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**Via Electronic Mail** (rule-comments@sec.gov)

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Self-Regulatory Organizations; Fixed Income Clearing Corporation; Notice of Filing of a 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 (Release No. 34-63361; File No. SR-FICC-2010-09)

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Dear Secretary Murphy:

On behalf of ELX Futures, L.P. ("ELX"), we respectfully submit these comments in connection with the proposed rule change filed by the Fixed Income Clearing Corporation ("FICC") with the Securities and Exchange Commission ("Commission") pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 19b-4 thereunder on November 12, 2010, of which notice was published in the Federal Register on November 30, 2010.[1] The proposed rule change (the "FICC Proposal") would allow FICC to offer cross-margining of certain positions cleared at its Government Securities Division ("GSD") and certain positions cleared at New York Portfolio Clearing, LLC ("NYPC"). NYPC is a 50/50 joint venture between the Depository Trust &

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[1] Securities Exchange Act Release No. 63361 (November 23, 2010), *75 FR 74110* (November 30, 2010) [File No. SR-FICC-2010-09] ("FICC Proposal Notice" or "FICC Proposal").

Clearing Corporation ("DTCC"), of which FICC is a subsidiary, and NYSE Euronext ("NYSE"). The proposed rule change would allow certain GSD members to combine their positions at the GSD with their positions or those of certain permitted affiliates cleared at NYPC, within a single margin portfolio ("one pot margining").

It is our contention that the proposed rule change violates numerous provisions of the Exchange Act. The FICC Proposal enshrines an exclusive arrangement between FICC and NYPC that precludes other clearing agents from offering one pot margining directly with FICC, forcing competitors of FICC affiliates to offer that service, if at all, through NYPC on inferior terms. By preventing market participants from receiving the benefits of cross-margining on equal terms, the FICC Proposal imposes a burden on competition without justification. For the reasons described below, the FICC Proposal should not be approved unless it is amended to require FICC to enter into one pot margining agreements with other exchanges/clearing agents on the same timetable as any arrangement with NYPC becomes operational.

<u>About ELX</u>

ELX is a CFTC-regulated electronic futures exchange which began trading on July 10, 2009. It currently trades U.S. Treasury and Eurodollar futures contracts that compete with products traded on the affiliated exchanges of the Chicago Mercantile Exchange Group ("CME"). ELX utilizes the Options Clearing Corporation ("OCC") as its clearing agent. ELX is the only significant competitor to the CME in the trading of U.S. Treasury and Eurodollar futures, and has garnered 2-3% of such trades. ELX expects to compete with NYSE Liffe U.S. ("NYSE Liffe"), the derivatives exchange arm of NYSE, when NYSE Liffe begins to trade U.S. Treasury futures upon the launch of NYPC.

Exchange Act Provisions Violated

The Exchange Act requires that self-regulatory organizations (such as securities exchanges and clearing agents) engage in behavior that does not promote anti-competitive or discriminatory impact. Additionally, relevant Exchange Act provisions and related guidance mandate cooperation and fair competition among clearing agencies and exchanges. Section 17A(b)(3)(I) provides that a clearing agency cannot be registered with the Commission unless the Commission determines that "[t]he rules of the clearing agency do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of [the Exchange Act],"[2] and Section 17A(b)(6) states that "[n]o registered clearing agency shall prohibit or limit access by any person to services offered by any participant therein."[3] Section 19(b)(2)(C)(i) calls for the Commission to approve a proposed rule change of a self-regulatory organization only if it is consistent with the requirements of the Exchange Act and applicable rules and regulations.[4]

The FICC Proposal (which anoints NYPC as the sole clearing agency able to provide one pot margining with FICC) violates these prohibitions for two separate reasons. *First*, "requir[ing]" the "proposed single pot" "to be accessed by other futures exchanges and DCOs via NYPC"[5] plainly impairs competition, and FICC offers no persuasive reason for precluding direct access to it by other DCOs. *Second*, contrary to what FICC states, the supposed "groundbreaking open access policies"[6] FICC proposes do not provide "access [to] the single pot" on "non-discriminatory

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[2] 15 U.S.C. § 78q-1(b)(3)(I).
[3] 15 U.S.C. § 78q-1(b)(6).
[4] 15 U.S.C. § 78s(b)(2)(C)(i).
[5] FICC Proposal, *supra* note 1, at 74115.
[6] *Id.*

terms."[7] Because NYSE Liffe is the derivatives exchange arm of NYSE (which, in turn, is the 50% owner of NYPC), the proposed arrangement effectively – and improperly – advantages NYSE Liffe over other futures exchanges.

