United States Senate

COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS

WASHINGTON, DC 20510–6250

December 20, 2010

VIA EMAIL (rule-comments@sec.gov)

Ms. Elizabeth M. Murphy
Secretary
Office of the Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

**RE: File Number S7–27–10: 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**

Dear Ms. Murphy:

The purpose of this letter is to express support for, and recommend enhancements to, the rules proposed to implement Section 765 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Alleviating conflicts of interest is central to the establishment of fair, economically sound, and effective trading and clearing operations which are, in turn, critical to safeguarding the U.S. financial system from risks associated with the multi-trillion-dollar swaps markets. The Commission should take strong measures to ensure that trading and clearing operations operate without the distortions that can result from decision making tainted by conflicts of interest.

This letter is substantially the same as my letter to the Commodity Futures Trading Commission in response to its proposal to implement similar conflict of interest provisions. Additionally, attached please find a recent article with a useful discussion of these very issues, including how the small number of firms that currently dominate the derivatives market now appear to be dominating the clearing firms as well, with attendant conflicts of interest.[1]

[1] Louise Story, *A Secretive Banking Elite Rules Trading in Derivatives*, N.Y. TIMES, Dec. 11, 2010, at A1.

## BACKGROUND

The severity of the recent financial crisis was due in part to the interconnectedness between financial institutions, and the opacity of those connections,[2] including through over-the-counter (OTC) swaps that were explicitly exempted from federal regulatory oversight.[3]

To address this issue, Congress has overhauled federal regulation of derivatives, including by eliminating the prohibition on federal oversight of security-based swaps.[4] Title VII of the Dodd-Frank Act provides a comprehensive new framework for regulating swaps, as well as the derivatives markets generally.

Title VII builds upon the premise that exchange trading and clearing operations are essential elements of financial reform. Its provisions are intended to: (1) increase fairness of trading for market participants by expanding pricing information and trading transparency; (2) reduce risk by ensuring adequate capital and margin requirements for firms that make trades; and (3) combat price manipulation and systemic risk by making trading information available to regulators.

A major concern, however, is that the current environment in which trading and clearing platforms are owned by large financial institutions that are also major dealers may lead to conflicts of interest and distorted decision making that may undermine the benefits of reform. Financial institutions that simultaneously trade swaps and own derivative trading and clearing operations, for example, may have incentives to: (1) limit access to the trading or clearing platforms by other firms in order to retain insider advantages, (2) limit public trading and clearing of some financial products in order to retain asymmetric information advantages and trading profits, and (3) specify artificially low capital and margin requirements in order to keep their trading expenses down. The proposed rules must enact strong safeguards to ensure such conflicts of interest do not endanger or distort the management of derivative trading and clearing operations.

## STATUTORY PROTECTIONS AGAINST CONFLICTS OF INTEREST

Title VII of the Dodd-Frank Act requires the Commission to adopt rules limiting conflicts of interest in the operation of security-based swap clearing agencies ("SBS CAs"), security-

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[2] *See, e.g.*, American International Group, House Comm. on Financial Services, 111th Cong. (2010) (statement of Ben S. Bernanke, Chairman of the Federal Reserve Bank Board of Governors).

[3] *See* Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, § 1, 114 Stat. 2763, 2763A-366 (2000) (which explicitly exempted a broad category of products defined as "swaps" from federal oversight). In an attempt to eliminate that exemption, on May 4, 2009, I introduced with Senator Collins the Authorizing the Regulation of Swaps Act, which would have immediately repealed the statutory prohibition on regulating swaps. S. 961, Authorizing the Regulation of Swaps Act, 111th Cong. (2010). Action was not taken on that bill, and the prohibition was instead removed as part of the Dodd-Frank Act.

[4] Dodd-Frank Act, § 762.

based swap execution facilities ("SB SEFs"), and securities exchanges that post or make available for trading security-based swaps ("SBS exchanges").[5]

While the Dodd-Frank Act allows these entities to remain subject to private ownership and market competition, it is incumbent upon regulators to ensure that conflicts of interest arising from market pressures do not keep these intermediaries from objectively performing their duties to manage and mitigate risks—both to individual firms and to the financial markets. In other words, to the extent that SBS CAs, SB SEFs and SBS exchanges are entrusted with gate-keeping functions, the conflict of interest restrictions are essential to prevent the owners of these facilities from exploiting their positions for individual gain at the expense of other market participants and overall economic stability.

The proposed rules regarding the ownership and governance of these firms are critical components of the statute's conflict of interest safeguards. If the critical risk-mitigating functions are manipulated by large market participants the reforms of the Dodd-Frank Act will be frustrated.

Given the differing roles that these entities have in the new regulatory framework, the proposed rules for these facilities need to be examined separately.

**Conflicts of Interest for SBS CAs**

The relationship between a SBS CA and its members lays the foundation for effective management of risks. A SBS CA manages its risks by imposing capital requirements on its members, setting margin and capital requirements on its traders, and managing the guarantee fund. In the event of a default by any trader, the guarantee fund and ultimately the members will be required to bear any loss.

Because of the possibility of shared losses, SBS CA members are strongly vested in how well the SBS CA performs its functions. To ensure effective SBS CA operations, member firms may seek to exercise control over the SBS CA's decision making process in at least four ways. First, members may help the SBS CA develop its criteria for membership in the SBS CA, including capital requirements. Second, members may influence what trades the SBS CA accepts for clearing (in addition to what trades they may want to send to the SBS CA). Third, members may assist in the risk-assessment and valuation processes used by the SBS CA to assess the capital and margins that must be posted for trading positions, as well as help manage the size of the guarantee fund. Fourth, members may help the SBS CA develop the procedures to be used in cases of default, including how positions and losses may be allocated among the members and the guarantee fund.

