From: Colin D Lloyd <clloyd@cgsh.com>
Sent: Tuesday, April 5, 2011 10:19 AM
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Cc: Edward J ROSEN <erosen@cgsh.com>
Subject: Swap and Security-Based Swap Execution Facilities; File Number S7-06-11; RIN Number 3038-AD18; RIN Number 3038-AD26; RIN Number 3038-AD25
Attach: Letter Regarding Swap Execution Facilities.pdf

On behalf of the Firms listed below, please find attached a comment letter regarding the following proposals:

SEC
Registration and Regulation of Security-Based Swap Execution Facilities: Proposed Rule, 76 Fed. Reg. 10948, File No. S7-06-11

CFTC
Core Principles and Other Requirements for Swap Execution Facilities: Proposed Rule, 76 Fed. Reg. 1214, RIN Number 3038-AD18
Antidisruptive Practices Authority: Proposed Interpretive Order, 76 Fed. Reg. 14943, RIN Number 3038-AD26
Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties: Proposed Rule, 75 Fed. Reg. 80638, RIN Number 3038-AD25

Please contact Edward J. Rosen at 212-225-2820 with any questions.

Thank you.

The Firms

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April 5, 2011

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
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David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
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Re: Regulation SB SEF—Registration and Regulation of Security-Based Swap Execution Facilities, File No. S7-06-11;[1]

Core Principles and Other Requirements for Swap Execution Facilities, RIN 3038–AD18.[2]

Dear Secretary Murphy and Secretary Stawick:

This letter is submitted, on behalf of the undersigned firms (the "Firms"), in response to the captioned rule proposals (the "Proposed Rules") published by the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC" and, together with the SEC, the "Commissions") regarding the swap and security-based swap execution facility (collectively, "SEF") provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). The Firms appreciate the opportunity to provide comments to the Commissions with respect to the Proposed Rules.

We welcome the attention the Commissions have given to the SEF definition and related provisions of Dodd-Frank governing SEFs. We believe, however, that the Proposed Rules include requirements that are not consistent with Dodd-Frank's provisions and objectives. If adopted in their current form, the Proposed Rules could interfere with Congress' efforts to promote the migration of trading to regulated multilateral trading venues because they would

[1] 76 Fed. Reg. 10948 (Feb. 28, 2011) (the "SEC Proposal").

[2] 76 Fed. Reg. 1214 (Jan. 7, 2011) (the "CFTC Proposal").

impose restrictions that could disrupt markets or adversely affect institutional or corporate users of swaps.[3]

INTRODUCTION

In this letter, we focus on those provisions of the Proposed Rules that address (i) the types of execution models that would be permitted to be operated as SEFs, (ii) the requirements governing access to SEFs and quotes displayed on SEFs, (iii) the scope of Dodd-Frank's requirement that certain swaps be executed on a SEF or a designated contract market ("DCM") or securities exchange ("exchange"), as the case may be, and (iv) certain issues relating to market oversight.

Dodd-Frank's SEF provisions address a number of related objectives. These include the promotion of swap trading on SEFs and, in so doing, enhanced pre-trade transparency, access to quote competition and oversight of swap execution.[4] Implicit in these related objectives is recognition that the extent to which they can be achieved depends both on the ability of SEFs to meet the execution objectives of market participants as well as the extent to which swap trading occurs on SEFs. As a result, to achieve Congress' objectives, the Commissions must take care to ensure that trade execution requirements imposed on SEFs do not unduly interfere with the efficiency of the SEF market itself or create disincentives to the use of SEFs (where swap counterparties have a choice). Because swaps differ from listed securities and futures in important respects (discussed in greater detail below), market participants need to have the ability, particularly in the case of less liquid swaps, to restrict the dissemination of their trading interest, on a non-discriminatory basis, to specific recipients or categories of recipients.

We agree with CFTC Commissioner Sommers that, "the best way to achieve [Congress'] twin goals [of promoting the trading of swaps on SEFs and promoting pre-trade price transparency in the swaps market] is to adopt a model that provides the maximum amount of flexibility as to the method of trading."[5] Flexibility in trading methods will help end users and other market participants achieve their preferred balance of pricing, execution certainty and liquidity objectives, will reduce operational risk through increased electronic execution, and will expand regulatory oversight of the swap markets. Absent necessary flexibility, end users will simply choose to take advantage of their exemption from SEF trading and other market participants will not obtain optimal execution or, in some cases, may forego using swaps that are subject to Dodd-Frank's mandatory execution requirement, with resulting adverse risk

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[3] References to "swaps" herein include "security-based swaps" unless otherwise specified or required by context.

[4] See Section 5h(e) of the Commodity Exchange Act, as amended by Dodd-Frank ("CEA"); see also SEC Proposal at 10949 ("A key goal of [Dodd-Frank] is to bring trading of SB swaps onto regulated markets").

[5] Commissioner Jill Sommers, CFTC, Opening Statement, Open Meeting on the Eighth Series of Proposed Rulemakings under the Dodd-Frank Act (Dec. 16, 2010). The Technical Committee of the International Organization of Securities Commissions ("IOSCO") recently expressed a similar sentiment, explaining that, "where regulatory requirements allow sufficient flexibility for platform operators to tailor their market structures according to a range of liquidity profiles, organised platform trading should be practicable for most OTC derivatives product classes falling within that range for which an appropriate level of standardisation has been attained." Report on Trading of OTC Derivatives (Feb. 2011) ("IOSCO Report").

management consequences. Prescription alone cannot achieve Congress' or the Commissions' objectives.

It is clear from the legislative record and the text of Dodd-Frank that Congress carefully crafted the SEF provisions with these considerations in mind. Congressional intent to accommodate flexible execution requirements is manifested in three key areas:

- The SEF definition, which was negotiated extensively during the legislative process to achieve the desired balance between transparency and liquidity. Congress expressly rejected SEF provisions included in superseded legislative drafts that would have required qualifying platforms to provide central order book functionality.[6] Instead, Congress ultimately adopted a definition that maximizes choice for market participants. Under this definition, multiple SEF participants each must be provided with the ability to execute against orders of multiple other participants, but are not required to do so. Thus, Congress required only that participants have the ability to access quote competition. Beyond this specific requirement, Congress did not specify any particular execution methodology or any minimum required degree of quote competition.

- The SEF core principles, which require SEFs to provide "impartial"—not "universal" or "equal"—access to the market, and allow SEFs to exercise "reasonable discretion" in establishing the manner in which such access is achieved. Consistent with similar requirements in other markets, the Commissions should permit selective, but not discriminatory, standards for access to trading on the SEF and for differentiation among SEF participants (e.g., liquidity providers and liquidity takers, among other possible commercially reasonable distinctions).

- The mandatory execution requirement, which is limited to swaps that are both subject to mandatory clearing and made "available to trade." Where both of these conditions are not satisfied, bilateral trading is to be permitted on an unrestricted basis. The criteria for determining whether a swap is "available to trade" should be established by the Commissions pursuant to notice and comment, be applied on a swap-specific basis, and require meaningful levels of trading frequency and market participation.

These provisions and the related statutory record do not support the Commissions' proposed imposition of specific restrictions on the execution model(s) that may or must be employed by SEFs. As discussed in greater detail below, the Commissions' proposed restrictions would, if adopted, discourage trading on SEFs, be disruptive, and adversely affect execution quality.