NYPC's Exclusive Access to One Pot Margining Violates the Exchange Act

The FICC Proposal concedes that "[t]he proposed single pot is required to be accessed by other futures exchanges and DCOs via NYPC."[8] This plainly "burden[s]" competition relative to alternative structures – for example, an alternative structure where other clearing agents, such as OCC, can directly access FICC and engage in one pot margining. The FICC Proposal explains that permitting one pot margining will provide an important new source of competition against the dominant CME in the business of trading U.S. Treasury futures. One pot margining promises "greater competition, increased capital and operational efficiencies, and enhanced transparency."[9]

However, the FICC Proposal makes FICC's affiliate NYPC a *monopolist* in providing this new source of competition against the CME. For up to two years, the proposed rule enables NYPC's affiliate NYSE Liffe to be the sole exchange permitted to offer one pot margining with FICC.[10] Even if NYPC eventually permits other exchanges – such as ELX – to clear through it, NYPC will remain the sole *clearing agency* permitted to offer one pot margining directly with FICC. Although the FICC Proposal contemplates that NYPC might permit other DCOs to "access"

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[7] *Id.* at 74116.

[8] *Id.* at 74115. The FICC Proposal indicates that Section 16 of the NYPC/FICC cross-margining agreement in principle permits FICC to permit other DCOs to engage in one pot margining as long as NYPC's "priority for margin offset purposes over any other cross-margining agreement" is preserved. *Id.* at 74115 n.8. FICC's concession elsewhere in the FICC Proposal that NYPC will be the exclusive DCO permitted to engage in one pot margining directly with FICC demonstrates that this "priority" means effectively exclusivity.

[9] *Id.* at 74116.

[10] *Id.*

NYPC, it is plain that such DCOs will be relegated to sub-agent status and required to pay "[r]easonable clearing fees" for the privilege.[11] "Reasonable clearing fees" charged to competitive exchanges do not place them on an even-handed "open access" basis with the exchange whose parent co-owns NYPC. Additionally, a provision in the NYPC/FICC cross-margining agreement explicitly states that FICC cannot (without prior written consent of NYPC) amend its CME cross-margining agreement if it would impact the priority NYPC has over CME positions.[12] No matter how FICC dresses up its supposed "open access policies," it is clear that the FICC Proposal inevitably interposes NYPC between exchanges such as ELX and access to the FICC's unique competitive asset of one pot margining against long positions in U.S. government securities. By doing so, FICC is leveraging its government-sanctioned monopoly in clearing fixed-income securities to secure competitive advantages for its business partner NYPC and NYPC's affiliate NYSE Liffe in clearing fixed income derivatives contracts, a field not intended to benefit from the favored legal and regulatory position that FICC enjoys in its core market.

Compared to FICC's proposed structure – one that makes NYPC the exclusive one pot margining gatekeeper – competition plainly would be greater if other clearing agents, such as ELX's clearing agent OCC, could *directly* offer one pot margining with FICC. First, the FICC Proposal contemplates that for up to two years only NYSE Liffe might be able to offer one pot margining to its customers to enhance competition against CME. Plainly, competition would be greater if ELX could also offer this service; granting NYPC and its affiliate NYSE Liffe up to two year exclusive access to one pot margining accordingly plainly imposes a "burden" on competition.

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[11] *Id.* at 74115.

[12] *See Id.* at 74115 n.8.

