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December 21, 2010

Ms. Elizabeth Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: *FICC Proposed Rule Change to Introduce Cross-Margining of Certain Positions Cleared at the Fixed Income Clearing Corporation and Certain Positions Cleared at New York Portfolio Clearing, LLC, File Number SR-FICC-2010-09*

Dear Ms. Murphy:

On November 12, 2010, the Fixed Income Clearing Corporation ("FICC") filed with the Securities and Exchange Commission ("the Commission") a proposed rule changes that would allow the FICC to cross margin certain positions cleared at New York Portfolio Clearing, LLC ("NYPC") with certain positions cleared at FICC's Government Securities Division. Under the FICC's cross-margining agreement with NYPC ("the FICC-NYPC Arrangement"), FICC and NYPC will allow joint customers[1] to reduce their margin requirements by offsetting each member's NYPC derivative positions with its FICC cash positions, as if the two positions "were in a single portfolio," or a "single-pot."[2]

While single-pot margining may reduce margin requirements and allow for a more efficient use of capital, NASDAQ OMX believes that (1) the exclusivity of the FICC-NYPC Arrangement is an unnecessary burden on clearinghouse competition; and (2) FICC's proposed cross-margining regime should be better understood, studied and tested so that its impact on

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[1] A member of FICC is a joint customer if such member (or its affiliate) is also a member of NYPC.

[2] See SEC Release No. 34-63361, File No. SR-FICC-2010-09 at 5, 10 (November 23, 2010) ("FICC November 23, 2010 SEC Notice").

systemic risk can be appropriately analyzed before being employed to increase the leverage of portfolio of derivatives and securities accounts.

I. THE FICC-NYPC ARRANGEMENT WILL UNNECESSARILY BURDEN COMPETITION IN THE MARKET FOR CLEARING FIXED INCOME DERIVATIVES TRADES

Section 17A of the Exchange Act provides that a clearing agency may not enact rules that "impose any burden on competition not necessary or appropriate in furtherance of the purposes" of the Act.[3] FICC and NYPC are poised to implement a cross-margining regime that will unnecessarily burden clearinghouse competition by effectively precluding competitors from offering similar cross-margining arrangements.

NYPC is a newly formed clearinghouse jointly owned by NYSE Euronext and The Depository Trust & Clearing Corporation ("DTCC"). DTCC is the parent company of FICC.[4] FICC is the only fixed income clearinghouse registered with the SEC and clears all, or virtually all, of fixed income trades.[5] As a practical matter, FICC has acknowledged that it serves as a for-profit "industry utility."[6]

Prior to the FICC-NYPC Arrangement, FICC employed what it and the Commission described as a "hub-and-spoke" cross-margining model, whereby FICC—as the industry "hub"—offered its cross-margining services "on a multilateral basis" to more than one participating clearinghouse.[7] Each participating clearinghouse entered into a separate cross-margining agreement with FICC, and FICC gave preference to no one participating clearinghouse over another.[8] FICC characterized its "hub-and-spoke" model as "the most efficient and appropriate approach for establishing cross-margining programs for fixed-income and other interest rate products."[9]

FICC has proposed a sweeping new cross margining system that would discard the pro-competitive "hub and spoke" model in favor of an exclusive single-pot arrangement with NYPC. Pursuant to the FICC-NYPC Arrangement, NYPC will have priority access to FICC cash positions for cross-margining purposes.[10] More importantly, the arrangement prohibits FICC

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[3] Section 17A(b)(3)(I) of the Securities Exchange Act, 15 U.S.C. § 78q-1(b)(3)(I) (2010).

[4] NYSE Euronext is also one of DTCC's two preferred shareholders and is represented on DTCC's board of directors.

[5] See SEC Release No. 34-62348, File No. 600-23 (June 22, 2010).

[6] See January 14, 2005 Letter from FICC to the Commission at 2, *available at* http://www.sec.gov/rules/sro/ficc/srficc200415-10.pdf.

[7] SEC Release No. 34-50790, File No. SR-FICC-2004-16 at 3 n. 9 (December 3, 2004), *available at*: http://www.sec.gov/rules/sro/ficc/34-50790.pdf.

[8] Id.

[9] SEC Release No. 34–45335, File No. SR–GSCC–2001–03 (January 25, 2002), 67 FR 4768.

