

Before the  
United States Securities and Exchange Commission  
Washington, D.C.

IN THE MATTER OF:  
RIN 3235-AK47  
File No. S7-27-10

**Comments of the United States  
Department of Justice**

**I. Introduction**

The United States Securities and Exchange Commission (“SEC”) has requested public comment on its proposed Regulation MC, as described in its Federal Register Notice entitled 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. The SEC published this request in the Federal Register on October 26, 2010.

As the executive branch agency primarily responsible for protecting competition in the nation’s markets, the United States Department of Justice (“Department”) is pleased to have the opportunity to comment on the conflicts of interest rules for the derivatives industry contained in proposed Regulation MC. The Department has significant experience in issues relating to the derivatives industry. It has conducted investigations into alleged anticompetitive conduct in the industry and studied the industry as part of its competition advocacy efforts. As a result, the Department has gained substantial knowledge with respect to promoting and maintaining competition in this sector. The Department also has broad experience in analyzing competition issues in the financial markets more generally, including the futures, fixed-income, foreign currency, equities, and options markets. It has conducted investigations and analyzed the likely impact of proposed mergers in these and other financial markets.

The derivatives industry is a critical component of the nation’s financial system and of the broader economy. The derivatives markets, by any measure, involve a tremendous amount of capital. The Bank for International Settlements, for example, stated in a recent report that the notional amounts outstanding of over-the-counter derivatives reached \$583 trillion at the end of June 2010.<sup>1</sup> Protecting competition in this sector thus is crucially important both for consumers and for the nation’s economic health. Indeed, Section 765(b) of the Dodd-Frank

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<sup>1</sup> Bank for Int’l Settlements, Triennial and Semiannual Surveys: Positions in Global Over-The-Counter (OTC) Derivatives Markets at End-June 2010, at 2 (Nov. 2010), *available at* [http://www.bis.org/publ/otc\\_hy1011.pdf](http://www.bis.org/publ/otc_hy1011.pdf).

Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) specifically mentions promoting competition as one of the reasons to promulgate these conflicts of interest rules. The Department therefore strongly approves of the SEC’s efforts to improve governance practices, reduce systemic risk, and promote competition in the derivatives sector through its proposed rulemaking.

The Department’s comments are restricted to the proposed ownership limits on Security-Based Swap Execution Facilities (“SEFs”) and National Securities Exchanges that post or make available for trading security-based swaps (“Exchanges”). The Department supports the imposition of individual ownership limits on SEFs/Exchanges. However, the Department is concerned that because the proposed rule does not include an aggregate ownership cap on major derivatives dealers, preserving the opportunity for these powerful entities to achieve majority ownership of SEFs/Exchanges, it may not sufficiently protect and promote competition in the industry.

If modified as described in these comments, the SEC’s rulemaking has the potential to promote competition in several ways. To begin with, limiting aggregate ownership and imposing stringent governance requirements on SEFs/Exchanges may prevent the emergence of a dominant trading platform controlled by major dealers to the detriment of other market participants. The creation of such a platform would be roughly analogous to the three or five largest airlines controlling all landing rights at every U.S. airport—the big carriers could use this control to disadvantage smaller carriers by restricting landing rights or raising their rivals’ costs to access the airports.

In the derivatives context, participating dealers might use such a platform to exclude rival dealers or other market participants that would otherwise compete for trading volume. A dealer-controlled trading platform also might release less innovative data products or be less transparent than would an independent platform. Further, major dealers might use their control of a dominant trading platform to disadvantage rivals by refusing to trade their products or to continue trading over the counter even in instances where exchange trading is feasible. This latter issue might arise even though the SEC has considerable authority to mandate central clearing of contracts. To the extent that dealers attempt to elude this authority by refusing to trade certain centrally cleared contracts in order to maintain markets in similar, over-the-counter contracts, aggregate ownership caps and governance restrictions on SEFs/Exchanges can serve as a backstop to protect competition.

Appropriate ownership restrictions also might heighten competition among SEFs/Exchanges themselves. For example, an aggregate ownership cap might lead to the creation of multiple SEFs/Exchanges, each sponsored by a dealer or two, in competition with each other. Such competition would benefit market participants in several respects: trading fees would likely

decline, and price competition would likely be complemented by vigorous innovation, bringing market participants faster execution times and new data products.

## **II. The SEC's Proposed Ownership and Governance Restrictions for SEFs and Exchanges**

The SEC proposes a 20 percent limitation on the voting equity or voting power that any single participant or member may own or control of a SEF or Exchange. However, the SEF/Exchange proposal includes no limit on the aggregate voting equity or voting power that participants or members may own or control. As a result, three major dealers together could own a controlling share of a SEF or Exchange, and five could own a platform outright.