Indeed, any "head start" would create a competitive benefit for NYPC as customer habits and inertia reward first-mover status. A 2008 Comment Letter of the U.S. Department of Justice's ("DOJ") Antitrust Division to the Department of the Treasury makes this point. The DOJ stated:

> More specifically, the Department believes that the control exercised by futures exchanges over clearing services — including (a) where positions in a futures contract are held ("open interest"), and (b) ***whether positions may be treated as fungible or offset with positions held in contracts traded on other exchanges ("margin offsets")*** — has made it difficult for exchanges to enter and compete in the trading of financial futures contracts.[13]

Plainly, if the Commission approves a rule change allowing NYPC's affiliate NYSE Liffe exclusive access to one pot margining with FICC, this would realize the same concerns that the DOJ expressed in its 2008 letter.

Second, even if NYSE Liffe's exclusive access to one pot margining at some point ends, competition plainly would be greater if other clearing agents, such as OCC, could offer direct one pot margining with FICC, and not through NYPC. For one thing, there is obvious harm to competition *during* the up-to 24 month transition period. NYSE and DTCC announced NYPC's formation and NYPC's exclusive access to FICC one pot margining approximately 18 month ago.[14] Futures traders thus have known for well over a year that ELX faces a significant handicap (compared to NYSE Liffe) when NYPC begins operations, and during that period ELX's ability to attract customers has accordingly been retarded. Simultaneously, the time-table for NYPC initiating operations has continued to slip. Accordingly, NYSE Liffe's supposed temporary period

[13] Comment letter from the United States Department of Justice entitled Review of the Regulatory Structure Associated with Financial Institutions, to the United States Department of the Treasury, TREAS-DO-2007-0018, at 1 (Jan. 31, 2008) (emphasis added), *available at* http://www.justice.gov/atr/public/comments/229911.pdf.

[14] *See* http://www.dtcc.com/news/press/releases/2009/nypc.php (June 18, 2009). Further, the proposed up to two year period of initial exclusivity has been generally known since announcement of NYPC's formation in June 2009. The fact that DTCC and NYSE have had this additional 18 months since announcing NYPC raises the question of why an exclusive period of that length (or any length) is still needed, as presumably operational concerns over one pot margining with NYPC, if any, could have been worked out over that time.

of exclusivity effectively places a long-term handicap on ELX, today the only rival to CME. Offering the marketplace the benefits of one pot margining does not require giving ELX's rival, NYSE Liffe, this time-to-market advantage.

For another, even if ELX is able to access NYPC before ELX is commercially impaired, putting ELX to the choice of one pot margining through NYPC, an affiliate of ELX's competitor NYSE Liffe, or no one pot margining at all, imposes an anticompetitive burden. If ELX cannot offer one pot margining, as explained, ELX will continue to suffer a significant competitive disadvantage that impairs its ability to provide significant competition to the CME. If ELX must clear through NYPC to offer customers one pot margining, competition also will suffer. ELX would need to disclose sensitive information to an affiliate of its competitor, NYSE Liffe; this could deter ELX from launching new initiatives that benefit consumers. Moreover, because NYPC's 50% owner, NYSE, also owns NYSE Liffe, if ELX customers clear trades through NYPC rather than OCC with FICC, antitrust economics predicts that NYSE Liffe would pull ***its*** competitive punches, thereby causing prices to consumers to rise relative to circumstances where ELX customers clear through OCC.[15]

None of these competition-burdening consequences are alleviated by the suggestion in the FICC Proposal that other clearing houses, such as OCC, might eventually be admitted as "limited purpose participants."[16] The FICC Proposal indicates that a participating DCO must commit its

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[15] *See, e.g.*, United States Department of Justice and Federal Trade Commission, *Horizontal Merger Guidelines* § 13, at 33-34 (Aug. 19, 2010) (explaining that holding a minority position in a rival can blunt incentives). As applied here, if an ELX client cleared through a clearinghouse 50% owned by NYSE, NYSE could have an incentive to raise the fees that NYSE Liffe charges its clients, because NYSE can "recapture" through NYPC losses from any customers switching to ELX from NYSE Liffe.