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[6] See infra notes 19 and 20 and related discussion in Part II of the Discussion section below.

The proposed restrictions also may depart significantly from the more flexible execution frameworks envisioned in other G-20 jurisdictions. As IOSCO has noted, "the resulting regulatory disparities have the potential to influence market participants' choice of venues in which to conduct business."[7] This would undermine the G-20 leaders' recognition of the importance of "implement[ing] global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage."[8]

DISCUSSION

I. Characteristics of the Swap Markets

Swaps are manifestly different from securities and futures in respects that are critical to developing appropriate quotation and execution requirements for SEFs, but which the Proposed Rules do not appear to take fully into consideration.

A. Swap Market Liquidity

Swaps are significantly less liquid than corresponding listed securities or futures. This is in large part because, as described in the recent IOSCO Report, the swap markets "commonly reflect a significantly more segmented product spectrum, with a greater number of distinct contract variations based upon a given product."[9] The IOSCO Report illustrates this by comparing the number of participants per instrument for the WTI futures contract (20,000 participants in 70 instruments, for a ratio of 258:1) and the E-Mini S&P futures contract (150,000 participants in 5 instruments, for a ratio of 30,000:1) with single-name credit default swaps (220 participants in 83,000 instruments, for a ratio of 0.03:1), index credit default swaps (180 participants in 80 instruments, for a ratio of 2.25:1) and plain vanilla interest rate swaps (500 participants in 100,000 instruments, for a ratio of 0.005:1).[10]

Moreover, the most liquid swaps (10-year dollar interest rate swaps) trade about 200 times per day, most swaps trade fewer than 20 times per day,[11] and some categories of swaps (such as credit default swaps) trade fewer than 5 times per day.[12] Swap market participants tend to be more creditworthy and sophisticated than participants in the listed markets and, even though most swap trading remains bilateral, most significant swap market participants have little difficulty obtaining prices from multiple dealers for more standardized swaps.

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[7] IOSCO Report at 50.

[8] Statement No. 12, Leaders' Statement: The Pittsburgh Summit (Sept. 24–25, 2009).

[9] IOSCO Report at 28.

[10] Id.

[11] Id. at 7.

[12] ISDA and SIFMA, Block trade reporting for over-the-counter derivatives markets (Jan. 18, 2011) ("ISDA/SIFMA Study"), at 20–21.

Additionally, swap transactions tend to involve much larger notional values than transactions in securities and futures.[13] As a result, swap execution quality tends to exhibit greater sensitivity to disclosure of trading interest than is characteristic of transactions involving smaller sizes or greater liquidity.

In light of these differences, the Firms recommend that the Commissions look to multilateral trading models operating in less liquid, more institutional markets rather than drawing directly on parallels to the listed securities and futures markets. Platforms that have succeeded in these markets (e.g., swaps and less liquid fixed income securities markets) have tended to prioritize customer choice as to execution method and to provide opportunities for minimizing leakage of confidential trading information (such as by selective participation criteria and display settings) that could unduly and adversely affect the pricing of resulting transactions.

Even in more liquid listed equities and futures markets, market participants have consistently sought to achieve best execution by utilizing crossing networks and other non-displayed alternative trading systems ("ATSs") (in listed equities) and entering into privately-negotiated block transactions that are effected off-exchange (in futures). This reflects a natural trade-off between displayed and non-displayed liquidity. Displayed liquidity traditionally has the advantages of establishing a reference price and increasing the likelihood of execution by attracting contra-side trading interest, as well as regulatory and market structure advantages, such as trade-through protection and resting quote credits/rebates (for listed equities) and mandatory exchange-trading for most transactions (for futures). Non-displayed liquidity, on the other hand, has the advantages of reducing market impact for larger size transactions, increasing the potential for size improvement, and enhancing certainty of execution on terms acceptable to the party seeking liquidity. Market participants have long exercised their judgment in balancing these different advantages. They often opt for non-displayed execution methods for large size orders, orders for less liquid instruments, and other orders where confidentiality considerations outweigh the benefits associated with pre-trade transparency. As a result, non-displayed trading volume accounts for approximately 20-30% of listed equity volume,[14] and off-exchange transactions predominate for a wide range of futures contracts.[15]

B. Other Distinctions from Securities and Futures Markets

1. Distinctions from Equity and Debt Securities

Unlike equity and debt securities, swaps are executory contracts that generally give rise to ongoing credit exposure and other obligations between the transacting parties. As a result, swaps also require the allocation and utilization of limited credit capacity. Other

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[13] See IOSCO Report at 28; see also ISDA/SIFMA Study at 14 (noting that the average size of 10-year USD interest rate swaps is $75 million, as compared to $2 million for U.S. Treasury note futures).

[14] See Concept Release on Equity Market Structure, Exchange Act Release No. 61538 (Jan. 14, 2010), 75 Fed. Reg. 3594, 3613 (noting that the overall percentage of trading volume between displayed and non-displayed trading venues has remained fairly steady for many years between 70% and 80%).

[15] See Core Principles and Other Requirements for Designated Contract Markets, 75 Fed. Reg. 80572, 80589 (Dec. 22, 2010) (noting that all or almost all of the trading in 410 of the 570 contracts analyzed occurred off-exchange).

characteristics of the overall trading relationship between the parties may also affect pricing, including trading volume and contractual margining arrangements, as may the mere pre-existence of a documented trading relationship.

The executory character of swaps may also affect their pricing for other reasons. For example, in contrast to securities, a trade that offsets rather than increases a pre-existing swap position or risk exposure (either at a particular clearinghouse or with a bilateral counterparty) may well be priced more favorably. Although the seller of a security may have the security in inventory or need to purchase it, the cost and risk differentials between disposing of a security in inventory versus purchasing a security for immediate resale are not as significant as the differential cost and risk of entering into a swap that eliminates an existing market and/or credit exposures, on the one hand, and entering into a swap that increases market and/or credit exposures, on the other hand. Any swap that does not offset an existing exposure with a particular bilateral counterparty or at a clearinghouse will necessarily give rise to an increase in exposure; post-settlement, this is not the case with the sale of a security. These differences are starkly reflected in each of the Commissions' corresponding capital treatment for securities in inventory as opposed to swap exposures.

2. Distinctions from Futures and Options

Although the executory character of swaps does not itself distinguish them from futures and options (commodity and security), other market structure differences between swaps and futures/options make the executory character of swaps more consequential than it would otherwise be. These critical differences between swap market structure and futures and options market structure, discussed immediately below, give rise to several permutations of credit risk, margin requirements and other pricing-determinative characteristics for any given swap.

Uniformly across the U.S. listed futures and securities option markets, open positions in individual contracts are cleared through a single clearinghouse. These clearinghouses have a uniform clearing and cost structure for each contract that they clear, and offsetting positions within the clearinghouse are eligible for mutual offset. In contrast, swaps may potentially be cleared in different clearinghouses, each with different cost, risk and other material clearing features. Moreover, under Dodd-Frank and under each Commission's existing regulatory framework, no clearinghouse has the obligation to give fungible treatment or other recognition to offsetting exposures in another clearinghouse.

As a result, the choice of clearinghouse in the swap markets may affect resulting net and gross outstanding exposures, with differential capital and cost of financing consequences, in addition to differences in direct clearing costs. Additionally, unlike futures and options clearing price structures, some swap clearinghouses do and may in the future base certain clearing charges on open interest, accentuating potential clearing cost disparities dependent on the clearinghouse in which a transaction is cleared.