The proposed rules would directly impact the amount of influence member firms may exert over the decisions of a SBS CA in these and other areas.

[5] Dodd-Frank Act, § 765.

**Access Restrictions.** SBS CA members may have incentives to keep membership in the SBS CA exclusive, not only to maximize profits from the SBS CA's operations, but also due to the benefits that may accrue from a member's insider status. Membership restrictions that advance legitimate concerns, such as ensuring that member firms are able to absorb losses in the event of a default, reduce risk and benefit both the SBS CA and the marketplace. Access restrictions, whether direct (based on membership) or indirect (based on corresponding relationships), that are based upon improper considerations may lead to skewed rules that intentionally disadvantage particular firms or market participants, leading to market inefficiencies and greater risk.

**Clearing Requirements.** One of the key substantive decisions made by Congress in the Dodd-Frank Act was to mandate clearing for as many trades as possible. This clearing requirement is intended to remedy a fundamental problem that contributed to the recent crisis—perhaps best illustrated by the collapse of AIG—when firms did not have enough capital available to cover their losses. The statute also, however, created a limited exception allowing a SBS CA to refuse to clear a trade if it believes that type of trade cannot be adequately covered by the clearinghouse. This limited exception is intended to address the concern that some trades are inherently too risky to clear, and that forcing a SBS CA to clear such a trade may actually increase rather than reduce risk. This exception is intended to be narrowly construed, given that the vast majority of trades can be cleared using conservative capital and margining requirements.

Some SBS CA participants may have an incentive, however, to pressure their SBS CAs to reject certain types of trades for clearing, not because they seek to better control the SBS CA's risks, but to promote their own self interests. Indeed, SBS CA participants may have strong financial incentives for certain trades to not be cleared because the transparency in pricing that would likely result from public trading and clearing may significantly restrict their trading profits.[6] The Commission will need to be vigilant in ensuring that clearable trades are cleared, investigating why clearable trades are being rejected, and taking action to ensure those trades are, in fact, accepted for clearing.

**Capital and Margin Requirements.** Another key substantive decision made by the Dodd-Frank Act was to favor the imposition of additional capital and margin requirements on dealers for swaps that are not cleared.[7] Participants may have a financial incentive to minimize capital and margin requirements in order to minimize their trading expenses. But if participants are allowed to pressure the SBS CA to impose, for example, artificially low margin requirements for clearing, then the potential risk-management gains from the clearing function may be lost, and risks may instead be concentrated. Inadequate capital requirements for participants may even endanger the SBS CA's survival in the event of a major market break. The Commission should reinforce the capital and margin requirements imposed by SBS CAs for cleared trades by imposing correspondingly higher capital and margin requirements on dealers for trades that are not cleared. These higher capital and margin requirements will not only reduce the risk of

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[6] *See, e.g.*, DARREL DUFFIE ET AL., FED. RESERVE BANK OF NEW YORK, POLICY PERSPECTIVES ON OTC DERIVATIVES MARKET INFRASTRUCTURE, Staff Report No. 424 (2010) ("Thus, from the viewpoint of their profits, dealers may prefer to reduce the migration of derivatives trading from the OTC market to central exchanges.").

[7] *See generally*, Dodd-Frank Act, § 764.

default for the trades that are not cleared, but will also create incentives for dealers to support the clearing of more trades.

**Ownership and Governance Standards for SBS CAs**

With respect to direct ownership and voting controls, SBS CA participants may have strong financial interests in the success of the SBS CA in managing risks, and may be well equipped to evaluate the financial risks and operational logistics attendant in operating a SBS CA.[8] But extremely concentrated ownership of a SBS CA by a handful of participants raises serious conflict of interest problems.[9]

To mitigate the conflict of interest problems, the proposed Rule 701 outlines two alternative sets of voting equity ownership restrictions: (1) a Voting Interest Focus Alternative, and (2) a Governance Focus Alternative. While the Governance Focus Alternative presents the better of the two approaches, both would benefit from strengthening measures.

As an initial matter, neither the Voting Interest Focus Alternative nor the Governance Focus Alternative is broad enough. Given that current U.S. and global derivative markets are dominated by a handful of large firms with the resulting conflicts of interest that entails, the restrictions ought to focus not only on equity voting interests, but also on general ownership of the SBS CA. Some suggest that general ownership interests should be subject to minimal, if any, restrictions, while voting interest restrictions may be appropriate.[10] However, this analysis fails to recognize that a firm with a significant ownership interest will likely have significant influence over the decision making of the entity, whether or not the firm has actual voting interests.[11] The proposed rules should be enhanced by focusing on both ownership and voting interests.

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[8] *See, e.g.*, Statement of Jeremy Barnum, Managing Director of J.P. Morgan Chase, Commodity Futures Trading Commission and Securities and Exchange Commission Joint Roundtable, Aug. 20, 2010, Roundtable Tr. at 60-61 ("[T]hose are the folks that have the capital to support this innovation and the knowledge and expertise to move it forward."); *see also* Statement of Rick McVey, Chief Executive Officer of Market Axess, Commodity Futures Trading Commission and Securities and Exchange Commission Joint Roundtable, Aug. 20, 2010, Roundtable Tr. at 121-22 ("And rightly or wrongly, historically a tremendous amount of the capital for clearing, e-trading, data and affirmation hugs, has come from the dealer community, and I think it would be very dangerous to cut off an important source of capital that can lead to some of the market improvements that we're all seeking to achieve.").

