



UNIVERSITY OF MARYLAND  
SCHOOL OF LAW

January 24, 2011

David A. Stawick  
Secretary  
Commodity Futures Trading Commission  
Three Lafayette Center  
1155 21<sup>st</sup> Street, NW  
Washington, DC 20581

**Re: Implementation of Conflicts of Interest Policies and Procedures by Swap Dealers and Major Swap Participants**

Dear Mr. Stawick:

These comments are submitted in response to the Notice of Proposed Rulemaking<sup>1</sup> issued by the Commodity Futures Trading Commission (“CFTC” or “Commission”) pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act<sup>2</sup> (the “Dodd-Frank Act”). The proposed rules would implement section 731 of the Dodd-Frank Act, which adds a new section 4s(j)(5) to the Commodity Exchange Act<sup>3</sup> (“CEA”) to direct each swap dealer (“SD”) and major swap participant (“MSP”) to implement conflicts of interest systems and procedures that establish “firewalls to ensure a separation between the research arm, the trading arm and the clearing activities of [SDs] and [MSPs], futures commission merchants and introducing brokers.”<sup>4</sup> In particular, the Commission is proposing to adopt Rule 23.605, which would ensure that any persons researching or analyzing the price or market for any commodity or swap, and any persons acting in a role of providing clearing activities or making determinations as to accepting clearing customers, are separated by “appropriate informational partitions” within the

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<sup>1</sup> Implementation of Conflicts of Interest Policies and Procedures by Swap Dealers and Major Swap Participants, 75 Fed. Reg. 71391 (November 23, 2010) [hereinafter “Proposed Rules”].

<sup>2</sup> Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

<sup>3</sup> 7 U.S.C. 1 *et seq.*

<sup>4</sup> See Statement of Gary Gensler, Chairman, Commodity Futures Trading Commission, *Implementation of Conflicts of Interest Policies and Procedures by Swap Dealers and Major Swap Participants* (Nov. 22, 2010) at 71397, *supra* note 1.

firm from review, pressure, or oversight of persons whose involvement in pricing, trading or clearing activities might potentially bias the judgment or supervision of the persons.<sup>5</sup>

The Commission's proposed rules are critically important in order to mitigate conflicts of interest in a SD and MSP. Therefore, there must be proper, objective oversight and enforcement of the proposed rules. As such, monitoring of firms' policies and procedures on conflicts of interest should be carried out at the Commission level, not by the self-regulatory organization. It is the CFTC's mission "to protect market users and the public from abusive practices" and "to foster open, competitive, and financial sound markets."<sup>6</sup>

## **I. Informational Partitions Between Research/Analysis and Pricing/Trading/Clearing**

Proposed Rule 23.605(c) correctly sets forth a number of restrictions that create informational partitions between the research and trading functions of SDs and MSPs. These restrictions are designed to prevent conflicts of interest that may arise as a result of research reports prepared by research analysts, including research analysts employed by an affiliate, of a SD or MSP. Specifically, Proposed Rules 23.605(c)(1) to (c)(6) impose necessary duties and constraints to remove any influence that employees in the trading function might have over research analysts.

Restricting the interaction between persons involved in research or analysis of the price and persons involved in pricing, trading, or clearing has already been proven to be necessary and critically important to preserve research analysts' independency and integrity. As the Commission correctly pointed out in Proposed Rules, in securities market, Section 15D of the Securities Exchange Act of 1934, as amended by section 501(a) of the Sarbanes-Oxley Act of 2002,<sup>7</sup> requires the Securities and Exchange Commission ("SEC") to adopt rules to address conflicts of interest and to improve the objectivity of research, and to provide investors with more useful and reliable information.<sup>8</sup> In particular, Section 15D mandates the establishment of structural and institutional safeguards to assure that securities analysts are separated by "appropriate informational partitions" within the firm from the review, pressure, or oversight of those whose involvement in investment banking activities might potentially bias their judgment or supervision.<sup>9</sup> This language is very similar to section 731 of Dodd-Frank.

Some market participants have argued that the Commission should modify the Proposed Rules to permit research management to solicit the views of business trading and clearing unit

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<sup>5</sup> See Proposed Rules at 71395, *supra* note 1.

<sup>6</sup> See official website of the Commodity Futures Trading Commission, *Mission & Responsibilities*, <http://www.cftc.gov/About/MissionResponsibilities/index.htm>.

<sup>7</sup> Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745 (2002).

<sup>8</sup> See Proposed Rules at 71392, *supra* note 1.

<sup>9</sup> *Id.*

personnel on analyst compensation and evaluation, provided that research management maintains exclusive authority over final decisions in these areas.<sup>10</sup> The Commission must not weaken the proposed rules to allow “indirect” influence because this kind of solicitation could compromise an analyst’s objective and independency. There is ample objective evidence concerning markets and market fundamentals to form sound analytical guidance without the need to obtain the view of traders in these markets, thereby raising the risk that analysts will want to please trader interests and support trading positions, rather than provide objective independent advice formed completely free of fulfilling trading strategies that may bear no relationship to market fundamentals. In this regard, there is no difference between the equity markets and futures markets, and the dangers of analyst/trading conflicts has already shown its disastrous impact in the stock markets with analysts recommending investments they knew full well to be unsound.