In the case of what the CFTC has defined as "permitted transactions," swaps may also result in bilateral exposures with differentiating cost and risk implications, as noted

immediately above.[16] Unless SEFs segregate quotes according to whether or not they are intended or required to be cleared (and, if so, according to the desired clearinghouse), the swap dealer or major swap participant counterparty may not know, either when submitting or accepting a quote, whether or where it will be cleared.[17] Clearinghouses and their clearing members also retain the right to reject a trade, which could result in parties who anticipated a cleared swap facing each other in a non-cleared bilateral transaction.[18] The resulting permutations present different economic and risk consequences that are material to the pricing of the relevant transaction.

In light of these product and market characteristics, it seems clear that restrictions on swap execution that parallel the requirements in the equities, futures and options markets could be highly disruptive where they prevent market participants from taking into account the full range of pricing considerations that are relevant to swaps. Inappropriate restrictions may also adversely impact execution quality by imposing a greater level of transparency than is warranted based on prevailing market liquidity. These consequences would discourage trading on SEFs and ultimately would be unsuccessful in forcing a greater level of transparency than market participants themselves desire.

II. Permitted Execution Functionalities

A. Statutory Framework

Congress recognized the unique characteristics of the swap markets by permitting swaps subject to the mandatory execution requirement to be traded on DCMs/exchanges and SEFs. Congress specifically tailored the SEF provisions to provide for more flexible means of execution than the central order book model characteristic of DCMs and exchanges. In particular, Congress modified the SEF definition to make it clear that SEFs may utilize a broader range of execution structures than "trading facilities."[19] Although Congress based many of the SEF core principles on the core principles applicable to DCMs, Congress did not include any provision in the SEF core principles requiring SEFs to execute, or offer execution of,

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[16] See CEA Section 2(h)(7)(A); Section 3C(g)(5)(A) of the Securities Exchange Act of 1934, as amended by Dodd-Frank ("Exchange Act") (end user clearing exceptions).

[17] For example, an end user may request quotes from liquidity providers for a swap and make its decision regarding whether to clear such swap based on the responses it receives. Moreover, unlike the existing futures and options market structures, Dodd-Frank gives unregistered counterparties the sole right to choose the clearinghouse at which a swap is cleared. See CEA Section 2(h)(7)(ii); Exchange Act Section 3C(g)(5)(B).

[18] In this regard, it would be helpful for the Commissions to consult with the industry to develop guidance, in the context of transactions subject to the mandatory execution requirement, as to the appropriate steps to be taken by the counterparties to a swap in such circumstances, consistent with the objective of maximizing transactional certainty.

[19] Specifically, the legislative text used as the base text for the House-Senate conference defined a SEF as a "facility in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by other participants that are open to multiple participants …" (emphasis added). H.R. 4173, 111th Cong. § 721(a)(21) (2010). This wording closely mirrors much of the wording in the CEA's existing "trading facility" definition. During the House-Senate conference, however, Congress specifically modified the SEF definition to require only that bids and offers be "made by multiple participants" and deleted the requirement that these be bids and offers "made by other participants that are open to multiple participants" (emphasis added).

transactions through a central order book. In contrast, execution through a central order book is a requirement that Congress did expressly include in its amendments to the core principles for DCMs.[20] There also is no provision in Dodd-Frank requiring that, or indicating that Congress intended that, swaps or security-based swaps were to become subject to the Exchange Act's national market system or any similar market system.[21]

The single defining characteristic of the SEF definition is the requirement that market participants be given the ability, but are not required, to access quote competition. This distinction is critical because the permutations of credit risk, margin requirements and other pricing-determinative characteristics for swaps discussed above necessarily mean that swaps are less suitable than listed securities and futures for trading in anonymous, continuous order book environments, and that firm quotations for different swap transactions are less comparable than would be the case for listed securities and futures. Accordingly, although Congress intended to enhance pre-trade transparency, access to quote competition and oversight of execution for swaps, it did so within a framework that emphasizes flexibility and customer choice to a greater extent than the regulatory framework for listed securities and futures.

As the SEC Proposal notes, subjecting SEFs to unduly prescriptive pre-trade transparency requirements could result in swaps not being made available to trade on a DCM/exchange or SEF (and hence not becoming subject to the mandatory execution requirement).[22] In the case of swaps that have been made available to trade, SEF participants might be unwilling to display two-sided firm quotes or might widen spreads, making trades uneconomical. This in turn could lead end users to utilize their exemption from SEF trading and preclude others from efficiently transacting in swaps subject to the mandatory execution requirement, with resulting adverse impacts either on pricing, risk mitigation, or both. Either result would impede the migration of swap trading onto SEFs, frustrating Congress' objectives. Accordingly, we have focused below on those aspects of the Proposed Rules (and other related CFTC proposals) that could unnecessarily discourage trading on SEFs and would be inconsistent with the swap market structure envisioned by Congress.

B. Mandatory Order Book Functionality

Each of the Proposed Rules would require SEFs to offer a "multiple-to-multiple" display functionality akin to an order book. The CFTC Proposal would require SEFs to provide participants with the ability to post both firm and indicative quotes on a centralized electronic screen accessible to all SEF participants.[23] The SEC Proposal would require a SEF to provide a

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[20] See CEA Section 5(d)(9) (requiring DCMs to provide "a mechanism for executing transactions that protects the price discovery process of trading in the centralized market" of the DCM).

[21] Cf. Exchange Act Section 11A(e) (instructing the CFTC and SEC to foster a national market system for security futures).

[22] See SEC Proposal at 10955.

[23] See CFTC Proposed Rule ("PR") 37.9(a)(1)(ii)(B)(1).

function that allows any participant to make and display executable bids or offers to all other SEF participants, if the SEF participant chooses to do so.[24]

Both Commissions have based these requirements on an interpretation of the SEF definition's requirement that "multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system."[25] The Commissions' interpretation of this language is inconsistent with its plain meaning and violates fundamental principles of statutory construction. First, Congress clearly could have specified that a SEF participant be able to execute or trade swaps by accepting bids and offers open to multiple participants in the SEF. It did not. It merely specified that a SEF participant be able to execute or trade swaps by accepting bids and offers made by multiple participants in the SEF. A participant can accomplish this through means other than accepting quotes displayed to all (or multiple) participants in the SEF. For instance, providing participants with the ability to request quotes from multiple participants, or to view streaming firm quotes from multiple participants, would, on their face, satisfy the statutory requirement.

Indeed, earlier versions of the SEF definition required a SEF to be a "trading facility," a term defined in the CEA that, unlike the final SEF definition, requires bids and offers to be "open to multiple participants."[26] If Congress had retained this wording in the SEF definition, it would have required a SEF to have the functionality envisaged by the Commissions' proposed order book requirement. However, Congress chose not to do so. On its face, the SEF definition encompasses a broader range of functionality than the order book model proposed by the Commissions. Specifically, the SEF definition reads: "a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system . . . . including any trading facility that . . . facilitates the execution of swaps"[27] (emphasis added).

The wording of the SEF definition in Dodd-Frank, and the legislative history of the definition, cannot be read to support the Commissions' proposed order book requirement.