[9] *See, e.g.*, 156 CONG. REC. H.R. 5217 (2010) (statement of Rep. Stephen Lynch). Indeed, as much as 97% of the swaps market may be controlled by only five banks.

[10] *See, e.g.*, Statement of Hal Scott, Nomura Professor of International Financial Systems and Director of Program on International Financial Systems, Harvard Law School, Commodity Futures Trading Commission and Securities and Exchange Commission Joint Roundtable, Aug. 20, 2010, Roundtable Tr. at 130-131.

[11] *See, e.g.*, Statement of Heather Slavkin, Senior Legal and Policy Advisor of AFL-CIO, Commodity Futures Trading Commission and Securities and Exchange Commission Joint Roundtable, Aug. 20, 2010, Roundtable Tr. at 153 ("I think most of us can imagine a situation where someone owns 5 percent of our company and asks us to do something. I don't think it matters if that person gets to vote for the board of directors, that person has real influence regardless of whether it's formal influence, there is going to be influence over the decision making, there's going to be influence over the strategy and innovation and the trajectory of the institution in general").

The Voting Interest Focus Alternative caps an individual voting interest by ostensibly capping ownership of any voting class of securities at 20% and by also capping at 20% the amount any individual voting interest may vote (through proxy or otherwise). Ownership interests that are "solely because such participant is a member of a group within the meaning of Section 13(d)(3)" would not count towards the cap, unless the owner can direct a vote of the ownership interests. This individual voting interest cap would be combined with an aggregate limit of 40%, so as to ensure the purposes of the cap are not undermined by having a small handful of firms effectively control the SBS CA, such as having 5 firms each own 20%. While the SEC has not applied these restrictions to clearing agencies before, it has similar restrictions on existing exchanges, and it should have similar restrictions on SB SEFs and SBS exchanges.

The Governance Focus Alternative, by contrast, would impose a 5% individual participant cap on voting ownership interests, but includes no aggregated cap. The Commission suggests in its request for comment that a SBS CA that operates as a "quasi-utility" may benefit participants and the securities markets generally because it will likely seek to minimize its costs, and not maximize profits.

With respect to the proposed Voting Interest Focus Alternative, it could be enhanced by placing a 10% cap on any individual party's voting equity *and* general ownership interests, and then outline how the Commission may grant limited waivers from those restrictions. Further, the Commission should condition any such waiver on a finding that the SBS CA: (1) complies with best practices in governance standards, and (2) has no single owner (including related persons) with greater than a 20% ownership interest (voting or non-voting) in the SBS CA. Separately, the Commission's proposed aggregate ownership caps on firms would need to be strictly enforced, with no waivers permitted. None of the proposed restrictions on voting equity or general ownership interests should be interpreted as precluding a SBS CA from soliciting risk management guidance, expertise, and systems from its members.

The requirement in the Voting Interest Focus Alternative that a SBS CA's board be comprised of at least 35% "independent directors" is critical to its effectiveness, as is the proposed requirement that the SBS CA's Risk Committee share a similar representation. Without this 35% requirement, both the board and the Risk Committee would be dominated by a small group of banks, raising numerous conflicts of interest. In addition, since the SBS CA's Risk Committee is likely to be primarily responsible for deciding which contracts can be cleared, it should be composed of a broad range of parties, including independent actors focused on the public objectives of systemic risk and fairness.

With respect to the Governance Focus Alternative, given the increased role of participants, it must require the board of the SBS CA, and any committees that it empowers, be comprised of at least a majority of independent directors.

Under either alternative, the Commission should require at least 10% of the SBS CA's Risk Committee to be composed of the SBS CA's trading customers. Some may argue that because customers do not contribute to the guarantee fund, they may be less concerned with the risk of default. To the contrary, inclusion of customers on the Risk Committee is critical to

ensuring fair assessments. The 10% requirement is also sufficiently low so as to alleviate concerns of SBS CA participants that their fates may be determined by those with less capital at stake.

The Commission should further enhance the proposed rules by applying the independent director limitations on any advisory committee, even if it is purely advisory and does not directly exercise powers of the Board. Advisory committees are likely to be heavily relied upon by others when making determinations. Indeed, if an advisory committee determines that a product should not be cleared or a potential participant not accepted, a committee empowered to effect those determinations, even if comprised of independent directors, would likely be under heavy pressured to follow that advisory committee's determination. To guard against improper influences in the advisory committee's functioning, the Commission should extend its independence requirement to them.

In addition, the proposed rules should be enhanced by requiring the Disciplinary Panels to be comprised of 100% independent members. To allocate the selection of Disciplinary Panels fairly, its membership could be selected by a combination of the participants and their trading customers. One way to do this would be to allocate at least 10% of its membership to unaffiliated trading customers, and then allocate the remaining membership on the Disciplinary Panel to be selected by each class of participants in the SBS CA in proportion to their contributions to the guarantee fund and average daily posted margin. This would give the customers of the SBS CA a hand in disciplining the firms which may be alleged to be harming them. At the same time, it would maintain the traditional role of having an informed, educated Disciplinary Panel of similarly situated individuals, while not giving rise to the potential conflicts of interest that may plague their efficacy and fairness.

