (available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=31090&SearchText=Better%20Markets).

3 "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).

4 See the comment letters referred to in footnote 2, above.

5 We thereafter filed a comment letter which in part summarized that meeting, which is attached hereto and incorporated herein as fully as though set forth in full. (available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=48110&SearchText=Better%20Markets).

watch as financial entities develop more and different ways of using their power and influence to gain advantage over others.

FIA/ISDA Document: Seeking Control and Influence through Documentation

Specifically, the NOPR describes a template document (the "FIA/ISDA Document") published by the Futures Industry Association and the International Swap and Derivatives Association for use by counterparties to over-the-counter swaps intended to be cleared.[6] The FIA/ISDA Document includes annexes, which expressly make an FCM for one of the counterparties a party to the document. The common usage would be that a swap dealer ("SD") and a customer would enter into the agreement and the customer's FCM would be made a party.

The SD would then establish a risk threshold for customer trades with the FCM, beyond which trades would not be permitted. The concept is that the SD would accept the risk that the trade would be broken because the FCM or DCO rejected it after review. As a practical matter, the threshold would constitute a risk "sublimit," restricting trading activity for the customer who could otherwise enter into trades up to the overall risk limit set by the FCM.

Of course, the FCM might be an affiliate of the SD creating potential that the FCM could directly or indirectly force the customer to deal with the trading desk of the FCM's affiliate.

The template was proposed as a way to address the issue raised by multiple trade-matching venues, each generating trades to be cleared at a given DCO. A matched trade might violate independent credit screens appropriately imposed by both the FCM and the DCO. The issue involves the lack of certainty at the point of execution that the transaction will pass the screens and indeed be cleared.

It cannot be denied: unequal access to clearing allows the few to control transaction flows at the expense of the many and at the ultimate peril of the financial system. This is what is really at stake when proposals that appear on their surface to be innocuous (like the FIA/ISDA Document) come from those who are positioned (and positioning themselves) to maximize their profits in the new infrastructure. There is no better way to maximize profits that by controlling that infrastructure, directly or indirectly.

Preventing that must be the top priority of the CFTC.

Summary of Comments

The Proposed Rules address both the appropriateness of the documentation and standards for timing of acceptance or rejection of matched trades by FCMs and DCOs in the context of the FIA/ISDA Document. Documentation standards are imposed which would reduce the potential that the process of clearing of OTC swaps would be a vehicle for large

[6] NOPR 76 FR at page 45731.

dealers to exert market power. The Proposed Rules re-examine and adjust the standards for speedy acceptance of swaps into the clearing process, which was the issue being exploited in the FIA/ISDA Document.

We applaud the CFTC's effort to protect the marketplace from the exercise of market power. However, the Proposed Rules must be expanded to address the next stages in the interfaces between SEFs and DCOs. In summary,

- The Proposed Rules appropriately and effectively address the issues raised by the template document described in the NOPR; and
- The Proposed Rules establishing standards for the process for accepting or rejecting trades constitute a practical solution for access by multiple matching venues to a DCO, given the current state of development of market infrastructure.

However, the CFTC must require that the solution for accessing clearing is implemented so as to provide fair and equitable access to each DCO. And, the Proposed Rules must articulate a direction for the development of market infrastructure which will lead to the most efficient and transparent solution.

Discussion of the Proposed Rules

The Proposed Rules appropriately prohibit customer documentation provisions which impede open access to clearing and execution venues.

The CFTC accurately analyzes the FIA/ISDA Document and its implication for the marketplace. If the over-the-counter clearing apparatus is to eliminate the market power that the large financial institutions have exerted in the past, customer clearing documents **must be prohibited** from having *any of* the attributes cited by the Proposed Rules:

- Disclosure of the identity of the customer's counterparty to an FCM, SD or major swap participant;
- Limitations on the number of counterparties with whom a customer may enter into a trade;
- Restrict the size of a position a customer may take with an individual counterparty (other than the FCM);
- Impair the customer's access to trade execution on terms that have a reasonable relationship to the best terms available; or
- Prevent compliance with specific timeframes for acceptance of trades into clearing.

While the FIA/ISDA Document purported to solve the problem of allocation of credit capacity in an environment of multiple execution venues, it opportunistically sought to do

so in a way that allows SDs to become the gatekeeper and force trading activity through their desks. This is a perfect example of how some are trying to use the rules to enable them to control the infrastructure of the new markets for their own narrow advantage.

It does not matter that the use of the FIA/ISDA Document is optional (as pointed out in the NOPR). First, any use of such a legal arrangement is inconsistent with the open access principle. That principle cannot be undercut even with the consent of a given customer; to do so impairs the value of the market to all other market participants. Moreover, the concept of "optional" is often meaningless when there are gross disparities of market power among the entities involved, which will inevitably be the case here.

Put another way, the history of the derivatives markets demonstrates that the large SDs will use their market power to influence customers to use the FIA/ISDA Document. Customers need access to SDs and, inevitably, the SDs will force the use of trading structures that favor them, maximize their profits and cement their power and control. Such matters are never a negotiation between equals. Therefore the prohibitions in the Proposed Rules are essential.

Time Frames for Acceptance into Clearing

The NOPR acknowledges that minimizing the time between trade execution and acceptance into clearing is an important risk mitigant for the market.[7] An earlier proposed rule had required that DCOs accept all transactions executed on a DCM or a SEF immediately.[8] If this standard were applicable, the ostensible motivation behind the FIA/ISDA Document would have been very weak.

However, as described in the NOPR several market participants expressed concern about that standard for acceptance or rejection.[9] The common theme of the **stated** objections is the need for DCOs and FCMs to screen proposed transactions for compliance with certain requirements: the transaction must be measured against available credit limits; certain classes of transactions, specifically block trades, require specific screens; and some DCOs express concern with off-market transactions.