The Commissions' proposed requirements also do not account for the dynamics of competition between trading venues. Given Dodd-Frank's mandatory clearing, public reporting, and other requirements, there is every reason to believe that, if market participants prefer an order book to a request for quote ("RFQ") system on the basis that it provides a superior order interaction methodology, then trading will naturally migrate to venues offering order books for appropriate swaps, without further regulatory intervention. However, if market participants do not have this preference, then the Commissions will have succeeded only in requiring SEFs to build and maintain a potentially unnecessary functionality that will, in many

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[24] See SEC Proposal at 10954.

[25] See CFTC Proposal at 1219 (basing this requirement on an interpretation of the SEF definition in conjunction with Dodd-Frank's impartial access requirement); SEC Proposal at 10954 (basing this requirement on an interpretation of the SEF definition in conjunction with a desire for increased price transparency).

[26] CEA Section 1a(51), as amended by Dodd-Frank ("trading facility" definition).

[27] CEA Section 1a(50); Exchange Act Section 3(a)(77).

cases, not be used. Imposing such a requirement at this point in time—before the development and operation of relevant market models—is highly unlikely to survive scrutiny under a rigorous cost-benefit analysis. Premature imposition of any such requirement could also shut out potential SEFs that wish to offer an RFQ functionality without offering an order book. This distortion to competitive dynamics is particularly troubling given that, as the SEC notes, the movement of swaps trading onto regulated platforms is only at an emergent stage.[28]

C. Mandatory Order Book Trading

The CFTC Proposal requests comment as to whether Dodd-Frank's SEF provisions support a requirement that swaps that meet a certain level of trading activity be limited to trading through order books.[29] Put simply, the SEF provisions of Dodd-Frank do not support any such requirement. Indeed, as noted in the preceding section, the modifications Congress made to the SEF definition clarify beyond doubt that the term "SEF" encompasses more than "trading facilities" and evidence Congress' specific intent that the Commissions not impose any such limitation on SEFs.

Moreover, we would expect—especially in the context of Dodd-Frank's mandatory clearing, public reporting, and other requirements—that, if a swap reaches a level of trading activity that would support trading through an order book, it would be natural, in light of liquidity network effects, for trading to migrate to the order book venue. If such migration does not occur, it will be because active participants in the type of swap—whether due to transaction size, customizability, number of participants, or other factors—do not believe that it would be beneficial from a pricing perspective to expose their trading interest on an order book. Requiring transactions to go through an order book in such a case would negatively impact pricing, execution certainty and liquidity, with the principal potential benefits accruing to incumbent order book venues.[30]

D. RFQ Systems

We agree with the Commissions' determination that RFQ systems (including traditional RFQ and streaming quote systems) should be permitted for the execution of swaps subject to Dodd-Frank's mandatory execution requirement. We are concerned, however, that the additional requirements that the Commissions would impose on RFQ systems go beyond the level of quote competition required by Dodd-Frank and would result in undesirable consequences. It must also be noted that the Commissions' implicit recognition that RFQ

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[28] See SEC Proposal at 10953.

[29] See CFTC Proposal at 1221. The CFTC has also proposed requiring that a minimum of 85% of total trading volume occur through an order book in order for a contract to be listed on a DCM. Contracts with total trading volumes below this threshold would be mandatorily migrated onto a SEF or allowed to trade for liquidation purposes only. See CFTC PR 38.502, Core Principles and Other Requirements for Designated Contract Markets, supra note 15. The Firms also believe that such a requirement is neither appropriate nor grounded in any careful empirical analysis of the swaps or futures markets.

[30] Like the requirement for an order book functionality, the Firms do not believe that a cost-benefit analysis would justify an order book trading requirement, particularly at this early stage in the development of SEF markets.

systems can satisfy the SEF definition undermines the justification for the Commissions' imposition of a requirement for an order book functionality.

1. Number of RFQ Recipients

The CFTC Proposal would require a minimum number of 5 recipients for each RFQ.[31] The SEC Proposal would not require a minimum number of recipients, but would require SEFs to allow participants to send an RFQ to all other SEF participants.[32]

We agree with the SEC that the most faithful reading of the statutory SEF definition would give a participant the ability to send an RFQ to only 1 participant (but potentially more) if it determines that doing so will meet its execution objectives. This flexibility gives SEF participants the ability to minimize information leakage and avoid adverse price movements. As the SEC Proposal observes, "[i]n some instances requestors may prefer to limit the number of recipients of an RFQ as a way to protect proprietary trading strategies as dissemination of their interest to multiple dealers may increase hedging costs to dealers, and thus costs to the requestors as reflected in the prices from the dealers."[33] Although the SEC Proposal goes on to note that competition between multiple dealer recipients of an RFQ may lead to lower spreads,[34] market participants—rather than the Commissions—are best-positioned to determine the extent of price competition that will lead to an optimal execution. Accordingly, we recommend that the Commissions, consistent with the SEC Proposal, do not adopt any mandatory minimum number of RFQ recipients.

2. Integration with Resting Bids or Offers; Price-Time Priority

We are concerned that certain aspects of the Proposed Rules (and other related CFTC proposals) would effectively impose price-time priority on swaps executed over SEFs. Any such requirement would be contrary to the flexible language contained in the SEF definition and, due to credit and relationship considerations involved in swap pricing and the illiquidity of the swap markets, would likely harm execution quality.

Specifically, the SEC Proposal states that a SEF that allows participants to display firm quotes (which, under the SEC Proposal, would include all SEFs) must be designed so that all trades, including those to be executed via RFQ, interact first with pre-existing resting bids and

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[31] See CFTC PR 37.9(a)(1)(ii)(A).

[32] See SEC Proposal at 10953.

[33] SEC Proposal at 10952. This represents an instance of the "winner's curse" phenomenon, where the winner of an auction is disadvantaged because other auction participants can use information obtained through the auction to act adversely to the winner's interests. The greater the level of transparency—and thus the number of participants that can trade against the winner—the more cautious participants will be in bidding. For a more detailed explanation, see Dunne, Moore, and Portes, Centre for Economic Policy Research, European Government Bond Markets: transparency, liquidity, efficiency, available at http://www.cepr.org/PRESS/TT_GovernmentFULL.pdf.

[34] SEC Proposal at 10954. As discussed in Part II.C.3, we also view the inclusion of responses to RFQs in any composite indicative quote as inappropriate, and so would not support a minimum number of RFQ participants as a means to enhancing composite indicative quotes.

offers available at an equal or better price.[35] The CFTC Proposal, in contrast, would only require that resting bids or offers for the same swap to be "taken into account" and communicated to the sender of an RFQ.[36] However, the CFTC has separately proposed to interpret CEA Section 4c(a)(5)(A)'s prohibition against trading that "violates bids or offers" to prohibit any person from buying a contract on a SEF at a price that is higher than the lowest available offer price on the SEF and/or selling a contract on a SEF at price that is lower than the highest available bid price on the SEF, unless the person exhausts all available bids or offers in the order book.[37]

In practice, the SEC Proposal would effectively give trading interest displayed in an order book price-time priority over responses to an RFQ. Furthermore, the CFTC's treatment of resting bids and offers and its rule against "violat[ing] bids and offers," taken together, would require market participants to execute at the best displayed price, whether that price is displayed in the order book or is the best-priced response to an RFQ. This requirement would effectively establish a "best execution" requirement based on price to the exclusion of other execution characteristics, which would be problematical if applied to trading on a SEF because the concept of a single "best" price is inapposite in the context of executory, counterparty- or clearinghouse-specific swap agreements.[38]

We believe that these requirements are based on the Commissions' experiences with the listed securities and futures markets and the order book trading venues that characterize those markets. As noted above, however, the swap markets differ significantly from the listed securities and futures markets. Furthermore, Dodd-Frank's SEF provisions were negotiated extensively and were ultimately crafted by Congress to provide execution flexibility beyond that of the central order book model. Imposing strict price (or price-time) priority or a price-only best execution rule on trading on SEFs would effectively eviscerate the RFQ execution paradigm, as well as other non-order book execution paradigms, and would frustrate customers' execution objectives, contrary to Congress' clear intent.