This recommendation would require a change from current industry practice. But the current proposal that a Disciplinary Panel have just members from each class of participants is not enough. First, it is unclear what the proportionality requirement relates to: ownership interests, dollars of transactions, numbers of transactions, dollars in margin, or something else. Further, while Disciplinary Panel members would presumably refrain from participating in the deliberations or voting on a disciplinary matter in which she or another member with which the member knowingly has a financial interest, there are simply too many interconnections in the U.S. financial system and too many variables to make that work. A Disciplinary Panel member could have ancillary business dealings with the target of a disciplinary action, for example, but claim it doesn't have a "financial interest" in the target. A Disciplinary Panel member could also be free of any existing business relationship, but still be influenced by the prospect of future business dealings with the disciplinary target. On the other end of the spectrum, a Disciplinary Panel could seek to overly penalize a competitor. These complex relationship issues support a simpler approach: that all Disciplinary Panels should be comprised of 100% independent persons.

**Protections Against Other Forms of Improper Influence on SBS CAs**

Lastly, the Commission should be mindful that SBS CA participant firms, as well as other firms, may exert influence over a SBS CA in a number of other ways, including through economic pressures. To the extent that multiple SBS CAs may compete with one another in the marketplace, and a participant firm or non-participant firm may control a high percentage of a SBS CAs trading volume, such firms may put competitive pressure on a SBS CA by reducing (or threatening to reduce) their trading volumes on the SBS CA. Those pressures may bias a SBS CA in any number of ways, including by causing it to alter asset valuations and collateral requirements, assessments for the guarantee fund, or even decisions about which trades it will accept for clearing. To prevent this distortion of SBS CA decision-making and the increased risks that may follow, the Commission should explicitly bar such practices.

**Conflicts of Interest for SB SEFs and SBS exchanges**

SB SEFs and SBS exchanges are subject to somewhat different conflicts of interest than SBS CAs. Because SB SEFs and SBS exchanges serve similar functions, the Commission's proposal to treat them similarly is appropriate. Further, like SBS CAs, their participants or member firms may seek to prioritize their commercial interests over other risk and fairness concerns.

**Ownership and Governance Standards for SB SEFs and SBS Exchanges**

With respect to ownership and voting interest controls, SB SEFs and SBS exchanges are subject to the same dangers as SBS CAs that a small oligopoly of firms will dominate their markets to the detriment of other market participants and the public. As with SBS CAs, the Commission should enhance the proposed rules by providing a 10% cap on voting equity *and* general ownership interests, subject to limited waivers that may be granted by the Commission. This 10% threshold for voting and general ownership interests would provide more protection from than the current general cap of 20% of voting interests imposed on the national exchanges.

The Commission should condition any such waivers on a finding that the SB SEF or SBS exchange: (1) complies with best practices for governance standards, and (2) has no firm (including related persons) that owns greater than a 20% ownership interest (voting or non-voting) in the SB SEF or SBS exchange. Further, the Commission should adopt an aggregated 40% cap, analogous to the cap provided for in the SBS CA proposal. Again, these restrictions on voting equity and general ownership interests should not be interpreted as precluding a SB SEF or SBS exchange from soliciting risk management guidance, technical support, and expertise from its members.

With respect to Boards and Committee composition, because access to a SB SEF or SBS exchange will likely have significant competitive advantages, it makes sense to require them to be generally comprised of a majority of independent directors. Despite this general requirement,

SB SEFs and SBS exchanges should have a heightened standard for their Regulatory Oversight Committees. For the Regulator Oversight Committees, it is critically important for SB SEFs and SBS exchanges to mimic the DCMs and SEFs with 100% independent directors. Regulatory oversight should operate independently from the day-to-day operations of the business, and business considerations should not be allowed to compromise a SB SEF's or SBS exchange's regulatory obligations. That broad regulatory oversight role should be performed at the director level, and, given its expansive responsibilities, it should be comprised of those with independent judgment. Nominating Committees should also be comprised of 100% independent directors.

Lastly, the proposed rules should be enhanced by requiring Disciplinary Panels to be comprised of 100% independent members. To allocate the selection of Disciplinary Panels fairly, its membership could be selected by a combination of the participants and their trading customers. One way to do this would be to allocate at least 10% of its membership to unaffiliated trading customers, and then allocate the remaining membership on the Disciplinary Panel to be selected by each class of participants in the SBS CA in proportion to their ownership interest or average daily trading volumes. This would give the customers of the SBS CA a hand in disciplining the firms which may be alleged to be harming them. At the same time, it would maintain the traditional role of having an informed, educated Disciplinary Panels of similarly situated individuals, while not giving rise to the potential conflicts of interest that may plague their efficacy and fairness.

This argument also holds true with respect to the composition of the required Disciplinary Panels. Rather than just requiring at least one public participant, as the proposed rules would, the Commission should require all panel members to be from the public. Indeed, the Commission has already recognized the importance of public participation on these disciplinary bodies. It should expand those benefits to the entirety of the disciplinary bodies, and remove the actual and potential conflicts of interest that arise when firms are asked to discipline their peers and likely future business partners.

**Protections Against Other Forms of Improper Influence on SEFs and DCMs**

As with SBS CAs, the Commission should strengthen the proposed rules for SB SEF and SBS exchanges by barring firms from exerting improper pressure on a SB SEF or SBS exchange, irrespective of the member's ownership or voting interests. Like SBS CAs, SB SEFs and SBS exchanges may compete with one another for firms with capital, expertise, and high trading volumes. Such firms, whether or not members, may put pressures on a SB SEF or SBS exchange by, for example, reducing or threatening to reduce their trading volumes. Similarly, these firms could increase the risks to a SB SEF or SBS exchange by, for example, asking it to price services in a way that disadvantages other market participants. To prevent these risks, the Commission should explicitly bar such practices.