While the NOPR properly acknowledges these assertions, it fails to analyze them fully. The key fact is that the information underlying all of the screens is under the control of the DCO or FCM. Further, the pertinent screens are not complex or difficult. For example, they involve comparing one number against another (for instance the risk

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7 NOPR, 76 FR at page 45732.

8 CFTC Notice of Proposed Rulemaking, Requirements for Processing, Clearing and Transfer of Customer Positions, March 10, 2011, 76 FR 13101.

9 *See* letter from Craig S. Donohue, Chief Executive Officer, CME Group, dated April 11, 2011; letter from R. Trabue Bland, Vice President and Assistant General Counsel, ICE, dated April 11, 2011; letter from Iona J. Levine, Group General Counsel and Managing Director, LCH.Clearnet, dated April 11, 2011; letter from William H. Navin, Executive Vice President and General Counsel, Options Clearing Corporation, dated April 11, 2011; letter from John M. Damgard, President, Futures Industry Association, dated April 14, 2011.

associated with a matched trade against available credit) or an objective calculation (a trade which constitutes a block trade).

The central issue is that there are multiple DCMs and SEFs with access to a DCO or FCM. The Proposed Rules establish a standard for acceptance/rejection: "as quickly as would be technologically practicable if fully automated systems were used."[10] The problem is that the timeframe has no meaning unless a systems framework is mandated which identifies the basic structure. "Fully automated systems" can only be understood in the context of a basic plan for how the systems are to be built and operate.

Fully Automated Systems. The only rational approach is that the DCOs and FCMs must make available an automated screening system that can be accessed by multiple SEFs and DCMs simultaneously. There are several reasons:

- The DCOs and FCMs have access to their own standards.
- Only the DCOs and FCMs have access to the current consumption of credit and other limits.
- Only a system which decrements available limits as each trade is executed (or increases limits for flattening trades) allows predictable results in a multiple DCM/SEF environment. Therefore, the system must be constructed and maintained by the DCO or FCM.

The alternative approach in which the trade execution venue applies screening standards pulled from the DCO or FCM would be chaotic and inefficient. Under such an approach, the concept of "as quickly as would be technologically practicable if fully automated systems were used" would have a completely different meaning.

Therefore the automated systems which are appropriately used as the standard must be

- provided by the DCO or FCM,
- capable of receiving and processing trade data from multiple sources in real time,
- able to screen against standards such as price levels and block trade sizes as a threshold matter, and
- able to decrement (or increase) available credit real time.

In addition, notification of acceptance or rejection must be pushed out by the DCO or FCM. A requirement that the execution venue retrieve acceptances or rejections would embed a lag time as the retrieval protocols would necessarily be periodic. Once acceptance or rejection is known, the push-out must be automatic.

[10] Proposed Rules, Sections 1.74(a), 23.610(a) and (b) and 39.12(b)(7).

It may be practically necessary that the concept of a fully automated system must evolve over time. It may be necessary for the final version of the Proposed Rules to require that DCOs and FCMs adopt a plan for meeting the general system parameters over a reasonable period of time. *However, the standards described in the next succeeding paragraphs relating to equal access must be effective immediately since the initial period of implementation of the Dodd-Frank Act regulatory regime will be critical to the establishment of an open and fair trading environment.*

Equal Access. Even more important than the absolute capabilities of a trade acceptance or rejection system is the need that its utility to all DCMs and SEFs be equal. As the troubling circumstances surrounding the FIA/ISDA Document starkly illustrate, enormous profits are at stake when the control of derivatives transaction flows are involved.

It cannot be denied: unequal access to clearing allows the few to control transaction flows at the expense of the many and at the ultimate peril of the financial system. This is what is really at stake when proposals that appear on their surface to be innocuous (like the FIA/ISDA Document) come from those who are positioned (and positioning themselves) to maximize their profits in the new infrastructure. There is no better way to maximize profits that by controlling that infrastructure, directly or indirectly.

If any entity can influence the reliability or speed of access to clearing, it can and will wield tremendous power. The market structure based on multiple trade execution venues involves many opportunities to exercise power over trade flow, which must not be allowed or reform will be defeated and our financial system will be put at grave risk - again.

The only way to prevent this is to ensure that the final rules provide that all systems allow fair and equal access. Systems provided by a DCO or FCM must be completely open and require no special capabilities on the part of the trade execution venue. Once data is input to the system, it must function strictly on a first come, first served basis using a reliable and common time stamping regime, ***regardless of any affiliation or contractual relationship between the trading venue and the DCO or FCM***. Impediments, such as unreasonable interconnection requirements, must be prohibited.

At the opposite end of the process, confirmation of acceptance or rejection must not only be rapid and initiated by the DCO or FCM, it must be even handed. Different lag times would greatly impair the potential for success of the trade execution venues for which the process is slower.

Only if access is open and fair, in every way, will the trading venues be free from the influence and control of the DCOs and the major financial institutions which are the source of their profitability. Undoubtedly, their goal is nothing less than to replicate their control

of 96% of the current OTC market[11] in the new infrastructure. Their current direct and indirect means and methods of control and influence, which enabled them to lock up that 96%, must not be allowed to seep into the new infrastructure. That is what is at stake in these Proposed Rules.

Conclusion

The Proposed Rules are unique in that they address a newly emerging form of market power and influence. In addition, they importantly address the fundamental issue of clearing access in a market structure based on multiple execution venues. As these issues are confronted, the questions of real-world access and fairness must be at the forefront.

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

Sincerely,

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[11] "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.)