Mandatory integration or other price priority requirements would also significantly diminish the ability of market participants to fill their trading interest in a single execution.[39] In many cases, credit and trading relationship considerations (as discussed above)

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[35] See SEC PR 811(d); see also SEC Proposal at n. 163 and accompanying text.

[36] See CFTC PR 37.9(a)(1)(ii)(A).

[37] See Proposed Interpretive Order regarding Antidisruptive Practices Authority, 76 Fed. Reg. 14943 (Mar. 18, 2011). The proposed interpretation would not apply to block trades or exchanges for related positions transacted in accordance with the rules of a SEF or bilaterally negotiated swap transactions. In contrast, the SEC's integration requirement would apply to block trades. See SEC Proposal at n. 163 and accompanying text.

[38] The CFTC has also proposed to require swap dealers and other CFTC registrants to execute a swap, if available for trading on a DCM or SEF, on terms that have a "reasonable relationship" to the best terms available. See Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 75 Fed. Reg. 80638 (Dec. 22, 2010). This requirement is not mandated by Dodd-Frank and, like the CFTC's proposed interpretation of "violates bids and offers," would be problematical in the context of executory, counterparty- or clearinghouse-specific swaps and should, accordingly, not be adopted.

[39] Unlike the equities markets, where a dealer can simply "sweep the book" before executing a transaction with a customer, and then execute a single trade with the customer, the bilateral, executory nature of swaps means that,

mean that the "all-in" costs for a trade are lower, and in many likely scenarios are considerably lower, for a single execution than for multiple executions at technically better (or merely equal) prices. Splitting a proposed transaction into multiple executions also would expose a requesting participant to separate and potentially differing reporting, margin, clearing and settlement costs for each execution, and would result in trade proliferation that is not consistent with Dodd-Frank's systemic risk reduction objectives for swaps.

As noted above, the executory character of swaps means that bilateral trading book effects can directly impact pricing. In the example given in the SEC Proposal,[40] the RFQ might be priced (or sought) in recognition of the fact that it flattens an existing exposure of 100,000 notional or will, for example, eliminate ongoing clearing costs for a position equal to 100,000 notional. If, however, a third party posting a resting order of 5,000 notional in the limit order book were able to participate in the execution, reducing the RFQ trade size to 95,000 notional and giving rise to a second trade of 5,000 notional with that third party, the resulting netting effects would be reduced and, worse, the sender of the RFQ may have a new exposure to that third party or at its desired clearinghouse. The possibility of this outcome would invariably lead RFQ responders to provide less competitive quotes, a result that would itself impair execution quality for participants that post RFQs.

The illiquidity of the swap markets could also cause mandatory integration and price priority requirements to have negative effects not seen in the listed securities and futures markets. One possible effect is that market participants would have little incentive to price resting quotes competitively if, under a price priority environment, they can expect less competitively-priced quotes nevertheless to receive execution priority any time that a larger-sized transaction is negotiated via RFQ at a price that is worse (viewed in absolute terms) due to its large size.[41] Liquidity providers, both in posting resting quotes and responding to RFQs, would face concerns about hedging costs in cases where multiple liquidity providers executing against a single customer order must hedge their exposures simultaneously. These concerns are also likely to adversely affect pricing for market participants, particularly given the limited liquidity (and resulting more limited hedging opportunities) available in the swap markets.

Additionally, the Proposed Rules do not account for the fact that order book and RFQ protocols are fundamentally different and not necessarily compatible. The RFQ process is generally supported by a trade protocol that sets certain predetermined periods within which recipients of a price inquiry can respond, followed by a fixed period during which such price is actionable. In contrast, an order book is updated in real-time. Mandatory integration and best

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under a mandatory integration requirement, the customer would be required to execute separate swaps with each participant posting an equal or better priced bid or offer in the order book.

[40] SEC Proposal at n. 163.

[41] The almost exclusively institutional character of the swap markets, the greater range of contract variations, and smaller number of participants make it significantly less likely that swaps can be executed by breaking larger "parent" orders into smaller "child" orders that can be executed via a displayed order book. This characteristic makes it likely that a greater proportion of swaps will be negotiated as block-sized trades via RFQ than is the case for listed equity securities. As a result, we expect that the negative effect on pricing incentives described in the text above would be more likely in the swap markets.

execution rules would require respondents to an RFQ to adjust their prices in order to account for fluctuations in prices displayed in the order book while their price is actionable, thereby leading to worse, not improved, pricing.

Based on the foregoing considerations, we urge the Commissions not to adopt any mandatory integration method or price or other priority as between order book and non-order book trading functionalities, so long as a SEF makes resting bids or offers executable by the requestor visible to the requestor.

We further recommend that the CFTC confirm that transactions executed other than on a SEF's central order book will not be deemed to "violate bids or offers" for purposes of CEA Section 4c(a)(5)(A), regardless of their price level. Nor should swaps with different bilateral counterparties or clearing destinations be deemed comparable to each other for such purposes. Market participants also should not have any obligation to execute against an executable bid/offer, whether or not the bid/offer is competitive. Rather, a market participant requesting quotes should be free to accept any quote, even if, when viewed in isolation of other trade characteristics, it is not the best-priced quote then available via the RFQ or otherwise.

3. Additional Display Requirements

The CFTC has requested comment regarding whether transparency should be required in the RFQ process (such as making all orders and quotes displayed to all participants) and whether responses to RFQs should be required to be transparent to all participants.[42] The SEC Proposal would require that a SEF offering an RFQ platform create and disseminate to all its participants a "composite indicative quote," which would show an "average quote" for each swap available on the SEF (including based on responses to RFQs).[43]

Dodd-Frank does not include any basis for imposing these requirements. Moreover, as discussed above, additional mandatory display requirements could adversely affect pricing and liquidity. In the case of responses to RFQs, they could also be misleading. RFQ responses are ephemeral, actionable quotes that are priced with respect to the particular swap transaction (including size), counterparty and, if applicable, clearing destination. Unlike a true indicative quote, RFQ responses do not necessarily show the level at which a liquidity provider is generally willing to enter into a transaction.

For this reason, composite indicative quotes are not typically computed by calculating an average of all forms of trading interest on a trading platform. They are computed by soliciting prices from liquidity providers and using an agreed algorithm to create a two-way price with a fixed bid-offer spread that does not change based on liquidity or depth of the market at any one time. This process is only possible for highly liquid "benchmark" swaps for which a critical mass of liquidity providers is willing to provide indicative quotes and for which there is a uniform set of assumptions regarding post-trade disposition (i.e., whether the trade is cleared or

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[42] See CFTC Proposal at 1221.

[43] See SEC PR 811(e) and SEC Proposal at n. 152.

not, if it is cleared, where it will be cleared and, if it is (or may be) bilateral, assumptions regarding the existence of a trading relationship, credit capacity and documentation).