## CONCLUSION

One of the great lessons of the financial crisis was that firms did not have enough capital on hand to cover their trading losses, forcing taxpayers to pick up the tab to avoid a total economic collapse. These proposed rules that are intended to mitigate the conflicts of interest in SBS CAs, SB SEFs, and SBS exchanges will have a significant impact on ensuring that taxpayers are never again forced to bail out firms that cannot cover their bad trades.

Thank you for the opportunity to comment on these proposed rules.

Sincerely,

Carl Levin
Chairman
Permanent Subcommittee on Investigations

December 11, 2010

# A Secretive Banking Elite Rules Trading in Derivatives

By LOUISE STORY

On the third Wednesday of every month, the nine members of an elite Wall Street society gather in Midtown Manhattan.

The men share a common goal: to protect the interests of big banks in the vast market for derivatives, one of the most profitable — and controversial — fields in finance. They also share a common secret: The details of their meetings, even their identities, have been strictly confidential.

Drawn from giants like JPMorgan Chase, Goldman Sachs and Morgan Stanley, the bankers form a powerful committee that helps oversee trading in derivatives, instruments which, like insurance, are used to hedge risk.

In theory, this group exists to safeguard the integrity of the multitrillion-dollar market. In practice, it also defends the dominance of the big banks.

The banks in this group, which is affiliated with a new derivatives clearinghouse, have fought to block other banks from entering the market, and they are also trying to thwart efforts to make full information on prices and fees freely available.

Banks' influence over this market, and over clearinghouses like the one this select group advises, has costly implications for businesses large and small, like Dan Singer's home heating-oil company in Westchester County, north of New York City.

This fall, many of Mr. Singer's customers purchased fixed-rate plans to lock in winter heating oil at around $3 a gallon. While that price was above the prevailing $2.80 a gallon then, the contracts will protect homeowners if bitterly cold weather pushes the price higher.

But Mr. Singer wonders if his company, Robison Oil, should be getting a better deal. He uses derivatives like swaps and options to create his fixed plans. But he has no idea how much

lower his prices — and his customers' prices — could be, he says, because banks don't disclose fees associated with the derivatives.

"At the end of the day, I don't know if I got a fair price, or what they're charging me," Mr. Singer said.

Derivatives shift risk from one party to another, and they offer many benefits, like enabling Mr. Singer to sell his fixed plans without having to bear all the risk that oil prices could suddenly rise. Derivatives are also big business on Wall Street. Banks collect many billions of dollars annually in undisclosed fees associated with these instruments — an amount that almost certainly would be lower if there were more competition and transparent prices.

Just how much derivatives trading costs ordinary Americans is uncertain. The size and reach of this market has grown rapidly over the past two decades. Pension funds today use derivatives to hedge investments. States and cities use them to try to hold down borrowing costs. Airlines use them to secure steady fuel prices. Food companies use them to lock in prices of commodities like wheat or beef.

The marketplace as it functions now "adds up to higher costs to all Americans," said Gary Gensler, the chairman of the Commodity Futures Trading Commission, which regulates most derivatives. More oversight of the banks in this market is needed, he said.

But big banks influence the rules governing derivatives through a variety of industry groups. The banks' latest point of influence are clearinghouses like ICE Trust, which holds the monthly meetings with the nine bankers in New York.

Under the Dodd-Frank financial overhaul, many derivatives will be traded via such clearinghouses. Mr. Gensler wants to lessen banks' control over these new institutions. But Republican lawmakers, many of whom received large campaign contributions from bankers who want to influence how the derivatives rules are written, say they plan to push back against much of the coming reform. On Thursday, the commission canceled a vote over a proposal to make prices more transparent, raising speculation that Mr. Gensler did not have enough support from his fellow commissioners.

The Department of Justice is looking into derivatives, too. The department's antitrust unit is actively investigating "the possibility of anticompetitive practices in the credit derivatives clearing, trading and information services industries," according to a department spokeswoman.

Indeed, the derivatives market today reminds some experts of the Nasdaq stock market in the 1990s. Back then, the Justice Department discovered that Nasdaq market makers were secretly colluding to protect their own profits. Following that scandal, reforms and electronic trading systems cut Nasdaq stock trading costs to 1/20th of their former level — an enormous savings for investors.

"When you limit participation in the governance of an entity to a few like-minded institutions or individuals who have an interest in keeping competitors out, you have the potential for bad things to happen. It's antitrust 101," said Robert E. Litan, who helped oversee the Justice Department's Nasdaq investigation as deputy assistant attorney general and is now a fellow at the Kauffman Foundation. "The history of derivatives trading is it has grown up as a very concentrated industry, and old habits are hard to break."

Representatives from the nine banks that dominate the market declined to comment on the Department of Justice investigation.

Clearing involves keeping track of trades and providing a central repository for money backing those wagers. A spokeswoman for Deutsche Bank, which is among the most influential of the group, said this system will reduce the risks in the market. She said that Deutsche is focused on ensuring this process is put in place without disrupting the marketplace.

The Deutsche spokeswoman also said the banks' role in this process has been a success, saying in a statement that the effort "is one of the best examples of public-private partnerships."

**Established, But Can't Get In**

The Bank of New York Mellon's origins go back to 1784, when it was founded by Alexander Hamilton. Today, it provides administrative services on more than $23 trillion of institutional money.

Recently, the bank has been seeking to enter the inner circle of the derivatives market, but so far, it has been rebuffed.

Bank of New York officials say they have been thwarted by competitors who control important committees at the new clearinghouses, which were set up in the wake of the financial crisis.

Bank of New York Mellon has been trying to become a so-called clearing member since early this year. But three of the four main clearinghouses told the bank that its derivatives

operation has too little capital, and thus potentially poses too much risk to the overall market.

