TOM HARKIN
IOWA

(202) 224-3254
FAX: (202) 224-9369
TTY (202) 224-4633
http://harkin.senate.gov

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United States Senate

WASHINGTON, DC 20510-1502

November 17, 2010

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

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

Re: RIN 3038–AD01, Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest

RIN 3235–AK74, 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 Mr. Stawick and Ms. Murphy:

I write today to provide comments on the Commissions' proposed rulemaking on requirements for Derivatives Clearing Organizations (DCO), Designated Contract Markets (DCM), and Swap Execution Facilities (SEF) regarding the mitigation of conflicts of interest.

To help mitigate risk in the swaps market, Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act), Pub. L. 111-203 (2010), requires swap and security-based swap contracts meeting applicable criteria to be cleared with a DCO and to be executed on a DCM or SEF. In order to work effectively, DCOs, DCMs, and SEFs will need to operate free of conflict of interest from large market participants (collectively referred to as enumerated entities) that may seek to influence market infrastructure to their advantage. To fulfill the reform purposes of the Dodd-Frank Act, the governance and day-to-day operation of these DCOs, DCMs, and SEFs must be free from conflicts of interest by market participants, particularly enumerated entities, as defined in the legislation. Therefore, these rules must ensure that conflicts of interest do not prevent the clearing of swaps and security-based swaps or their execution on transparent trading platforms.

BACKGROUND:

Over two years ago the worldwide financial system failed, in large measure as a direct result of the inability of the largest financial institutions to effectively manage their risk in the swaps market. For this reason, as part of the Dodd-Frank Act, Congress required the Commissions to enact strong rules to reshape the risk management framework of the swaps market, including rules that will mitigate the conflicts of interests from large market participants also controlling DCOs, DCMs, and SEFs.[1]

As the Commissions have noted, 97 percent of the notional value of derivatives held by commercial banks is in the hands of five large institutions.[2] Conflicts of interest inherently emerge from such a closed system. For reasons of profit, gaining informational advantages, and maintaining informational asymmetry, market dominance, and reputation, entities that have significant market share will seek to maintain that control in a number of ways, including by controlling DCOs, DCMs, or SEFs.[3] Unless these conflicts are addressed, the reforms of the Act will be incomplete.[4]

Ensuring that DCOs, DCMs, and SEFs are able to function free of domination by enumerated entities, or any market participant or group, is of paramount importance. Conflicts of interest may improperly affect decisions of a DCO regarding what contracts to clear, who gets to be a clearing member, who can enter into clearing arrangements with clearing members, and the amount and types of collateral needed to effectively manage risks. Similarly, conflicts of interest may improperly affect decisions of a DCM or SEF regarding which and how many participants

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[1] See the colloquy on the floor of the House of Representatives between Rep. Stephen Lynch and Rep. Barney Frank on June 30, 2010. Of general note is the statement of Rep. Lynch: "this problem arises because, right now, 95 percent of all of the clearinghouses in this country are owned by just five banks. So, while we are relying on the clearinghouses to reduce systemic risk, we have the banks now owning the clearinghouses."

[2] According to the Office of the Comptroller of the Currency (OCC), as of the second quarter of 2009 the top five commercial banks held derivatives in the amount of $197 trillion of the $203.5 trillion in notional value.

[3] See Robert Litan, *The Derivatives Dealers' Club and Derivatives Markets Reform: A Guide for Policy Makers, Citizens and Other Interested Parties*, Brookings Institution (Apr. 7, 2010) page 8:"From the limited publicly available data (and it is limited precisely because the markets here are so opaque), the derivatives-related revenues generated by the major dealer banks are substantial, in the range of $30 billion annually. Publicly available data do not indicate how these revenues translate into profits, but it seems safe to assume that dealers' derivatives trading profits are substantial."