[10] FICC-NYPC Cross Margining Agreement at ¶ 16(a), *available at*: http://www.cftc.gov/stellent/groups/public/@otherif/documents/ifdocs/nypcdcoappexn-1.pdf.

from entering into any cross-margining agreement with a NYPC competitor that would affect NYPC's priority rights.[11] As a result of this arrangement, FICC has acknowledged that NYPC will become the only clearinghouse with direct access to FICC for cross-margining purposes.[12]

A. Despite FICC's Claims to the Contrary, the FICC-NYPC Arrangement Will Exclude Competition from the Futures and Derivatives Clearing Market

FICC attempts to downplay the clear anticompetitive nature of the exclusive provisions of its arrangement by offering NYPC competitors the illusory promise of "open access" to the single pot. Notwithstanding such promises, FICC and NYPC have constructed a multitude of unnecessary rules and procedures that will effectively preclude NYPC's rivals from offering single-pot margining.

First, NYPC competitors can only offer their customers single-pot margining by reselling NYPC clearing services.[13] If approved by NYPC, an NYPC competitor would be able to access FICC for margin offset purposes only through the NYPC "portal" as a "limited purpose participant."[14] The competitor must submit all single-pot customer trades to NYPC for clearing, and NYPC becomes the central counter-party and clearing organization for that competitor's customer.[15] In light of this arrangement, it is not evident why customers would ever elect to clear through a middleman NYPC reseller, rather than with NYPC directly.

Second, NYPC will have complete discretion over which, if any, of its competitors can resell its clearing services. NYPC will allow a competitor access to the single pot only if the two clearinghouses reach an agreement on the allocation of clearing fees, guaranty fund contributions and other economically significant issues. NYPC's rules do not require that NYPC offer its services at cost or even negotiate in good faith.[16] Indeed, the gross disparity in negotiating leverage will result in a clearing fee allocation that is more favorable to NYPC than the competing clearinghouse. As a result, NYPC will likely reach agreement with few, if any, clearinghouses in a way that permits the competing clearing house to offer a cost effective service, with the result that customers who wish to access the single pot will likely have only one competitive option, NYPC.

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[11] Id. at ¶ 16(b).

[12] See FICC November 23, 2010 SEC Notice at 18 (noting that under section 16 of the FICC-NYPC Arrangement "[t]he proposed single pot is required to be accessed by other futures exchanges and DCOs via NYPC.").

[13] See FICC November 23, 2010 SEC Notice at 14.

[14] Id. at 19, 23,

[15] Id. at 20.

[16] See Rule 801(b)(2), Rules of New York Portfolio Clearing, LLC, Exhibit C to NYPC's CFTC DCO Application ("NYPC Proposed Rule"), *available at*: http://www.cftc.gov/stellent/groups/public/@otherif/documents/ifdocs/nypcdcoappexc.pdf.

Third, FICC and NYPC plan to allow NYPC-approved competitors to resell NYPC services only "as soon as feasible," which may be as much as 24 months after NYPC's launch.[17] Such a lengthy delay will provide NYPC a significant first-mover competitive advantage. Members who expend the time, money and resources to apply for a NYPC membership, establish a NYPC link and make the required collateral contributions are extremely unlikely to spend the time and money go through a similar process with a competing clearinghouse 24 months later; this is especially true if the competing clearinghouse is merely reselling NYPC's clearing services.

Fourth, FICC and NYPC apparently plan to exclude some of NYPC's competitors outright. For example, NYPC will not allow a clearinghouse to become a reseller of NYPC's services if such clearinghouse limits "the provision of clearing services on a vertical basis to a single market or limited number of markets."[18] Given that NYPC itself is currently part of a vertical "silo" with its sister company, NYSE LIFFE U.S., its position on this issue is baffling. FICC offers no reason why NYPC need be the arbiter of the appropriate business model for the futures derivatives clearing industry; nor does it explain why NYPC may exclude competitors that fail to employ a business model which NYPC has yet to find "feasible" to implement.[19] In short, NYPC's position seems to be that (a) vertically integrated competitors need not apply, and (b) no one else need apply unless and until invited by NYPC based on to-be-determined feasibility criteria.