The SEC's proposal also would establish governance restrictions on SEFs/Exchanges by setting minimum membership requirements for independent directors on their boards of directors and management committees. Specifically, the SEC would require that at least 50 percent of the members of a SEF/Exchange's board of directors and executive and membership committees be independent, and that 100 percent of a SEF/Exchange's nominating and regulatory oversight committees be independent.

## **III. Department Recommendations**

The Department strongly supports the SEC's efforts to create meaningful limits on ownership of SEFs and Exchanges, as well as its proposed use of governance restrictions as a separate safeguard against conflicts of interest.<sup>2</sup> However, the Department is concerned that the proposed ownership limits for SEFs and Exchanges, which include individual share thresholds but no aggregate cap on ownership by participants or members, will not sufficiently reduce the risk that major dealers may control a SEF or Exchange to restrict competition among dealers and other market participants. For example, major dealers might use their control of a SEF or Exchange to exclude rivals, limit pre- and post-trade transparency, decline to trade certain contracts to disadvantage rivals, or try to evade exchange-trading requirements. In the Department's view, limiting both individual ownership shares and the aggregate shares held by major dealers would be the most effective structural approach to protecting competition in the derivatives markets. Further, the Department believes that an aggregate ownership cap may encourage some entities to sponsor new, viable SEFs/Exchanges, leading to increased competition in this sector.

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<sup>2</sup> The Department firmly endorses the governance restrictions the SEC has proposed for SEFs/Exchanges and believes that these restrictions should be maintained even if the SEC institutes an aggregate ownership cap on SEFs/Exchanges. The Department also supports the SEC's proposed governance restrictions for Security-Based Swap Clearing Agencies.

The SEC's Notice of Proposed Rulemaking explains that the proposed 20 percent cap on individual participant or member ownership of SEFs/Exchanges is based on the SEC's concern that if a participant or member, either alone or with related entities, "were to own a significant stake" in a SEF/Exchange, it could "use its significant ownership interest to influence the operations of" the SEF/Exchange "to unduly derive benefits at the expense of other owners and market participants." The Department shares the SEC's concerns that SEF/Exchange participants or members might exercise control over a trading platform to anticompetitively limit access to rival dealers or buy-side firms or to otherwise restrict competition in trading. The SEC's Notice clearly identifies this risk, noting that the SEC is "particularly concerned" that a participant or member "may have financial incentives to limit the level of access to, and the scope of products traded on," SEFs/Exchanges "as a means to impede competition from other market participants."

In the Department's view, however, it is not sufficient to impose restrictions only on individual ownership or control; an aggregate cap on ownership or control by participants and members also should be required. This is because the major dealers as a group likely share very similar incentives to limit access and to otherwise insulate themselves from competition. Accordingly, while the cap on individual ownership will eliminate the chance that a single entity could gain direct control over a SEF/Exchange to the detriment of competition, under the SEC's proposal, there is no barrier to a group of entities—major derivatives dealers, for example—working together to control a SEF/Exchange to their combined competitive advantage.

The SEC's Notice of Proposed Rulemaking identifies this risk, observing that "the proposed limit by itself would not completely prohibit a small number of entities from potentially exerting undue influence over SB SEFs, SBS exchanges, or SBS exchange facilities in a way that could benefit the few to the detriment of others." The Department agrees: if a small group of major dealers gained control of a SEF or Exchange, they could limit access to other market participants, restrict the amount of pre- and post-trade transparency the SEF/Exchange offers or the trades the platform will accept, and, as the SEC Notice explains, "restrict the scope of security-based swaps that are eligible for trading at SB SEFs or SB exchanges if there is a strong economic incentive to keep such swaps in the OTC market."

The Department has a great deal of experience analyzing the competitive impact of joint ownership of platforms like SEFs/Exchanges and understands the potential for abuse in these situations. The Department believes that allowing three to five major dealers to control a trading platform would greatly increase the risk that those entities will use their control to block or limit rival dealers' or buy-side firms' access to the platform, to choose not to support trading of instruments sponsored by other market participants, to impose undue burdens on rivals, or otherwise to limit competition.

One way to understand the issues raised by this scenario is to view this type of joint ownership arrangement as an over-inclusive joint venture. The Department will have concerns with a joint venture if it appears likely to harm competition by increasing incentives to raise price above or reduce output below what would prevail in the absence of the agreement.<sup>3</sup> A joint venture potentially can be problematic if it involves more competitors than necessary to achieve the joint venture's efficiencies. Airline alliances provide a useful example of this concept. The Department provides comments on applications for antitrust immunity submitted by participants in airline alliances to the Department of Transportation ("DOT"). Airline alliances can provide benefits to the public in the form of greater flight and ticketing options, improved access to services like frequent flyer programs, and reduced fares. However, the Department has recommended that certain immunity applications be limited when the public benefits of extending immunity to additional airlines are more than offset by reductions in competition among participants in the alliance. In 2009, the Department described these types of concerns regarding an application to expand Star Alliance.<sup>4</sup> When the DOT approved the application, it carved out certain routes from the grant of antitrust immunity, specifically citing the Department's concerns.<sup>5</sup>