In light of these considerations, we believe it would be preferable to permit individual SEFs to select the swaps (and related assumptions) that are appropriate for inclusion in composite indicative quotes. An overly expansive mandatory composite indicative quote requirement has enormous potential to be misleading, as surveyed liquidity providers could only provide quotes that, like stub quotes in the equities markets, are intended to fulfill a requirement but not to provide meaningful price information.

D. Wholesale Brokerage

We agree with the SEC that wholesale brokers should, if they submit a customer's request to trade a swap to all participants in the system or platform (or to fewer than all participants, if the customer so chooses), be permitted to execute swaps subject to Dodd-Frank's mandatory execution requirement.[44] The SEC has observed that wholesale brokers often act as intermediaries in executing swap transactions and that, as a result, they may interact with multiple other participants in order to execute such transactions.[45] The SEF provisions should not be read in a manner that would prevent or prohibit brokers from attempting to find such liquidity, even if those efforts take place principally via voice. Any such reading would conflict with the "any means of interstate commerce" language contained in the SEF definition. It would also inhibit an important mechanism through which end users, dealers and other market participants source liquidity for more illiquid transactions. It is unlikely that market participants will seek out such executions where electronic and substantially instantaneous executions that would result in superior pricing and reduced execution risk are available through other platforms.

E. 15-Second Rule

The CFTC Proposal (but not the SEC Proposal) would require a minimum delay of 15 seconds before a market participant could execute as principal against a customer's order or, as agent, execute two customer orders against each other.[46] We believe this requirement to be based on requirements adopted by DCMs in order to adapt the CEA's prohibition on pre-arranged trades to an electronic trading environment. That prohibition, of course, is premised on the expectation of a competitive, price-time priority execution environment arising from the requirement that DCMs operate central order books. In contrast, Dodd-Frank merely requires that SEFs provide their participants with the ability to access quote competition.

Accordingly, consistent with the SEC Proposal, we do not believe that an execution delay requirement should be adopted for swaps. If any such requirement is adopted, the Firms recommend that the CFTC clarify that the delay applies only to swaps subject to the mandatory execution requirement (i.e., for which bilateral execution is not permissible) and only

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[44] See SEC Proposal at 10957.

[45] See id.

[46] See CFTC PR 37.9(b)(3).

in the context of principal or agency cross transactions to be executed through a central order book.[47] Market participants have an expectation of a competitive, price-time priority execution environment only in the context of an order book. There is no such expectation in an RFQ environment (or, as noted above, any Dodd-Frank requirement for one).[48] Any such requirement applied to the RFQ process would fundamentally undermine the RFQ execution paradigm, which involves predetermined periods within which recipients of a price inquiry can respond, followed by a fixed period during which such price is actionable. These periods often measure less than 15 seconds.

For RFQ systems, it would, however, be consistent with Dodd-Frank to adopt a requirement intended to ensure that participants retain the ability to access their desired level of quote competition. Specifically, in cases where a liquidity provider also exercises execution discretion as an agent of a customer, that liquidity provider should be required to obtain the express consent of the customer before initiating an RFQ on behalf of that customer solely with itself or another one of its customers. In this way, the customer would retain meaningful discretion over whether to put the liquidity provider in competition with others. At the same time, unlike the CFTC's proposed execution delay, the requirement would not disrupt the RFQ process itself.

III. Impartial Access

We support the Proposed Rules' impartial access requirements.[49] We are concerned, however, that the preamble to the CFTC Proposal suggests an approach far more restrictive than impartiality demands. Specifically, the CFTC Proposal notes that "[a]ny participant should be able to demonstrate financial soundness either by showing that it is a clearing member of a DCO that clears products traded on that SEF or by showing that it has clearing arrangements in place with such a clearing member."[50] As described in Part I above, there are several permutations of credit risk, margin requirements and other pricing-determinative characteristics for any given swap, even for swaps that are cleared. In this regard we agree with the SEC Proposal's observation that "lessening capital or other financial

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[47] For transactions subject to the delay, the display of the customer's order during the delay should be subject to any credit filters or other limitations on display relevant to the transaction (e.g., if the transaction is to be cleared at a particular clearinghouse, the customer's order should be displayed only to SEF participants with the credit capacity at that clearinghouse or with a clearing member necessary to clear the transaction). The length of the delay should also be calibrated to the liquidity characteristics of the relevant swap.

[48] Of course, for a swap subject to Dodd-Frank's mandatory execution requirements, market participants will not be permitted to negotiate and agree to execute the transaction other than on a SEF and simply use an RFQ to process a swap that has already been agreed.

[49] See CFTC PR 37.202 (requiring access criteria to be "impartial, transparent, and applied in a fair and nondiscriminatory manner") and SEC PR 809 (requiring a SEF to permit access to certain SEC registrants and eligible contract participants, subject to risk management requirements).

[50] CFTC Proposal at 1223.

requirements to increase participation beyond a certain level may increase the overall risk of the [SEF's] operations."[51]

We recommend that the CFTC clarify that SEFs will be permitted to have selective, but not discriminatory, participant standards, such as objective minimum capital or credit requirements or limits on participation to objective classes of sophisticated market participants (e.g., "qualified institutional buyers" only). This clarification would be consistent with the SEC Proposal, which would permit SEFs to limit access to registered security-based swap dealers, major security-based swap participants and securities brokers.[52] It would also be consistent with the impartial access requirements applicable to SEC-registered ATSs and multilateral trading facilities regulated in the European Union, which are models that have worked effectively in the past.[53]

We believe that the Commissions intend, and should confirm, that SEFs, like ATSs and exchanges, may distinguish between liquidity providers and liquidity takers. SEFs should therefore be permitted to establish minimum objective requirements for liquidity providers, such as a requirement to quote a bona fide inside market and additional capital requirements.[54]

We also recommend that the Commissions modify the Proposed Rules so that SEFs and SEF participants have the flexibility needed to address the full range of considerations that affect whether, at what price, and to whom market participants will wish to display their trading interest or quotes. CFTC PR 37.702 and SEC PR 815 would each permit a SEF or its participants to take credit risk into account in the context of non-cleared transactions. However, as noted in Part I, transactions clearable in different clearinghouses may involve different pricing structures. Non-credit factors (such as trading relationships and post-trade market/credit risk effects) may influence pricing. Even in the case of transactions that will be cleared in a known clearinghouse, considerations such as available credit capacity at the clearing member or clearinghouse may be relevant.

SEF participants should therefore be permitted to vary the availability and level of their quotes (whether on an RFQ, central order book, streaming quote or other platform) based on any non-discriminatory considerations, such as clearing destination, credit limits (including at the clearing member level), counterparty exposure, market exposure, customer relationship, and similar commercially reasonable considerations. As a result, we do not support the SEC's

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[51] SEC Proposal at 10979.

[52] See SEC PR 809.

[53] See SEC Release No. 34-40760 (Dec. 8, 1998), 63 Fed. Reg. 70844, 70874 (Dec. 22, 1998) (guidance on the application of Regulation ATS "fair access" requirements); MAR 5.3.1 of the FSA Handbook (merely requiring multilateral trading facilities to have "transparent rules, based on objective criteria").

