From: Cameron, Tim <tcameron@sifma.org>
Sent: Wednesday, November 24, 2010 1:45 PM
To: 'rulecomments@sec.gov'; SEFRules <SEFRules@CFTC.gov>; Recordkeeping <Recordkeeping@CFTC.gov>; RealTimeReporting <RealTimeReporting@CFTC.gov>; 'rule-comment@sec.gov'
Cc: 'sanown@sec.gov'
Subject: FW: SEF Letter
Attach: SIFMA.AMG.SEF.and.Reporting.Comment.Letter.pdf

Subject: Dodd-Frank Trade Execution and Related Reporting Requirements

Attached please find a comment letter on certain issues related to swap execution facilities, security-based swap execution facilities and related reporting issues.

Please feel free to contact me with any questions or comments.

Sincerely,

Tim Cameron

November 24, 2010

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

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

Dear Mr. Stawick and Ms. Murphy:

The Asset Management Group (the "**AMG**") of the Securities Industry and Financial Markets Association ("**SIFMA**")[1] appreciates the opportunity to provide the Commodity Futures Trading Commission (the "**CFTC**") and the Securities and Exchange Commission (the "**SEC**" and, together with the CFTC, the "**Commissions**") with our comments regarding the trade execution and related reporting requirements in the derivatives title ("**Title VII**") of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").

The AMG's members represent U.S. asset management firms whose combined assets under management exceed $20 trillion. The clients of AMG member firms include, among others, registered investment companies, state and local government pension funds, universities, 401(k) or similar types of retirement funds, and private funds such as hedge funds and private equity funds. In their role as asset managers, AMG member firms, on behalf of their clients, may engage in transactions, including transactions for hedging and risk management purposes, that will be classified as "swaps" and "security-based swaps" (collectively, "**Swaps**") under Title VII.

Flexibility in trading methods is needed to promote pre-trade price transparency and trading on SEFs.

AMG members believe that the statutory definitions of "swap execution facility" and "security-based swap execution facility" (collectively, "**SEF**") include trade execution platforms that offer request-for-quote ("**RFQ**") systems and flexible block trading. Encouraging the proliferation of flexible trading platforms is the best way to achieve the two Congressional goals underlying the creation of SEFs: "to *promote* the

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

trading of swaps on swap execution facilities and to *promote* pre-trade price transparency in the swaps market"[2] and to preserve freedom and flexibility in trading styles necessary for members of the investment community to best accomplish their investment goals.

AMG members are opposed to mandatorily limiting trading on SEFs to central limit order book-style trading. No single trading method fits all trades. The most liquid Swaps may trade efficiently in a central limit order book or similar trading environment, but less liquid Swaps require RFQ systems and block trading with adequate delays in public reporting to encourage more liquidity on SEFs. As liquidity in a particular Swap on a SEF grows, trading will naturally migrate towards the most efficient trading method.

One size does not fit all.

Central limit order books work by aggregating numerous bids and offers in a given instrument, with buyers trading at the lowest ask and sellers trading at the highest bid. In highly liquid instruments, the market sees the price at which participants are willing to buy and sell, and pre-trade price transparency naturally occurs. In less liquid instruments, however, trades are executed more rarely so there is not sufficient information to support realistic quotes and for the market to coalesce around an appropriate market price. Quotes may sit on the central limit order book for a long period of time without being executed, reflecting stale information about the Swap. Moreover, when quotes are made public before a trade can occur in a less liquid Swap, third parties may be tipped off to the upcoming trade, resulting in an unlevel playing field that could result in front-running. Liquidity providers aware of these negative effects will be unwilling to provide quotes. Rather than reflecting the dynamic interaction of supply and demand, quotes will reflect the posting liquidity provider's hope to extract the highest price from uninformed liquidity seekers. Any "pre-trade price transparency" that results is illusory, and liquidity is diminished.

Unlike fully standardized futures contracts, swaps exist in a variety of forms across a range of terms (*e.g.*, maturities, interest rates, currencies, credits, etc.). Many swaps have very limited liquidity. To limit the trading of the Swaps markets to central limit order book-type systems is to ignore this critical difference between futures and swaps.

With flexible trading on SEFs, Swaps will gravitate towards central limit order book and similar systems as liquidity increases.