The bank dismisses that explanation as absurd. "We are not a nobody," said Sanjay Kannambadi, chief executive of BNY Mellon Clearing, a subsidiary created to get into the business. "But we don't qualify. We certainly think that's kind of crazy."

The real reason the bank is being shut out, he said, is that rivals want to preserve their profit margins, and they are the ones who helped write the membership rules.

Mr. Kannambadi said Bank of New York's clients asked it to enter the derivatives business because they believe they are being charged too much by big banks. Its entry could lower fees. Others that have yet to gain full entry to the derivatives trading club are the State Street Corporation, and small brokerage firms like MF Global and Newedge.

The criteria seem arbitrary, said Marcus Katz, a senior vice president at Newedge, which is owned by two big French banks.

"It appears that the membership criteria were set so that a certain group of market participants could meet that, and everyone else would have to jump through hoops," Mr. Katz said.

The one new derivatives clearinghouse that has welcomed Newedge, Bank of New York and the others — Nasdaq — has been avoided by the big derivatives banks.

### Only the Insiders Know

How did big banks come to have such influence that they can decide who can compete with them?

Ironically, this development grew in part out of worries during the height of the financial crisis in 2008. A major concern during the meltdown was that no one — not even government regulators — fully understood the size and interconnections of the derivatives market, especially the market in credit default swaps, which insure against defaults of companies or mortgages bonds. The panic led to the need to bail out the American International Group, for instance, which had C.D.S. contracts with many large banks.

In the midst of the turmoil, regulators ordered banks to speed up plans — long in the making — to set up a clearinghouse to handle derivatives trading. The intent was to reduce risk and increase stability in the market.

Two established exchanges that trade commodities and futures, the InterContinentalExchange, or ICE, and the Chicago Mercantile Exchange, set up clearinghouses, and, so did Nasdaq.

Each of these new clearinghouses had to persuade big banks to join their efforts, and they doled out membership on their risk committees, which is where trading rules are written, as an incentive.

None of the three clearinghouses would divulge the members of their risk committees when asked by a reporter. But two people with direct knowledge of ICE's committee said the bank members are: Thomas J. Benison of JPMorgan Chase & Company; James J. Hill of Morgan Stanley; Athanassios Diplas of Deutsche Bank; Paul Hamill of UBS; Paul Mitrokostas of Barclays; Andy Hubbard of Credit Suisse; Oliver Frankel of Goldman Sachs; Ali Balali of Bank of America; and Biswarup Chatterjee of Citigroup.

Through representatives, these bankers declined to discuss the committee or the derivatives market. Some of the spokesmen noted that the bankers have expertise that helps the clearinghouse.

Many of these same people hold influential positions at other clearinghouses, or on committees at the powerful International Swaps and Derivatives Association, which helps govern the market.

Critics have called these banks the "derivatives dealers club," and they warn that the club is unlikely to give up ground easily.

"The revenue these dealers make on derivatives is very large and so the incentive they have to protect those revenues is extremely large," said Darrell Duffie, a professor at the Graduate School of Business at Stanford University, who studied the derivatives market earlier this year with Federal Reserve researchers. "It will be hard for the dealers to keep their market share if everybody who can prove their creditworthiness is allowed into the clearinghouses. So they are making arguments that others shouldn't be allowed in."

Perhaps no business in finance is as profitable today as derivatives. Not making loans. Not offering credit cards. Not advising on mergers and acquisitions. Not managing money for the wealthy.

The precise amount that banks make trading derivatives isn't known, but there is anecdotal evidence of their profitability. Former bank traders who spoke on condition of anonymity because of confidentiality agreements with their former employers said their banks typically

earned $25,000 for providing $25 million of insurance against the risk that a corporation might default on its debt via the swaps market. These traders turn over millions of dollars in these trades every day, and credit default swaps are just one of many kinds of derivatives.

The secrecy surrounding derivatives trading is a key factor enabling banks to make such large profits.

If an investor trades shares of Google or Coca-Cola or any other company on a stock exchange, the price — and the commission, or fee — are known. Electronic trading has made this information available to anyone with a computer, while also increasing competition — and sharply lowering the cost of trading. Even corporate bonds have become more transparent recently. Trading costs dropped there almost immediately after prices became more visible in 2002.

Not so with derivatives. For many, there is no central exchange, like the New York Stock Exchange or Nasdaq, where the prices of derivatives are listed. Instead, when a company or an investor wants to buy a derivative contract for, say, oil or wheat or securitized mortgages, an order is placed with a trader at a bank. The trader matches that order with someone selling the same type of derivative.

Banks explain that many derivatives trades have to work this way because they are often customized, unlike shares of stock. One share of Google is the same as any other. But the terms of an oil derivatives contract can vary greatly.

And the profits on most derivatives are masked. In most cases, buyers are told only what they have to pay for the derivative contract, say $25 million. That amount is more than the seller gets, but how much more — $5,000, $25,000 or $50,000 more — is unknown. That's because the seller also is told only the amount he will receive. The difference between the two is the bank's fee and profit. So, the bigger the difference, the better for the bank — and the worse for the customers.

It would be like a real estate agent selling a house, but the buyer knowing only what he paid and the seller knowing only what he received. The agent would pocket the difference as his fee, rather than disclose it. Moreover, only the real estate agent — and neither buyer nor seller — would have easy access to the prices paid recently for other homes on the same block.