[54] See SEC Proposal at 10979. The Commissions should also allow SEFs to charge participants on the two sides of the market different prices without violating fair access or "equitable fee" requirements. This would be consistent with SEC rules permitting exchanges to offer differential pricing to liquidity providers and liquidity takers—the former receiving a rebate and the latter paying an access fee—in order to ensure adequate liquidity. See SEC Rule 610(c).

proposal to require SEFs that display firm, executable trading interest to display that interest to all participants.[55]

IV. Scope of Mandatory Execution Requirement

A. "Available to Trade"

We agree with the Commissions that, by creating an exception from Dodd-Frank's mandatory execution requirement for swaps that no DCM/exchange or SEF has made "available to trade," Congress intended for the Commissions to establish a higher liquidity threshold for mandatory execution than for mandatory clearing, and that a swap is not "available to trade" merely because it is listed on a DCM/exchange or SEF. The CFTC Proposal suggests that the CFTC will establish the relevant factors (including frequency of volume and open interest) for determining whether a SEF has made a swap "available to trade," but that those factors will be applied by the SEF.[56] The SEC Proposal appears to contemplate a similar process, explaining that the SEC, rather than one or a group of SEFs, should establish objective measures for determining when a swap is "available to trade."[57]

The "available to trade" standard should be clear, quantitative, and reflect a meaningful level of volume and participation. The Commissions should undertake empirical analyses of swap market liquidity to determine the appropriate metrics, such as a minimum average daily trading volume over a relevant measurement period coupled with a minimum average daily number of transactions over such period.[58] We recommend that the Commissions set the specific quantitative thresholds for these metrics based on an empirical analysis of market liquidity for individual swaps. The Commissions initially should set those thresholds cautiously giving due regard for the nascent state of the post-Dodd-Frank swap markets. The Commissions could then re-calibrate the thresholds as those markets evolve and the Commissions gain access to more and better data. Such an approach would be consistent with the process by which the Federal Reserve Bank of New York has facilitated increased swap clearing and reporting, as well as the recommendations recently issued by IOSCO.[59]

SEFs should be required to perform the calculations necessary to determine whether the Commissions' metrics have been satisfied. SEFs should perform these calculations on a swap-by-swap (rather than asset category or sub-category) basis, recognizing that minor deviations in contract terms (such as coupon or tenor) can lead to dramatically different liquidity characteristics.[60] The calculation process should occur and be re-performed on a quarterly basis

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[55] See SEC Proposal at 10972.

[56] See CFTC PR 37.10.

[57] See SEC Proposal at 10969.

[58] For purposes of these calculations, a single transaction executed by an investment manager that is allocated to multiple accounts should be considered to be a single transaction.

[59] See IOSCO Report at 44, 46.

[60] This calculation process should involve purely mechanical application of the Commissions' criteria to the relevant swaps trading on that SEF. It should not involve a subjective assessment as to whether different swap

to consider whether a swap has been made available to trade and, to address the potential for market disruption due to precipitous drops in liquidity, at least monthly (and perhaps more frequently) to determine whether a swap is no longer available to trade. This addresses the fact that the level of liquidity for a swap can vary significantly over time, with individual swaps going "off" the run and otherwise declining in liquidity for other than ephemeral reasons. Based on these computations, SEFs should certify to the relevant Commission those swaps that qualify as "available to trade." These certifications should be accompanied by underlying data sufficient for the relevant Commission and the public to evaluate the accuracy of the SEF's calculation and its compliance with Commission rules. After a specified period following the SEF's certification and public notice and comment, the Commission should confirm (or reject) the SEF's certification and, if confirmed, the mandatory execution requirement should come into effect with respect to the relevant swap(s).[61]

The CFTC Proposal includes a requirement that, if at least one SEF has made the same or an "economically equivalent" swap available for trading, all SEFs are required to treat the swap as available for trading.[62] The SEC Proposal similarly suggests that a determination by even one SEF or DCM/exchange that a swap is available to trade would prevent the swap from trading in the over-the-counter market.[63] To avoid unintended consequences, including unduly concentrating trading volume on a single SEF or preventing participants from entering into customized swaps in the same general swap category, a stringent fungibility test should be applied in determining whether a particular swap is "economically equivalent" to one made available for trading on another SEF (i.e., a clearinghouse would recognize the swaps as mutually off-settable without residual market risk). This approach would be consistent with the CFTC's proposed requirement that terms of cleared swaps must conform to templates established under clearinghouse rules.[64]

B. Permitted Transactions

Consistent with Dodd-Frank, transactions that are not subject to the mandatory execution requirement should not be limited in their method of execution. The CFTC Proposal's distinction between "required" and "permitted" transactions, and its proposed requirement that permitted transactions may only be executed on an order book, RFQ system, or voice-based system, is not supported by Dodd-Frank and would be unnecessarily restrictive. As a practical matter, the proposed distinction assumes that whether a transaction is "required" or "permitted" will be known in advance, which will not necessarily be the case. Substantively, the proposed distinction would appear to prevent permitted transactions from being executed using other

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instruments should be aggregated in order to apply such criteria. This is consistent with our comment below regarding the standard for whether swaps are "economically equivalent."

[61] To address rapid declines in liquidity, a SEF's determination that a swap is no longer "available to trade" should, in contrast, become effective promptly following SEF certification and Commission confirmation.

[62] See CFTC PR 37.10.

[63] See SEC Proposal at 10969.

[64] See Risk Management Requirements for Derivatives Clearing Organizations, 76 Fed. Reg. 3698 (Jan. 20, 2011).

systems, such as single dealer systems, instant messaging platforms and the like, and then processed by a SEF. We do not perceive any policy rationale for imposing such a restriction and request that the CFTC clarify that there is no restriction on the execution methodology used to execute a "permitted transaction"—whether or not on a SEF—so long as, if the transaction is effected on a facility offered by a SEF, the SEF makes it clear whether or not the transaction is being effectuated on a licensed SEF-compliant platform.

C. Exceptions

Dodd-Frank authorizes the Commissions to promulgate rules defining the universe of swaps that can be executed on a SEF, provided that those rules "take into account the price and non-price requirements of the counterparties to a swap" and the goals of promoting trading of swaps on SEFs and pre-trade price transparency in the swaps market.[65] We urge the Commissions to use this authority to permit the following types of transactions, if they would otherwise be subject to Dodd-Frank's mandatory execution requirement, to be executed off of a SEF but then processed subject to the rules of a SEF:

- ***Block Trades.*** We agree with the CFTC that transactions that qualify as block trades should not be required to be executed using the SEF's order book, RFQ, or other execution functionalities.[66] This interpretation is consistent with SEF Core Principle 2, which requires SEFs to adopt "rules specifying trading procedures to be used in entering and executing orders traded or posted on the facility, <u>including block trades</u>" (emphasis added).[67] DCMs already have such rules in the context of futures transactions and may provide a useful model for SEF block trading rules. The block trade thresholds for SEFs should be no higher than those established under the Commissions' reporting frameworks, which should reflect a rigorous analysis of liquidity for particular swaps and swap markets.[68]

- ***Inter-Affiliate Trades.*** Inter-affiliate trades represent allocations of risk within a corporate group. Requiring that such transactions—to which no unrelated person is a counterparty—be executed on a SEF would

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[65] CEA Section 5h(d)(1). This provision applies both to the SEC and the CFTC, although it is only present in the CEA. Accordingly, we believe that it would be consistent with congressional intent for the Commissions to use their further definitional authority under Section 712 of Dodd-Frank to define "swap" for purposes of Section 5h(d)(1) to include both "swaps" and "security-based swaps."