Finally, NYPC competitors will not be allowed access to the single pot unless they contribute \$50 million (\$25 million in cash) to NYPC's guaranty fund.[20] The \$50 million requirement creates yet another significant hurdle that will work to burden and reduce clearinghouse competition. Although FICC told the Commission that contribution to guaranty funds is "standard practice" for *exchanges*, FICC has failed to explain why contribution to the guaranty fund is necessary for clearinghouses merely reselling NYPC's clearing services. Other DTCC clearing agencies rely solely on retained earnings, fund contributions and member assessments to cover losses. <u>See</u> Depository Trust Company, Rule 4 (requiring each participant to make a fund contribution from which DTC's losses or liabilities will be satisfied); National Securities Clearing Corporation Rules & Procedures, Rule 4 (same), FICC Government Securities Division Rulebook, Rule 4 (same), FICC Mortgage-Backed Securities Division Clearing Rules, Article IV (same).[21]

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[17] FICC November 23, 2010 SEC Notice at 15.

[18] <u>Id</u>. at 20.

[19] <u>Id</u>. at 19 ("NYPC will initially clear certain contracts transacted on NYSE LIFFE U.S. NYPC will clear for additional DCMs that are interested in clearing through NYPC as soon as it is feasible for NYPC do so.")

[20] <u>Id</u>. at 20 n. 13 ("Pursuant to NYPC Rule 801(b)(3), limited purpose participants will be required to make a contribution to the NYPC guaranty fund in form and substance similar to and in an amount not less than the NYSE guaranty, which will initially consist of a \$50,000,000 guaranty secured by \$25,000,000 in cash during the first year of NYPC's operations.").

[21] All rulebooks cited are available at: http://www.dtcc.com/legal/rules_proc/.

Indeed, FICC's $50 million guaranty fund contribution requirement appears to be somewhat at odds with the views of its sister company. Another wholly-owned DTCC subsidiary, EuroCCP,[22] has recently explained that European regulations prohibit clearinghouses from contributing to each other's default funds because central counterparties "are not risk-taking intermediaries, should deal with each other as peers and so should not be exposed to the additional risk of loss mutualisation," since a clearinghouse will "will not have sight of or be able to control" the risk created by participants of a linked clearinghouse.[23]

B. The Anticompetitive Burden Imposed by FICC-NYPC Exclusivity Is Unnecessary

The burden placed on competition by the FICC-NYPC cross-margining agreement is unnecessary, and FICC's justifications for the exclusive arrangement are mere pretext. FICC and NYPC argue that the exclusive nature of their arrangement is required in order "to appropriately manage" FICC's risk.[24] FICC explains that NYPC's contractual obligations to FICC ensure that operational issues, risk methodologies and management are "understood, uniform and consistent for all participants in the one-pot arrangement."[25] FICC does not explain, however, why similar contractual obligations to FICC could not be achieved by entering into non-exclusive arrangements with multiple qualified clearinghouses.

FICC may be able to manage its risk just as effectively, but without creating anticompetitive burdens, by permitting NYPC's qualified competitors to undertake substantially similar contractual obligations as NYPC. For example, FICC could require that all clearinghouses that wish to participate in a one-pot hub-and-spoke arrangement implement uniform, consistent risk methodologies and operational protocols. Clearing customers would then be able to choose which competing derivatives clearinghouse to use to cross-margin against FICC, basing their decisions on price, service, reliability and factors other than NYPC's exclusive access to FICC.

Indeed, it is the FICC—not NYPC—that is the "administrator" charged with implementing risk methodologies and calculating cross-margin requirements under the FICC-NYPC Arrangement.[26] NYPC has not explained why FICC could not perform the same administrative function pursuant to similar contracts with NYPC's qualified competitors. GSCC, FICC's predecessor, told the Commission in 2002 that:

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[22] European Central Counterparty Limited (EuroCCP) is a wholly owned subsidiary of DTCC, created to provide clearing, netting, settlement and risk management services to support NASDAQ Europe and Europe 's capital markets.

[23] EuroCCP *Recommendations For Reducing Risks Among Interoperating CCPs* at , January 2010, *available at*: http://www.euroccp.co.uk/docs/leadership/EuroCCP_InteroperatingCCPs.pdf.

[24] FICC November 23, 2010 SEC Notice at 23.