**An Electronic Exchange?**

Two years ago, Kenneth C. Griffin, owner of the giant hedge fund Citadel Group, which is based in Chicago, proposed open pricing for commonly traded derivatives, by quoting their prices electronically. Citadel oversees $11 billion in assets, so saving even a few percentage points in costs on each trade could add up to tens or even hundreds of millions of dollars a year.

But Mr. Griffin's proposal for an electronic exchange quickly ran into opposition, and what happened is a window into how banks have fiercely fought competition and open pricing. To get a transparent exchange going, Citadel offered the use of its technological prowess for a joint venture with the Chicago Mercantile Exchange, which is best-known as a trading outpost for contracts on commodities like coffee and cotton. The goal was to set up a clearinghouse as well as an electronic trading system that would display prices for credit default swaps.

Big banks that handle most derivatives trades, including Citadel's, didn't like Citadel's idea. Electronic trading might connect customers directly with each other, cutting out the banks as middlemen.

So the banks responded in the fall of 2008 by pairing with ICE, one of the Chicago Mercantile Exchange's rivals, which was setting up its own clearinghouse. The banks attached a number of conditions on that partnership, which came in the form of a merger between ICE's clearinghouse and a nascent clearinghouse that the banks were establishing. These conditions gave the banks significant power at ICE's clearinghouse, according to two people with knowledge of the deal. For instance, the banks insisted that ICE install the chief executive of their effort as the head of the joint effort. That executive, Dirk Pruis, left after about a year and now works at Goldman Sachs. Through a spokesman, he declined to comment.

The banks also refused to allow the deal with ICE to close until the clearinghouse's rulebook was established, with provisions in the banks' favor. Key among those were the membership rules, which required members to hold large amounts of capital in derivatives units, a condition that was prohibitive even for some large banks like the Bank of New York.

The banks also required ICE to provide market data exclusively to Markit, a little-known company that plays a pivotal role in derivatives. Backed by Goldman, JPMorgan and several other banks, Markit provides crucial information about derivatives, like prices.

Kevin Gould, who is the president of Markit and was involved in the clearinghouse merger, said the banks were simply being prudent and wanted rules that protected the market and themselves.

"The one thing I know the banks are concerned about is their risk capital," he said. "You really are going to get some comfort that the way the entity operates isn't going to put you at undue risk."

Even though the banks were working with ICE, Citadel and the C.M.E. continued to move forward with their exchange. They, too, needed to work with Markit, because it owns the rights to certain derivatives indexes. But Markit put them in a tough spot by basically insisting that every trade involve at least one bank, since the banks are the main parties that have licenses with Markit.

This demand from Markit effectively secured a permanent role for the big derivatives banks since Citadel and the C.M.E. could not move forward without Markit's agreement. And so, essentially boxed in, they agreed to the terms, according to the two people with knowledge of the matter. (A spokesman for C.M.E. said last week that the exchange did not cave to Markit's terms.)

Still, even after that deal was complete, the Chicago Mercantile Exchange soon had second thoughts about working with Citadel and about introducing electronic screens at all. The C.M.E. backed out of the deal in mid-2009, ending Mr. Griffin's dream of a new, electronic trading system.

With Citadel out of the picture, the banks agreed to join the Chicago Mercantile Exchange's clearinghouse effort. The exchange set up a risk committee that, like ICE's committee, was mainly populated by bankers.

It remains unclear why the C.M.E. ended its electronic trading initiative. Two people with knowledge of the Chicago Mercantile Exchange's clearinghouse said the banks refused to get involved unless the exchange dropped Citadel and the entire plan for electronic trading.

Kim Taylor, the president of Chicago Mercantile Exchange's clearing division, said "the market" simply wasn't interested in Mr. Griffin's idea.

Critics now say the banks have an edge because they have had early control of the new clearinghouses' risk committees. Ms. Taylor at the Chicago Mercantile Exchange said the people on those committees are supposed to look out for the interest of the broad market, rather than their own narrow interests. She likened the banks' role to that of Washington lawmakers who look out for the interests of the nation, not just their constituencies.

"It's not like the sort of representation where if I'm elected to be the representative from the state of Illinois, I go there to represent the state of Illinois," Ms. Taylor said in an interview.

Officials at ICE, meantime, said they solicit views from customers through a committee that is separate from the bank-dominated risk committee.

"We spent and we still continue to spend a lot of time on thinking about governance," said Peter Barsoom, the chief operating officer of ICE Trust. "We want to be sure that we have all the right stakeholders appropriately represented."

Mr. Griffin said last week that customers have so far paid the price for not yet having electronic trading. He puts the toll, by a rough estimate, in the tens of billions of dollars, saying that electronic trading would remove much of this "economic rent the dealers enjoy from a market that is so opaque."

"It's a stunning amount of money," Mr. Griffin said. "The key players today in the derivatives market are very apprehensive about whether or not they will be winners or losers as we move towards more transparent, fairer markets, and since they're not sure if they'll be winners or losers, their basic instinct is to resist change."

**In, Out and Around Henhouse**

The result of the maneuvering of the past couple years is that big banks dominate the risk committees of not one, but two of the most prominent new clearinghouses in the United States.

That puts them in a pivotal position to determine how derivatives are traded.

Under the Dodd-Frank bill, the clearinghouses were given broad authority. The risk committees there will help decide what prices will be charged for clearing trades, on top of fees banks collect for matching buyers and sellers, and how much money customers must put up as collateral to cover potential losses.

Perhaps more important, the risk committees will recommend which derivatives should be handled through clearinghouses, and which should be exempt.