In the current context, if the inclusion of an additional dealer in a SEF/Exchange joint venture reduces dealers' incentives to compete with each other but is not necessary to ensure the SEF/Exchange's viability, that joint venture may be over-inclusive. Aggregate limits on dealer ownership of SEFs/Exchanges should prevent these platforms from including more dealers than is necessary to successfully sponsor a SEF/Exchange and thus mitigate the potential for major dealers to use their control of a SEF/Exchange to exclude their rivals, reduce transparency, or otherwise undermine competition. In addition, in the Department's experience, structural protections, like aggregate ownership limits, are likely to more effectively safeguard competition and require less oversight than relying solely on ongoing regulatory restrictions.

Further, the Department believes that an aggregate ownership cap on participants and members may facilitate competition by encouraging the creation of new SEFs/Exchanges. If ownership by participants and members of individual SEFs/Exchanges is capped at 40 percent, it is more likely that some entities will decide to sponsor new SEFs/Exchanges, which, with this backing, will be able to compete alongside existing platforms. Increased competition among SEFs/Exchanges would likely result in lower transaction fees and increased innovation, as has been the case with exchange competition in other financial

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<sup>3</sup> See U.S. DEPARTMENT OF JUSTICE & FEDERAL TRADE COMMISSION, ANTITRUST GUIDELINES FOR COLLABORATIONS AMONG COMPETITORS § 3.3 (2000), *available at* <http://www.ftc.gov/os/2000/04/ftcdojguidelines.pdf>.

<sup>4</sup> See Comments of the Department of Justice on the Show Cause Order, DOT-OST-2008-0234 (filed June 26, 2009), *available at* <http://www.justice.gov/atr/public/comments/247556.htm>.

<sup>5</sup> See Final Order, DOT-OST-2008-0234-0253 (filed July 10, 2009).

markets. For example, studies have shown that increased competition among options exchanges in the listing of equity options resulted in lower transaction fees.<sup>6</sup> And, in the Treasury futures market, the entry of the BrokerTec Futures Exchange in 2000 led to a significant shift to electronic trading of Treasury futures contracts, an important innovation.<sup>7</sup> In the absence of an aggregate cap, however, there is a serious risk that the largest dealers simply will join the same platform and control it to suit their own best interests.

It could be argued that economies of scale in trading are so pronounced that derivatives markets will best be served by a single trading platform. This claim would seem to be inconsistent with developments in other financial markets—for example, cash equities—where multiple trading platforms have flourished. However, even if economies of scale are pronounced in derivatives trading, competition to become the sole trading platform will benefit all market participants and is much preferred to simply allowing a handful of major dealers to establish a dominant platform that caters to their narrow self-interest.

In sum, an aggregate ownership cap would serve at least two important goals: it would greatly reduce the risk that major derivatives dealers controlling a SEF/Exchange could impose anticompetitive access restrictions on competitors or engage in other anticompetitive conduct, and it would encourage major dealers or other entities to sponsor new, viable SEFs/Exchanges, increasing competition among trading platforms.

#### **IV. Conclusion**

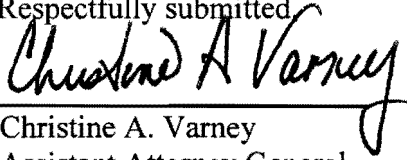
The Department shares the SEC's concerns about the potential for conflicts of interest in ownership and governance of SEFs and Exchanges. The Department also generally endorses the SEC's approach to reducing the risk that these conflicts of interest will harm competition. However, the Department urges the SEC to enhance its proposed ownership limitations, as described in these comments. The Department believes that an aggregate ownership cap on SEFs and Exchanges will reduce the likelihood that members of these organizations will be able to control these platforms to limit access or otherwise harm competition in the derivatives sector. The Department also believes that an aggregate ownership cap will lay the groundwork for the development of new, viable SEFs and Exchanges, resulting in increased competition in these markets.

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<sup>6</sup> See, e.g., Patrick de Fontnouvelle, Raymond P.H. Fishe, and Jeffrey H. Harris, "The Behavior of Bid-Ask Spreads and Volume in Options Markets during the Competition for Listings in 1999," *Journal of Finance*, 58(6): 2437-2464 (2003); Stewart Mayhew, "Competition, Market Structure, and Bid-Ask Spreads in Stock Option Markets," *Journal of Finance*, 57(2): 931-958 (2002).

<sup>7</sup> See Comments of the United States Department of Justice in Response to the Department of the Treasury's Request for Comments on the Regulatory Structure Associated with Financial Institutions 11-12 (Jan. 31, 2008).

Respectfully submitted



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