[25] Id.

[26] FICC-NYPC Cross-Margining Agreement at ¶¶ 3(b), 4(a).

> … [T]he most efficient and appropriate approach for establishing cross-margining programs for fixed-income and other interest rate products is to do so on a multilateral basis with [FICC] as the "hub." Each clearing organization that participates in a cross-margining program with [FICC], such as NYCC, CME, and now BOTCC, (hereinafter ''Participating CO'') enters into a separate cross-margining agreement between itself and [FICC]. Each of the agreements will have similar terms and no preference will be given by [FICC] to one Participating CO over another.[27]

FICC has failed to explain why it believes the pro-competitive "hub-and-spoke" agreements are no longer the "most efficient and appropriate approach" to cross-margining, and whether DTCC's newly-acquired financial interest in NYPC was a factor in its reversal. FICC's own sister company, EuroCCP, has pointed out that:

> The more protected a [central counter party's "CCP's"] market position, the less willing a CCP is to collaborate with other CCPs to achieve full interoperability. The commercial interests of trading venues to favour certain CCPs and withhold trade feeds to others also impede interoperability from delivering the real benefits of competition to market participants. Although addressing risk management is important to make interoperability safe, the investment required is excessive if the market participants that ultimately pay cannot have free choice because commercial barriers are allowed to prevent full and effective competition among CCPs.[28]

One useful model that FICC should consider is FINRA's participation in several Trade Reporting Facilities ("TRFs"), which are operated by national securities exchanges but regulated as FINRA facilities. Under the TRF model, competing exchanges have access to FINRA's facilities on non-discriminatory basis. Importantly, FINRA does not share in the earnings of the TRFs it "sponsors," which removes from FINRA any economic incentive to discriminate in favor of any particular TRF. Unfortunately, in the present case, FICC's parent company's 50% economic stake in NYPC may prove fatal to NYPC's competitors. So long as DTCC's 50% ownership stake in NYPC is maintained, any expectation of equal treatment by FICC of NYPC's competitors seems unrealistic. As a self-avowed industry "utility" (and, more to the point, monopoly), FICC should grant market participants equal access to its facilities, rather than exclude its competitors in favor of its affiliates.

II. FICC'S PROPOSED CROSS-MARGINING REGIME MAY CREATE SYSTEMIC RISK

The Commission should not adopt FICC's novel cross-margining experiment without further review of the methodology it plans to use. Cross-margining necessarily allows for

[27] SEC Release No. 34–45335, File No. SR–GSCC–2001–03 (January 25, 2002), 67 FR 4768 (January 31, 2002).

[28] EuroCCP *Recommendations For Reducing Risks Among Interoperating CCPs* at 14, January 2010, *available at*: http://www.euroccp.co.uk/docs/leadership/EuroCCP_InteroperatingCCPs.pdf.

greater leverage than a standard margin account, and greater leverage has the potential to create greater losses in the event of adverse market movements. In light of the volatility of the securities and derivatives markets and the role played by excessive leverage in the recent financial crisis, *ad hoc* approvals of unproven, novel cross-margining arrangements that expand margin credit for fixed income and derivative products may needlessly increase the levels of systemic risk.

A. The Commission and the CFTC Should Confer, Study and Stress-Test FICC's Novel Cross-Margining Regime

From the regulatory perspective, an appropriate first step for derivative cross-margining would be to devise (in a transparent, public manner) effective stress tests needed to understand fully the systemic risks of various cross-margining regimes and cross-margining risk methodologies. Neither the Commission nor the CFTC have previously allowed single-pot portfolio cross-margining for fixed income securities, which present a far more complicated risk profile than equities. This is particularly true for certain individual interest rate securities and OTC derivatives; risk is exacerbated if the cross-margining regime involves a novel application of a risk methodology.