[4] Litan, 37: "As long as dealers have the ability and incentive to prevent or delay the maximum degree of derivatives clearing, exchange trading and transactions pricing (pre and post), systemic risk arising out of derivatives market activity will be higher than is socially optimal[.]").

may use the trading exchange or facility, which contracts are eligible for trading on the exchange or facility, and the balancing of commercial demands and self-regulatory responsibilities.[5]

I am especially concerned about the influence enumerated entities may exert on a DCO in its decision whether it will accept a swap or security-based swap contract for clearing or upon a DCM or SEF in its decision whether to list a contract for trading. During the course of the debate over the Act, I expressed concern over the ability of DCOs, DCMs, and SEFs to choose not to clear or execute a transaction for any reason. If enumerated entities, or any market participants for that matter, are able to exert undue influence in this process, either by controlling that decision-making process directly or through indirect means such as hidden financial incentives or other benefits, the decisions of DCOs, DCMs, or SEFs not to accept contracts for clearing or execution will clearly undermine the goals of the Act.[6]

Some market participants have argued that the types of conflicts described by the Commissions and above will not emerge because clearing and executing on trading platforms is financially profitable or because clearing does not reduce profits in trading.[7] This argument is incorrect. Indeed, if this were the case, those market participants would not have opposed the clearing and execution requirements of the Act in the first place. While dominant market players may still generate revenues from clearing and executing swaps, their opposition to these reforms really betrays the fact that, in general, it would be vastly more profitable for them to continue trading in the opaque over-the-counter market where customers – and our economy more generally – bear the cost of noncompetitive bids and offers. In addition, while it may be profitable to clear and execute certain contracts, many - especially new contracts - will certainly be more profitable if they are able to trade OTC.[8]

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[5] See the comments of Jason Kastner from the Swaps and Derivatives Market Association at the CFTC-SEC Public Roundtable on Governance and Conflicts of Interest in the Clearing and Listing of Swaps: "If we're going to be really clever about keeping people out of the system, the system is not going to work effectively. We're going to have the same OTC style, bilateral, closed, untransparent, opaque, risky system. And what we need to do is allow more entrants to diversify risk, address too big to fail and too interconnected to fail."

[6] Section 723(a)(4)(B) and 763(d)(2) of the Act require the Commissions to issue public reports on instances when swaps that are required to clear are not listed for clearing at a DCO. If the Commission finds that enumerated entities are manipulating this process to their advantage to the detriment of market integrity it should note that in those public reports and adopt additional rules to mitigate those conflicts.

[7] See for example the comments of Bill Hill of Morgan Stanley at the CFTC-SEC Public Roundtable: "I think there's a bit of a misconception that somehow clearing makes trades less profitable. That's clearly not the case."

[8] Darrel Duffie, Federal Reserve Bank of New York, Policy Perspectives on OTC Derivatives Market Infrastructure, Staff Report No. 242 (2010): "Even after an OTC derivatives product has achieved relatively active trading, and would be suitable for exchange trading, dealers have an incentive to maintain the wider bid-ask spreads that they can obtain in the OTC market relative to the spreads that might apply to the same product on an exchange, where buyers and sellers can more directly compete for the same trade."

PROPOSED RULES:

While the Commissions have thoughtfully identified many of the conflicts that may emerge, I believe that some important improvements should be made to the proposed rules to ensure that those conflicts are adequately addressed.

DCMs/SEFs Limits on Ownership or Voting Power

As drafted, the proposed rules limit DCM or SEF members (and their related persons) from either beneficially owning more than twenty percent of any class of voting equity in the registered entity or directly or indirectly voting an interest exceeding twenty percent of the voting power of any class of equity interest in the registered entity. Certainly, large market participants can bring a valuable perspective and capital to the operation of a DCM or SEF. However, I am very concerned that DCMs and SEFs are not subject to any aggregate ownership limitation. An aggregate ownership cap, at an absolute maximum of forty percent, is critical in order to diversify voting ownership of DCMs and SEFSs and prevent enumerated entities from exerting undue influence on them.

The reasons given for applying such an aggregate limitation with respect to DCOs but not to DCMs or SEFs is not convincing. Spreading ownership between multiple enumerated entities through an aggregate cap will force large entities to invest in multiple SEFs and DCMs, helping to increase liquidity and enhance price transparency. In addition, diverse ownership will help encourage innovation in this area, enhancing market efficiency and transparency. An aggregate cap on ownership will help to ensure these outcomes.

Treatment of DCMs and SEFs:

I commend the Commissions for subjecting DCMs and SEFs to the same governance and ownership requirements. In defining and establishing requirements for SEFs, Congress recognized that even though all swaps or security-based swaps would not be able to be executed on a DCM, it was important that they nonetheless be executed on trading platforms that promote pre-trade price transparency. In deciding to subject SEFs and DCMs to similar ownership, voting, and governance requirements, the CFTC and SEC wisely recognized that DCMs and SEFs fulfill almost identical market functions.