[16] FICC Proposal, *supra* note 1, at 74115.

capital by contributing to the NYPC's guaranty fund, something that likely will deter other DCOs from participating in such an arrangement. Moreover, because both NYPC and a "limited purpose participant" DCO will both charge fees,[17] futures traders – the consumers – will be deterred from trading products cleared by non-NYPC clearinghouses if they thereby face higher costs because of the fee structure NYPC demands.

Discrimination in Favor of NYPC and its Affiliate NYSE Liffe

The FICC Proposal also burdens competition because it does not, contrary to what FICC contends, provide "access [to] the single pot" on "non-discriminatory terms."[18]

Other exchanges, such as ELX, that might clear through NYPC are discriminated against in two ways. First, to obtain one pot margining through NYPC, ELX must "contribute to the NYPC guaranty fund in the same manner as NYSE Euronext has done."[19] Notably, ELX is not required to contribute to the guarantee fund of its current clearing agent, OCC. More importantly, this requirement is discriminatory because there is no parallel burden for NYPC's affiliate NYSE Liffe. Indeed, because NYSE, the owner of NYSE Liffe, profits from NYPC's operations, NYSE Liffe is advantaged because it has an equity stake in NYPC's success that ELX does not. Second, as explained, ELX cannot obtain access to NYPC for up to 24 months, by which time ELX could be commercially impaired by NYSE Liffe's exclusive access.

[17] *Id.* The FICC Proposal states that "[r]easonable clearing fees will be allocated between NYPC and the limited purpose participant DCO as may be agreed by NYPC and the DCO, taking into account factors such as the cost of services (including capital expenditures incurred by NYPC), technology that may be contributed by the limited purpose participant, the volume of transactions, and such other factors as may be relevant." *Id.*

[18] *Id.* at 74116.

[19] *Id.*

Other clearing agents, such as OCC, not only must also contribute to NYPC's guarantee fund if they wish to engage in cross margining with FICC, but also must agree with NYPC on the fees to be charged.[20] As these fees may be based on numerous factors,[21] there is no guarantee that the total fees customers confront will be the same as those charged by NYPC. They may well be higher, and thus discriminatory. Because it is in NYPC's economic interests for customers to clear through it rather than through another clearing agent, one can expect that the aggregate fees customers will face clearing through a non-NYPC clearinghouse will be greater, thereby also impairing competition.

<u>Lack of Justification for Competition-Reducing Burdens</u>

The FICC Proposal advances three justifications for the above burdens the proposed rule change places on competition. None persuasively shows that the anticompetitive burdens are "necessary or appropriate in furtherance of the purposes of [the Exchange Act]."[22]

*First*, FICC contends that mandating one pot margining through NYPC is "required" to "ensure the uniformity and consistency of risk methodologies and risk management."[23] But FICC fails to explain why FICC cannot offer one pot margining directly with multiple clearing agents and still "ensure the uniformity and consistency of risk methodologies and risk management." There are numerous examples of other clearing agents adhering to settled methodologies. For example, OCC offered a one pot margining system to both CME and CBOT concurrently before they merged

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[20] *Id.* at 74115.
[21] *See supra* note 17.
[22] 15 U.S.C. § 78q-1(b)(3)(I).
[23] FICC Proposal, *supra* note 1, at 74115.

that allowed for cross margining between equity options on stocks listed on both the S&P 500 and the Dow Jones Indices.

Moreover, the FICC's proposed rule changes themselves require DCOs that are admitted as "limited purpose participants" to "agree to participate using the uniform risk methodology and risk management policies" and "systems and procedures that have been adopted by FICC and NYPC."[24] The FICC Proposal provides no reason why, if the DCOs must implement these very procedures when engaging in one pot margining *through* NYPC, the DCOs could not implement these same procedures *directly* with FICC. Put simply, FICC's contention that exclusivity is "required" to "ensure" uniformity masks the fact that FICC settled on exclusivity without exploring any other way of achieving uniformity.