B. FICC's Modified Risk-Based Margining Methodology is Untested and Requires Further Study

The historically-based FICC value at risk (VaR) method for calculating margin requirements, which FICC now proposes to utilize, should be better understood, studied and tested before being employed to increase the leverage of portfolio accounts that include derivative products.[29]

FICC appears to have discarded the derivatives industry standard in favor of applying an untested method. The Standard Portfolio Analysis of Risk ("SPAN") was designed by the Chicago Mercantile Exchange (CME) for derivative instruments and is now used to calculate margin for derivative and non-derivative instruments at 50 exchanges and clearing organizations worldwide, including the CME.[30] SPAN is a scenario-based method of assessing risk, subjecting a portfolio to certain hypothetical market fluctuations that may or may not have any recent historical antecedent. The FICC VaR model, on the other hand, looks at historical market fluctuations over a fixed period of time (approximate 250 front weighted days in FICC's case), and calculates portfolio margin requirements based on market movements in that time period. It is unclear whether the application of the SPAN methodology to the combined portfolio would

[29] The historically-based VaR method has been used to establish net capital requirements for consolidated supervised entities. However, the adequacy of historical VaR's performance during the most recent financial crisis has been questioned. The application of the FICC's VaR methodology certainly needs to be better understood before it is used as a basis to increase leverage in the fixed income and fixed income futures markets.

[30] See CFTC Glossary, *available at*: http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/glossary_s.html.

result in higher margin requirements than FICC's proposed method. FICC should demonstrate that its proposed methodology provides more effective collateralization of risk than SPAN.

The rules proposed by FICC appear to reflect FICC's own unease about sufficiency of its proposed method to guarantee adequate collateral requirements in the event of unusual market movements. The objective[31] of NYPC-FICC single-pot margining is to achieve a combined portfolio margin requirement that is less than the sum of the individual requirements of NYPC and FICC. The FICC-NYPC Arrangement, however, provides that either FICC or NYPC may increase a participant's margin requirement "based upon the financial condition of the participant, unusual market conditions or other special circumstances."[32] FICC has failed to explain why the Commission should approve a cross-margining scheme that contemplates the possibility of insufficient collateral requirements in "unusual market conditions or special circumstances."

The adequacy of FICC's methodology is also uncertain because FICC has not been forthcoming in supplying the results of its back-testing analysis. FICC and an "independent firm" performed the analysis, but FICC has not disclosed factors considered for the test, the results of the test or even the name of the firm that helped FICC conduct the analysis. Indeed, subjecting each member's margin requirement to a daily back test and applying a "coverage component" if the back test reflects insufficient coverage reflect FICC's uncertainty as to the efficacy of its methodology.[33]

CONCLUSION

The burden that FICC's exclusive cross-margining agreement with NYPC places on clearinghouse competition is far greater than any claimed benefits of the proposed arrangement. Moreover, FICC's novel cross-margining proposal and the application of FICC's VaR model to fixed income and derivative products should be better understood, studied and stress-tested before being employed to increase the leverage of portfolio derivative accounts.

The Commission and the CFTC should follow Congress' direction and further study market models and risk methodologies for single pot cross-margining. The Dodd-Frank Act directs the CFTC and Commission to consult and adopt rules of general applicability governing

[31] FICC indicates that it expects reductions of approximately 20% but recognizes that it may not be achieved. (In light of the uncertainty about the expected reductions, it should be asked again how the concomitant significant competitive burden can reasonably be justified. <u>See</u> discussion above.)

[32] FICC November 23, 2010 SEC Notice at p. 6.; NYPC Proposed Rule 305.

[33] Furthermore, FICC has failed to show that mechanics of its proposed risk model are appropriate in light of the risk. FICC proposes to front-weight market events in calculating margin requirements. Front weighting introduces pro-cyclicality into the margin process which could serve to increase the demand for margin capital during periods of stress. FICC has not demonstrated the impact of pro-cyclical front-weighting on the proposed risk model. FICC has also chosen 3-day and 1-day liquidation periods that, respectively, apply to cash and derivative positions. FICC has not demonstrated that these periods are adequate in light of the fact that it is unlikely that the close out of the transactions will occur on the day of insolvency.

the cross-margining of securities and futures instruments.[34] Since Congress clearly intended that the CFTC and the SEC implement portfolio cross-margining regimes through the rulemaking process, the agencies should confer and promulgate rules to permit non-exclusive portfolio margining that protect the public and promote competition, rather than approve exclusive and untested cross-margining regimes through the *ad hoc* SRO rule approval process.

Sincerely,

[34] Section 713 Dodd-Frank Wall Street Reform and Consumer Protection Act, 7 U.S.C. § 6(d) (2010).