DCOs Limits on Ownership or Voting Power:

To limit ownership or voting control of enumerated entities, the Commissions have proposed two alternative scenarios: (1) a single-member equity and voting limit of 20 percent combined with an aggregate limit on enumerated entities of 40 percent, and (2) a hard limit of 5 percent that applies irrespective of whether or not the firm is a DCO member. In addition, upon application by a DCO, the Commission may grant a waiver from these two restrictions.

As with DCMs and SEFs, the aggregate limitation is critical to ensure that DCOs are free of conflicts of interest. For this reason, I strongly urge the Commissions to remove the five percent second alternative ownership or voting limit that does not included an aggregate limitation. Under this second scenario in the absence of an aggregate cap, a few large dealers would have the ability to come together to dictate the decisions made by the DCO. That arrangement would allow those dealers to continue to dictate the terms of the market by controlling the operating decisions of that DCO, including what products to clear, who can be a clearing member, and how much capital and margin is required. To prohibit such a scenario, aggregate limits should apply to all DCOs, including start-ups, and all enumerated entities, including those that are not clearing members.

Effective risk-mitigation, free of conflicts of interest, requires an independent and unbiased perspective. As the financial crisis revealed, the absence of an unbiased perspective allows market participants to take on excessive risk in pursuit of higher profit. A strong aggregate limit will allow for effective input from enumerated entities while ensuring that other market participants and independent investors are also able to voice their perspective. For this reason, the final rule should maintain the aggregate limit at a maximum forty percent for enumerated entities as in the first alternative and either apply that limit in the second alternative or remove the second alternative entirely.

Finally, I believe that the Commissions should only grant waivers in extremely limited circumstances. While there may be select instances where a waiver might be warranted, it should only be done after a thorough review and for a limited period of time.

Board of Directors Structural Requirements:

As the Commissions noted, preventing of conflicts of interest also includes structural requirements. In particular, it is critical for boards of directors to have a strong independent perspective. For this reason, I believe the Commissions should require boards of directors of DCOs, DCMs, and SEFs to be composed of at least 51 percent public directors. Given that DCOs, DCMs, and SEFs are intended to mitigate systemic risks to the financial system by stabilizing the swaps market, it will be important that they are operated with this public mission in mind. A board of directors composed of 51 percent public directors can most effectively ensure such an outcome.

DCO Risk Management Committee:

The proposed rules also require DCO risk management committee's to be composed of 35 percent public directors and 10 percent customers of clearing members. The decisions of a DCO risk management committee are critically important to the sound operation of a DCO and include such decisions as the amount of margin and capital required to manage the risk of each swap, the size of the guarantee fund, what swaps are listed for clearing, and who can be a swap clearing member. Market participants seeking to control the operation of a DCO will likely attempt to gain influence over this committee in particular.

Certainly, large market participants bring an important perspective to effective risk-mitigation. Indeed, these actors are the predominant market participants actively clearing swaps. However, under the framework established by Congress in Title VII of the Dodd-Frank Act, more entities will become involved in the clearing process, bringing important risk management perspectives to the table. Therefore, risk management committees must also be opened to those perspectives for effective risk management. For this reason, I believe it is prudent for risk management committees to include the outside perspective provided by significant involvement public directors and customers of clearing members.

Additional Considerations:
Finally, the Commissions should consider adopting additional rules to address incentives provided from DCOs, DCMs, or SEFs to enumerated entities that are used to attract the business of enumerated entities. Given the dominance of the swaps market by a select few entities, policies designed to attract business could create conflicts that cannot be adequately addressed by ownership or governance arrangements. These arrangements could take a number of forms, but most likely will appear in the form of volumetric or profit-based incentives.

For example, the pricing terms of a SEF or DCM may be used to help recruit large liquidity providers to use that facility. If those terms are overly generous to large liquidity providers it will have the impact of stifling competition, prohibiting new entrants to the facility, and skewing the pricing in favor of large liquidity. In short, those incentives could undermine the improvements made by voting and ownership limitations and other governance requirements.

To help address these types of conflicts, I encourage the Commissions to adopt additional rules that would prevent DCOs, DCMs, and SEFs from adopting policies, such as pricing terms, that may maintain the conflicts of interest the Commissions and Congress have sought to address.

Thank you for your consideration of my views.

Sincerely,

Tom Harkin

Tom Harkin
United States Senator