The AMG believes that flexible trading on SEFs will permit less liquid swaps naturally to gravitate towards central limit order book and similar systems as liquidity increases. As increasing numbers of liquidity seekers enter both the long and short sides of the market, SEFs will emerge that allow buy-side participants to execute trades among themselves. As a result, given sufficient liquidity and flexibility, buy-side participants will drive the market towards a central limit order book or similar type of system. In this

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[2] New Commodity Exchange Act § 5(H)(e) (emphasis added); *see also* New Securities Exchange Act § 3D. This rule of construction applies to swaps but does not appear in the provisions relating to security-based swaps. The AMG believes Congress intended the rule to apply to security-based swaps as well as swaps.

regard, Swaps may be analogized to equity securities that trade on "pink sheets." When liquidity increases, "pink sheet" securities migrate towards securities exchanges. There is every reason to believe that Swaps would behave similarly.

RFQs are foundational to SEFs.

Members of the AMG believe that the availability of RFQs for trading of Swaps is foundational, as we expect competition among multiple SEFs, as well as alternative trading methods, to evolve as traders gravitate towards the most efficient trading methodology. We believe that SEFs should include RFQs in which multiple liquidity seekers can individually request quotes from multiple liquidity providers.[3] In addition, the AMG suggests the following minimum requirements designed to ensure flexibility, liquidity and transparency:

- market participants must have the ability to ask for a bid, offer or "market" (*i.e.*, both a bid and an offer), depending on their preference;
- SEFs should not restrict (as either a minimum or maximum) the number of liquidity providers from which market participants can request prices;
- SEFs should not signal to market participants that a trade is about to occur; and
- SEFs should not provide unnecessary post-trade information to market participants that can be used to harm the parties that have transacted; for example, they should not publish the "cover," or second best price quoted.

Robust and flexible block trades are essential components of SEFs.

Robust and flexible block trading is essential to Swap liquidity and should be encouraged through Commission rules. Block trading has been an accepted feature of exchange-traded markets in securities, options and futures.[4] Generally, the term "block

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[3] *See* new Commodity Exchange Act § 1a(50). We believe that RFQ facilities satisfy the Dodd-Frank Act's definition of "swap execution facility." "Swap execution facility" is defined as:

> 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, through any means of interstate commerce, including any trading facility, that—
> (A) facilitates the execution of swaps between persons; and
> (B) is not a designated contract market.

An RFQ facility on which a liquidity seeker can request quotes from many liquidity providers satisfies the definition's requirement that "multiple participants have the ability to execute or trade swaps by accepting bids or offers made by multiple participants." In addition, a flexible reading of the definition of "swap execution facility" is consistent with the term's definition, which includes, but is not limited to, "trading facilities," and the fact that the statutory definition of SEF was broadened during the legislative process.

[4] *See* Market Regulation Advisory Notice, RA1006-3, CME & CBOT Rule 526 (Oct. 25, 2010) *and* RA1004-4, NYMEX & COMEX Rule 526 (Oct. 4, 2010) (collectively "**Rule 526**"). Notably, the CME, CBOT, NYMEX and COMEX all have rules permitting block trading (…continued)

trade" refers to a large size transaction privately negotiated between sophisticated counterparties and executed apart from an exchange's floor. Typically, block trades are entered into between a dealer and its client or multiple clients who have been brought together by a dealer or an asset manager in an "agented" trade. After the block trade has been executed, one or more of the parties, including an asset manager on behalf of its multiple clients, will seek to reduce risk by hedging its exposure, usually by transacting on the exchange itself.