Regulators will have the final say. But banks, which lobbied heavily to limit derivatives regulation in the Dodd-Frank bill, are likely to argue that few types of derivatives should have to go through clearinghouses. Critics contend that the bankers will try to keep many types of derivatives away from the clearinghouses, since clearinghouses represent a step towards broad electronic trading that could decimate profits.

The banks already have a head start. Even a newly proposed rule to limit the banks' influence over clearing allows them to retain majorities on risk committees. It remains

unclear whether regulators creating the new rules — on topics like transparency and possible electronic trading — will drastically change derivatives trading, or leave the bankers with great control.

One former regulator warned against deferring to the banks. Theo Lubke, who until this fall oversaw the derivatives reforms at the Federal Reserve Bank of New York, said banks do not always think of the market as a whole as they help write rules.

"Fundamentally, the banks are not good at self-regulation," Mr. Lubke said in a panel last March at Columbia University. "That's not their expertise, that's not their primary interest."

TimesPeople

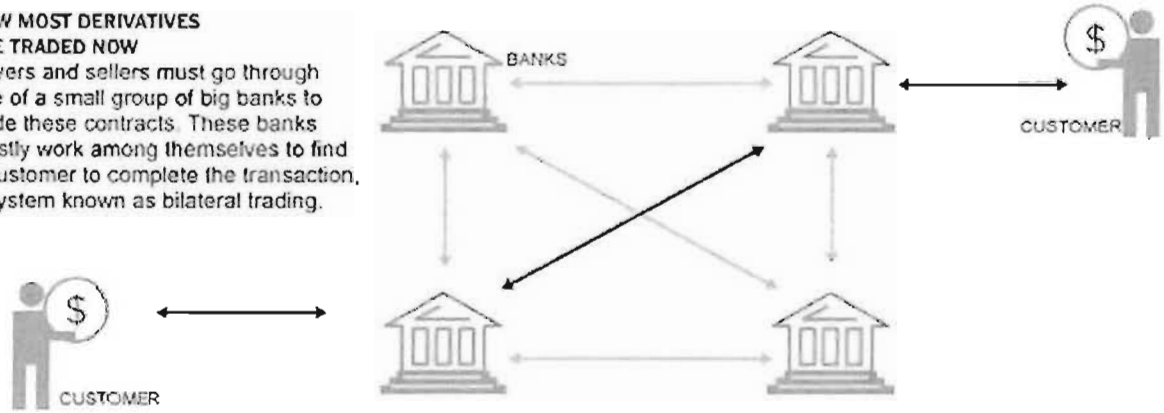
The New York Times

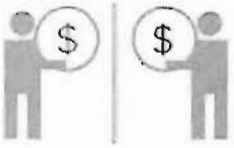
December 12, 2010

# Bank's Money-Making Machine

Trading of derivatives, a type of insurance, is a multitrillion-dollar market controlled by a handful of banks.

**HOW MOST DERIVATIVES ARE TRADED NOW**
Buyers and sellers must go through one of a small group of big banks to trade these contracts. These banks mostly work among themselves to find a customer to complete the transaction, a system known as bilateral trading.

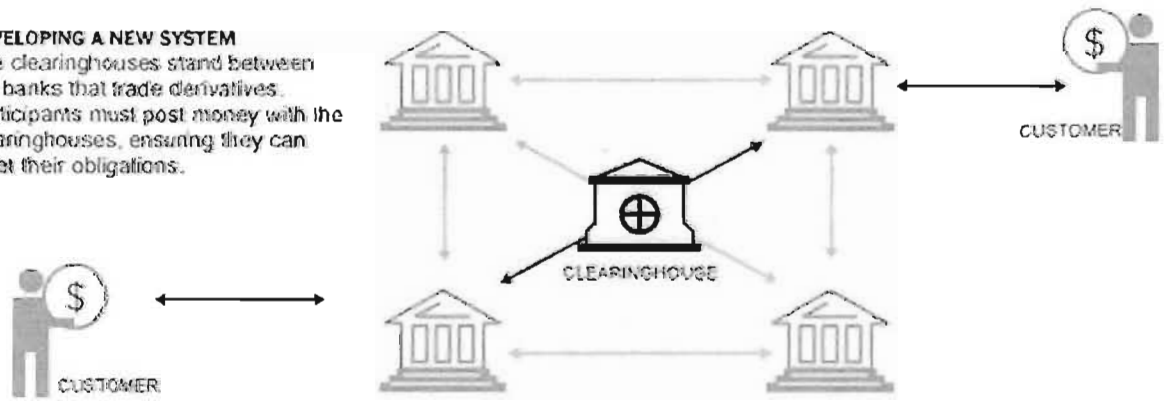


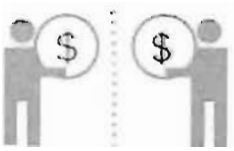




**PROBLEMS: A MURKY MARKET ...**
Unlike the stock market, customers cannot see pricing or other trading information. Buyers and sellers are left uncertain if they have overpaid or have gotten a good deal.

**... AND SYSTEMIC RISKS**
With the banks trading directly with each other, it heightens the risk that the failure of one bank could bring down the others. The system also tends to hide risks that big players like hedge funds might be taking.

**DEVELOPING A NEW SYSTEM**
The clearinghouses stand between the banks that trade derivatives. Participants must post money with the clearinghouses, ensuring they can meet their obligations.




**LESS MURKY ...**
The clearinghouses bring some transparency to the market, making some information easily available.

**... BUT BANKS STILL RULE THEM**
Key committees at the clearinghouses are dominated by people from the banks that control the market. Other institutions have been blocked from entering the market, and trading information is still not freely available.

RECOMMEND

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