*Second*, the FICC Proposal asserts that NYPC's exclusivity is "required" to "standardize operational requirements for new participants."[25] But again, if exchanges and clearing agents must agree to particular "operational requirements" to "participate" in one pot margining through NYPC, there is no reason why FICC could not mandate that other clearing agents and exchanges follow these very requirements in direct agreements with FICC. That it may take time "to allow" "for the completion of the material operational challenge of connecting and integrating with the separate technologies of other DCMs and/or DCOs"[26] would apply equally to permitting multiple DCMs and/or DCOs to engage in one pot margining with FICC itself. Last, even if there were sound uniformity-based reasons to require NYPC exclusivity, that would not justify the above-described

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[24] *Id.*

[25] *Id.*

[26] *Id.* at 74116.

competitive advantages that NYSE Liffe will enjoy over ELX (and other rivals) both during NYPC's initial 24 months and thereafter.

*Third*, the FICC Proposal asserts that the limitations on competition its proposed rule change imposes are necessary "to maximize the effectiveness of the one-pot arrangement."[27] This apparently means maximizing the size of NYPC's guarantee fund.[28] But if the justification is scale, that cannot support giving NYPC exclusive access to one-pot margining. FICC itself has a Clearing Fund of over $11 billion. If scale is the objective, we believe the Commission can condition the proposed rule modification on FICC allowing direct one pot margining with multiple clearing agents and permitting them to access its deep Clearing Fund, thereby creating a much deeper guarantee fund than NYPC likely will enjoy without the burdens on competition imposed by FICC's proposed exclusivity in favor of NYPC (and, for up to the next two years, NYSE Liffe). It appears that FICC elected to sacrifice scale to secure a monopoly position for NYPC in providing one pot margining for U.S. Treasury futures.

There is, at bottom, no sound policy reason for the Commission to approve an application that gives NYSE Liffe a competitive advantage over other exchanges such as ELX, a competitive advantage DTCC and NYSE Liffe themselves have explicitly identified on more than one occasion.[29] On the contrary, permitting NYSE Liffe to offer one pot margining through its clearing

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[27] *Id.* at 74115.

[28] *Id.* ("[T]he proposal between FICC and NYPC has the potential to create a substantial pool of highly correlated assets that are capable of being cross-margined. This pool will deepen as more DCOs and DCMs join NYPC, creating the potential for even greater margin and risk offsets.").

[29] *See* http://www.dtcc.com/news/newsletters/dtcc/2010/apr/AprilNews.pdf, at 3 (Apr. 2010) (extolling how cross-margining will benefit participants that transact on NYSE Liffe). Additionally, Thomas Callahan, the CEO of NYSE Liffe, has been quoted making the very point that the tie up is a competitive advantage, stating that "[t]o compete on price alone in the U.S. futures market is a losing strategy. The value proposition to compete in the U.S. futures market has to be unquestionable or else you'll fail. We feel very strongly that, in partnership with FICC, we do have an

agent of choice when ELX cannot threatens to deprive investors of one of the few alternatives to CME – ELX – in derogation of Exchange Act provisions designed to avoid imposing "any burden on competition not necessary or appropriate in furtherance of the purposes of [the Exchange Act]."[30]

The "Exclusivity" of This One Pot Margining Arrangement is Inconsistent with Prior Rule Changes Addressing Cross-Margining

As noted above, Section 19(b)(2)(C)(i) of the Exchange Act calls for the Commission to approve a proposed rule change of a self-regulatory organization only if it is consistent with the requirements of the Exchange Act and applicable rules and regulations.[31] Previous Commission releases approving cross-margining arrangements of FICC and predecessor entities[32] have cited Section 17A(b)(3)(F) of the Exchange Act (which requires that clearing agency rules be designed "to foster cooperation and coordination with persons engaged in the clearance and settlement of securities transactions, to remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions, and, in general, to protect investors and the public interest" and not to "permit unfair discrimination in the admission of participants or among participants in the use of the clearing agency"[33]) and/or Section 17A(a)(2)(A)(ii) of the Exchange Act (which directs the Commission, having due regard for the public interest, the protection of investors, and maintenance of fair competition, to "facilitate the

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unquestionable value proposition. This is innovative." *See* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aU9mOm_Oapg0 (June 18, 2009).

[30] 15 U.S.C. § 78q-1(b)(3)(I).

[31] 15 U.S.C. § 78s(b)(2)(C)(i).