[66] For the reasons noted in earlier in this letter, we do not believe that the SEC's requirement that block trades be executed against resting bids and offers—nor the analogy to the national market system for listed equities implicit in that requirement—is appropriate for swaps.

[67] CEA Section 5h(f)(2)(C); Exchange Act Section 3D(d)(2)(C).

[68] We discussed this topic in greater detail in our letter on the Commissions' proposed real-time reporting rules. <u>See</u> Letter from Edward J. Rosen, Partner, Cleary Gottlieb Steen & Hamilton LLP, to David Stawick, Secretary, the CFTC and Elizabeth Murphy, Secretary, the SEC, dated Feb. 14, 2011.

unnecessarily increase the cost of risk management by corporate groups with no corresponding public benefit.[69]

- ***Packaged Trades.*** Packaged trades arise when at least one component of an integrated pair or group of transactions is subject to Dodd-Frank's mandatory execution requirement, while other transactions comprising the package are either not subject to Dodd-Frank or are not capable of being executed on a SEF. Despite being subject to different regulatory requirements, the price of each component of the package is generally dependent upon and negotiated together with the price of the other transactions. Requiring one component transaction to be subject to the execution requirement, while the others are not, may be impractical, expensive, disruptive, and could compromise the confidential nature of the other components to the transaction. The Firms urge the Commissions to permit such trades to be executed off of a SEF, subject to the requirement that the component subject to the mandatory execution requirement be submitted to the SEF after execution in order to meet the appropriate regulatory requirements, similar to current rules for exchanges of futures for related positions.

- ***Exchanges of Related Products.*** As in the futures markets, the Commissions should permit bilateral negotiation and posting to a SEF of transactions in which parties agree to exchange or enter into price-correlated positions on opposite sides of the market. An example of such a transaction might be the exchange of a position in a swap cleared in one clearinghouse for a position in the same swap that is cleared in another clearinghouse. Facilitating such transactions could help reduce or ameliorate the increased costs and inefficiencies associated with the existence of multiple, risk-silo'd clearinghouses for the same swap.

D. Non-U.S. and Cross-Border Transactions

As the Commissions are aware, other G-20 jurisdictions are also working toward the goal of requiring all standardized OTC derivatives contracts to be traded on exchanges or electronic trading platforms.[70] To avoid undue interference with the way in which other jurisdictions implement this requirement, the Commissions should clarify that Dodd-Frank's mandatory execution requirement applies only to transactions with a U.S. person subject to the execution requirement. Additionally, to the extent that Dodd-Frank's mandatory execution requirement applies to a cross-border transaction because one counterparty is a U.S. person, and the transaction is also subject to regulation in a jurisdiction with a similar mandatory execution framework, the Commissions should exercise their exemptive authority to permit the parties to satisfy Dodd-Frank's mandatory execution requirement by trading on a comparably regulated

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[69] To the extent that the Commissions exempt inter-affiliate trades from clearing requirements, they would also not be subject to SEF trading requirements.

[70] Statement No. 13, Leaders' Statement: The Pittsburgh Summit (Sept. 24–25, 2009).

execution platform in that jurisdiction.[71] We also emphasize that it will facilitate such comparability determinations (both for foreign SEFs and reciprocal determinations by non-U.S. authorities with respect to U.S. SEFs) if the Commissions adopt the more flexible approach to SEFs outlined above, which would be more consistent with the approach currently contemplated in other G-20 jurisdictions.

V. SEF Market Oversight Functions

We are concerned that, absent clarification, certain aspects of the Proposed Rules could be read to require a SEF to exercise a market oversight role not only with respect to transactions executed on that SEF, but also transactions executed by that SEF's participants on other SEFs, DCMs/exchanges, and bilaterally. This concern arises in particular in the case of the CFTC's proposed implementation of Core Principle 6 regarding position limits. Core Principle 6 requires a SEF that is a trading facility to monitor positions established on or through the SEF in order to ensure compliance with the position limits adopted under Section 4a of the CEA.[72] Read literally, this requirement would necessarily mean that a SEF would need access to real-time information from each of its participants regarding positions established bilaterally, on other SEFs, and on DCMs/exchanges.

Unlike SEFs, who will not know their participants' net or aggregated positions in a particular swap, DCMs do have access to analogous information because, at the current time, all futures contracts executed on a DCM are processed through a single clearinghouse with which each DCM has integrated systems and access to open interest information.

The CFTC should instead clarify how a SEF may satisfy Core Principle 6 without maintaining real-time information about positions established off of the SEF, for example, through participation in the Commission's large trader reporting framework for swaps with respect to information available to it in the ordinary course of its operations. In the case of position limit excessions, the SEF would fulfill the core principle by prohibiting the execution of transactions other than liquidating transactions, or possibly executing liquidating transactions for the account of the relevant participant in extreme cases, upon receipt of instructions from the CFTC.

Finally, we support the Commissions' proposals to prohibit a SEF from using for non-regulatory purposes any confidential information it receives in connection with its regulatory obligations.[73] To further ensure the independence of SEFs' self-regulatory functions from their market operations and commercial interests, SEFs should also be subject to safeguards consistent with those applicable to demutualized DCMs/exchanges, including safeguards relating

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[71] Although Dodd-Frank does not expressly grant the SEC the same exemptive authority with respect to comparably regulated foreign security-based SEFs as it grants to the CFTC with respect to comparably regulated foreign SEFs, we note that the SEC's plenary exemptive authority under Section 36 of the Exchange Act extends to the mandatory execution requirement in Section 3C and the SEF registration requirement in Section 3D.

[72] See CFTC PR 37.600. There is no comparable requirement in the SEC Proposal, since security-based SEFs are not subject to a core principle regarding position limits.

[73] See CFTC PR 37.7; SEC PR 810(c).

to the outsourcing of performance of regulatory oversight to a qualifying self-regulatory organization.

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The Firms appreciate the opportunity to comment on the SEF provisions of Dodd-Frank and the associated Proposed Rules. As discussed above, we strongly encourage the Commissions to take a more flexible approach to implementing the SEF provisions, consistent with Congress' intent to provide swap users with enhanced opportunities to achieve their preferred execution objectives. A more flexible approach will also better enable SEFs to comply with both Commissions' rules, which will be an important and necessary capability given the practical likelihood that every SEF registered with the SEC will also be registered with the CFTC. It will also facilitate international convergence as envisioned by the G-20.

We urge the Commissions not to regard the SEF rulemaking as the definitive and final position of the Commissions, or one that commits the Commissions in perpetuity, on the ultimate swap market structure. Establishing appropriate market structure requirements is a difficult task under the best of circumstances. Where, as here, the relevant markets do not exist, the task is both more difficult and fraught with greater risk of unintended consequences. For that reason we urge the Commissions to adopt a cautious, phased approach, recognizing that, as these markets develop, the Commissions will want to evaluate them and determine whether additional measures are warranted.

We would be pleased to provide further information or assistance at the request of the Commissions or their staffs. Please do not hesitate to contact Edward J. Rosen (212 225 2820) of Cleary Gottlieb Steen & Hamilton LLP, outside counsel to the Firms, if you should have any questions with regard to the foregoing.

Respectfully submitted,

Edward J. Rosen, for

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Morgan Stanley
Nomura Securities International, Inc.
Société Générale
UBS Securities LLC
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