Block trades permit market participants to execute a large order at a single negotiated price, even if slightly worse than the current trading price, without signaling to the whole market important information about the market participant's position or trading strategy. For block trades to work effectively, this critical information must not be reported to the market until sufficient time has elapsed to permit the parties to hedge their exposure, thereby permitting a party to properly reduce its risk. Allowing the market immediate access to such critical information will result in the "winner's curse." In other words, it will allow and encourage "front running" and an increased bid/ask spread which will result in increased costs to the end-user-client rather than decreased costs. Under a post-trade public reporting system that gives dealers sufficient time to hedge, the dealer will execute the block trade at a certain price based on the anticipated amount of risk and cost the dealer will incur in the transaction, reflected in the bid-ask spread. If the dealer must incur the additional risk and cost imposed by opportunistic traders, who are likely to get ahead of the hedging transaction and drive up the transaction cost, the dealer will require a higher bid-ask spread in order to justify the additional risk incurred and will pass this additional cost on to the Swap customer. This same problem arises more generally in a trade execution platform that offers RFQ. The need for promoting transparency must be balanced against the increased costs that will arise in the context of Swaps trading. To be clear, the AMG recognizes the need for full regulatory transparency and therefore would expect that information with respect to all block trades would be available immediately to the relevant Commission.

In recent years, the futures exchanges have recognized this "winner's curse" problem and have sought to address it by permitting delays in reporting of block trades. However, the 5-15 minute[5] delays permitted are frequently not long enough to hedge exposure to a block trade. As a result, the amount of block trading that has taken place through futures exchanges since the introduction of block trading procedures has been extremely limited; instead market participants have turned to the over-the-counter Swap markets. The data for 2010 reflects this limitation, as the average percentage of block trades on U.S. Treasury futures this year is less than 3% of total daily volume (*i.e.*, approximately 254 block trades).[6] This average percentage is even lower when all trades for this year are included in the calculation and not just trades on those days where there were block trades.

(continued…)

in futures and/or options contracts. http://www.cmegroup.com/clearing/trading-practices/block-trades.html.

[5] *See* Rule 526F.

[6] This does not include the ultra-long contract whose average percentage is a bit higher but actually has very little trading activity.

The need for robust and flexible access to block trading in Swaps is even more pronounced than in futures for two main reasons. First, the mandatory trade execution requirements of Title VII largely eliminate the escape valve currently available for futures traders via the over-the-counter Swaps markets. Second, the informational signaling problem described above is more acute for Swaps than futures because the highly idiosyncratic terms of even "standardized" Swaps reveal larger amounts of information about the positions and trading strategies of the counterparties to a trade than in futures, and can often be used to infer the identity of at least one of the counterparties to the trade.

The Commissions may be concerned that easy access to block trading on SEFs will undermine price discovery and liquidity for Swaps. The opposite is true. Block trading will enhance price discovery on SEFs by eliminating the noise of off-market pricing that results from manipulative third-party market behavior. In addition, block trading will draw liquidity to SEFs because, without it, market participants will refrain from executing large size transactions.

Therefore, the AMG believes the Commissions should adopt rules for SEFs that would encourage flexible block trading. In particular, minimum permissible sizes for block trades should vary with asset classes and be set low enough to encourage the use of block trades. In addition, initial block trade reporting rules should permit delays in reporting of block transactions to the market until the later of 24 hours following the time of execution of the trade and the opening of the next following trading day.[7] We believe the 15-minute delay recently proposed by the CFTC[8] is too short and note that it is significantly shorter than the SEC's recent proposal allowing for block trade size reporting delays of between 8 and 26 hours.[9] We believe that appropriate delays will help eliminate the so-called "winner's curse" and thus the unnecessary harm it will cause to end-users.

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[7] Once SEFs have accumulated sufficient historical transactional information to better evaluate the effectiveness of the block trading procedures, these delay periods might be reduced for certain asset classes.

[8] *See* Fact Sheet: Proposed Rule on Real Time Public Reporting of Swap Transaction and Pricing Data (Nov. 19, 2010), available at http://cftc.gov/ucm/groups/public/@newsroom/documents/file/rtpr_factsheet.pdf. The AMG intends to comment on this proposal in a separate letter to the Commissions.

[9] *See* Exchange Act Release 34-63446 (Nov. 19, 2010). The AMG intends to comment on this proposal in a separate letter to the Commissions.

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The AMG thanks the Commissions for the opportunity to comment in advance of their rulemaking on trade execution requirements in Title VII. The AMG's members would appreciate the opportunity to further comment on these topics, as well as other rulemakings the Commissions will undertake under Title VII of the Dodd-Frank Act. If you have any questions, please do not hesitate to call the undersigned at 212-313-1389.

Sincerely,

Timothy W. Cameron, Esq.
Managing Director, Asset Management Group
Securities Industry and Financial Markets Association