## II. Conflicts of Interest of SD and MSP in Clearing Activities

Proposed Rule 23.605(d) sets forth restrictions that are designed to “establish structural and institutional safeguards to ensure that the activities of any person within the firm [...] acting in a role of providing clearing activities or making determinations as to accepting clearing customers are separated by appropriate informational partitions within the firm from the review, pressure, or oversight of persons whose involvement in pricing, trading, or clearing activities might potentially bias their judgment or supervision and contravene the *core principles of open access* and the *business conduct standards* described in this Act.”<sup>11</sup>

One of the main principles shaping derivatives regulation under the Dodd-Frank Act is to provide *free and open access to clearing and exchange trading*.<sup>12</sup> This necessitates that there be informational partitions between persons making clearing determinations and persons involved in pricing and trading swaps in order to protect against potential bias or interference in relation to the provision of clearing activities.

The Commission should be mindful that the market is already fearful of the undue influence of a handful of large swaps dealers as they are able to bundle the clearing service with the execution service as an explicit or implicit condition of clearing. This bundling or “tying”

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<sup>10</sup> See Comment Letter by the Futures Industry Association, International Swaps and Derivatives Association, Inc., and Securities Industry and Financial Markets Association to David Stawick, Secretary, the Commodity Futures Trading Commission (January 18, 2011), *available at* <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27171&SearchText=>.

<sup>11</sup> See § 731 of the Dodd-Frank Act (emphasis added).

<sup>12</sup> See, e.g., S. REP. 111-176, at 32–35 (2010) (noting that draft provisions concerning OTC derivatives were designed to minimize non-cleared, off-exchange trades); Transcript of Public Roundtable on Governance and Conflicts of Interest in the Clearing and Listing of Swap, August 20, 2010, at 33, *available at* <http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/derivative9sub082010.pdf> (statement of Randy Kroszner, University of Chicago, Booth School of Business, “And the law is clear: Open access is the fundamental principle.”) [hereinafter “Roundtable Tr.”].

raises potential conflicts of interest and undermines the tenets of the Dodd-Frank Act – “free and open access.” During the joint CFTC/SEC Roundtable on conflicts of interest and governance, Mr. Olesky from Tradeweb raised the same concern, “As we see in the futures markets and other markets, if you have both execution and clearing, we think it's very important for there to be a competitive environment among execution venues. And in order to have that competitive environment among execution venues, that requires really equal and fair access from any execution venue into a clearing corp.”<sup>13</sup>

Rule 23.605(d) properly addresses these conflicts of interest. In particular, the rule would prohibit any SD or MSP from directly or indirectly interfering with or attempting to influence the decision of any affiliated clearing member of a derivatives clearing organization with regard to the provision of clearing services and activities. Furthermore, subsection (d)(2) would require each SD and MSP to create and maintain an “appropriate informational partition” between business trading units of the SD or MSP and the “clearing member personnel of any affiliated member of a derivatives clearing organization.”<sup>14</sup>

The Commission is correct that there must be a set of restrictions that “prevent risk-taking units from interfering with decisions by any affiliated clearing member of a derivatives clearing organization regarding whether to accept a client for clearing services.”<sup>15</sup> In light of this, the proposed rules require that “all such decisions regarding the acceptance of customers for clearing should be made in accordance with *publicly disclosed, objective, written criteria*.”<sup>16</sup> Only when the customer acceptance criteria are publicly available will there be meaningful supervision by the Commission. Moreover, the disclosure of the criteria is consistent with the legislative intent, which is that SDs and MSPs provide *free and open access to clearing and exchange trading*. In light of this, the Commission must reject the Futures Industry Association, International Swaps and Derivatives Association, Inc., and Securities Industry and Financial Markets Association’s request to label client acceptance criteria confidential,<sup>17</sup> thereby allowing them to evade their responsibilities not only to the Commission, but also to the general public.

### **III. Full Disclosure to Customers**

The proposed rule 23.605(e) correctly requires that each SD and MSP implement policies and procedures mandating the disclosure to customers of any material incentives or any material conflicts of interest that relate to a customer’s decision on the execution or clearing of a

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<sup>13</sup> See Roundtable Tr. at 19, *supra* note 12.

<sup>14</sup> See Proposed Rules, *supra* note 1.

<sup>15</sup> See Proposed Rules at 71393, *supra* note 1.

<sup>16</sup> *Id.*

<sup>17</sup> See Comment Letter by the Futures Industry Association, International Swaps and Derivatives Association, Inc., and Securities Industry and Financial Markets Association to David Stawick, Secretary, the Commodity Futures Trading Commission (January 18, 2011), *available at* <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27171&SearchText=>.

transaction. The Commission is correct that such disclosures will enable customers to make fully-informed business decisions, thereby minimizing the potential influence of any incentives or conflicts of SDs and MSPs.

Sincerely,

A handwritten signature in blue ink that reads "Michael Greenberger". The signature is written in a cursive style with a large initial "M".

Michael Greenberger, J.D.  
Law School Professor  
University of Maryland School of Law