[32] *See, e.g.*, Securities Exchange Act Release No. 45656 (March 27, 2002), *67 FR 15646* (April 2, 2002) [File No. SR-GSCC-2002-01].

[33] 15 U.S.C. § 78q-1(b)(3)(F).

establishment of linked or coordinated facilities for clearance and settlement of transactions in securities, securities options, contracts of sale for future delivery and options thereon, and commodity options"[34]). For the reasons discussed above, the FICC Proposal will not create "linked or coordinated facilities" – rather, it will create a system of clearing that reduces competition, and in which certain exchanges will be able to offer services that others cannot. Consistent with the Exchange Act provisions noted above, the Commission should reject an "exclusive" cross-margining agreement which would hinder competition and discourage the development of linked clearing facilities. The inability of other firms to participate on equal terms with NYPC or NYSE Liffe will negate many of the positive effects one pot margining could create.

The Commission itself has recognized the inherent unfairness of "exclusive" cross-margining arrangements. For example, in granting the Clearing Corporation for Options and Securities an exemption from registration as a clearing agency, the Commission conditioned the exemption on the prompt linking of services with other specific agencies, which it called "vital to the satisfaction of the statutory goals of Section 17A."[35] In that release, the Commission also indicated that Congress and the Commission "contemplated a national system … in which there could be multiple clearing agencies serving a securities market"[36] and that the Commission "repeatedly has found that cross-margining programs are consistent with clearing agency responsibilities under Section 17A."[37] Further, the Commission stated that "[w]here more than one clearing agency for a market exists, the Commission believes that the linking of these clearing

[34] 15 U.S.C. § 78q-1(a)(2)(A)(ii).
[35] Securities Exchange Act Release No. 36573 (December 12, 1995), *60 FR 65076* (December 18, 1995) [File No. 600-27] at 65085.
[36] *Id.* at 65084.
[37] *Id.* at 65085.

agencies...promotes competition and innovation while still allowing for one account settlement"[38] and that it "believes that rather than mandate centralized clearance and settlement...it should encourage the coordination of any competing systems through economically efficient linkages that ultimately will foster both competition and investor confidence."[39] This shows the Commission's intention to prevent systems in which one clearing agency has a priority arrangement over other clearing agencies or any other exclusive advantages. The Commission also stated in that release that "cross-margining programs, among other things, tend to enhance clearing member and systemic liquidity both in times of normal trading and in times of stress. . . . By enhancing market liquidity, cross-margining arrangements remove impediments to and help perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions."[40] By allowing certain parties only limited cross-margining, and driving potential participants away due to the priority given NYPC, FICC's proposed rule change will not be able to achieve the benefits of cross-margining that have previously been championed.

Before its parent company became 50% owner of a derivatives clearing organization, the FICC and its predecessor entities entered into direct cross-margining agreements with multiple clearing agents,[41] and did not champion the use of one exclusive clearing entity for all cross-margining. The FICC Proposal gives the appearance of using general operational arguments and risk management discussions (including a discussion of proper risk management in a post Dodd-Frank environment, despite the fact that the exclusive arrangements of DTCC/NYSE were first

[38] *Id.* at 65084.
[39] *Id.*
[40] *Id.* at 65085.
[41] *See, e.g.*, Securities Exchange Act Release No. 41766 (August 19, 1999), *64 FR 46737* (August 26, 1999) [File No. SR-GSCC-98-04].

announced over a year before Dodd-Frank was passed) to leverage FICC's virtual monopoly position in clearing fixed-income securities for the competitive advantage of its business partners NYPC and NYSE Liffe. The Commission should not approve a proposed rule change that is a device for extending a government-granted monopoly at one level (clearing U.S. government debt securities) to another (clearing interest rate derivatives).[42]

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We are available to answer any follow-up questions.

Sincerely,

Richard D. Marshall

Richard D. Marshall

[42] As the Supreme Court once wrote in the context of the Sherman Act: "If monopoly power can be used to beget monopoly, the Act becomes a feeble instrument indeed." *United States v. Griffith*, 334 U.S. 100, 109 (1948).