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VIA E-MAIL: rule-comments@sec.gov; dfadefinitions@cftc.gov

Ms. Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609.

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

Re: The Definition of Swap Execution Facility in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (File No. S7-16-10)

Dear Ms. Murphy and Mr. Stawick:

We are responding to Release No. 34-62717 (the "*Proposing Release*"), in which the Securities and Exchange Commission (the "*SEC*") and the Commodity Futures Trading Commission (the "*CFTC*" and, together with the SEC, the "*Commissions*") solicited comments on certain definitions contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("*Dodd-Frank*").

We appreciate the opportunity to comment on the definition of a "swap execution facility" (a "*SEF*") and the requirement imposed by Dodd-Frank that certain swaps and security-based swaps be executed either on a formal exchange or a SEF (the "*Execution Requirement*").[1] As discussed further below, we believe that Dodd-Frank provides the Commissions with the necessary flexibility to determine the manner of execution for each market, consistent with the Core Principles for SEFs, and that the definition of a SEF permits a "request-for-quote" ("*RFQ*") system. We understand the main objective of the Execution Requirement is to promote liquidity in the market and increase transparency for market participants. As the market participants generally will want to decide what price discovery mechanisms work best for their particular transaction in light of the relative liquidity of the product being traded, we believe in allowing a diversity of solutions and letting winners emerge. We are concerned that the Execution Requirement may be interpreted so restrictively that it will prevent market participants from entering into transactions or force transactions to non-U.S. venues. Both consequences would undermine the objectives of Dodd-Frank by constraining liquidity, reducing competition and impairing transparency, resulting in sub-optimal execution levels for clients, and also would make U.S. banks less competitive. Rather, the Commissions should consider these practical implications and implement the Execution Requirement with the flexibility that Congress

[1] This letter focuses specifically on satisfying the Execution Requirement through the execution of swaps on SEFs and not through the execution of swaps on exchanges.

intended and the statutory language permits in order to accommodate the realities of an institutional market such as the over-the-counter derivatives market.

Recommendations Regarding the Swap Execution Requirement

Dodd-Frank imposes the Execution Requirement through two separate provisions. With respect to swaps, Section 723 of Dodd-Frank adds a new Section 2(h)(8) to the Commodity Exchange Act, as amended (the "*CEA*"), which states that "[w]ith respect to transactions involving swaps subject to the clearing requirement of paragraph (1), counterparties shall (i) execute the transaction on a board of trade designated as a contract market under section 5; or (ii) execute the transaction on a swap execution facility registered under [section] 5h or a swap execution facility that is exempt from registration under section 5h(f) of this Act." Section 763 of Dodd-Frank amends the Securities Exchange Act of 1934, as amended (the "*Exchange Act*"), in a similar fashion with respect to security-based swaps. Our comments pertain to the Execution Requirement as it applies to both swaps and security-based swaps.

1. Separate Determination of the Execution Requirement

One of the principal purposes of the Execution Requirement is to increase liquidity. Therefore, cleared swaps that do not have sufficient liquidity for sustainable trading on an exchange or SEF should not be subject to the Execution Requirement. Section 2(h)(8)(B) of the CEA, as amended by Dodd-Frank, excludes from the Execution Requirement swaps that are not made "available to trade" on any board of trade or SEF, which requires more than a listing.[2] In our view, the mere listing of a swap on a SEF without sufficient liquidity in the relevant market will not ensure that the swap will be "available to trade." A SEF might list thousands of possible swaps, some of which might never trade, and others of which might trade very infrequently. In order to satisfy the higher liquidity standard that arises from the requirement that a swap be available to be traded, Congress imposed upon the Commissions the obligation to make a separate determination with respect to whether the Execution Requirement is applicable to a particular swap, even if it has already been determined that the swap should be cleared.[3] To make this determination, it will be necessary for the Commissions to find that sufficient liquidity in the swap market exists to enable parties that are interested in entering into a particular swap to find a willing counterparty at a price that is consistent with and reflective of prevailing market conditions and dynamics.

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2 Section 3C(h)(2) of the Exchange Act, as amended by Dodd-Frank, includes substantially the same provision.

3 CFTC Chairman Gary Gensler recognized the distinction between those swaps that will be subject to the Execution Requirement and those swaps that will be subject to a clearing requirement. Testimony of Chairman Gary Gensler, Hearing of Senate Comm. on Agriculture, Nutrition and Forestry, April 21, 2010.

Congress also expressed its expectation that not all cleared swaps should be subject to the Execution Requirement by specifically listing considerations that the SEC and CFTC should weigh in determining the scope of the Execution Requirement. In particular, the Execution Requirement is subject to Section 5h(d)(1) of the CEA, which states that "[t]he [SEC] and the [CFTC] may promulgate rules defining the universe of swaps that can be executed on a swap execution facility. These rules shall take into account the price and nonprice requirements of the counterparties to a swap and the goal of this section as set forth in subsection (e)." If, in applying the rule so established, it is determined that a particular swap does not trade with sufficient liquidity for the swap to be "made available to trade," then such swap should be considered to be a swap that need not be executed on a SEF.[4]

To determine whether sufficient liquidity exists in a particular market, the Commissions could consider (i) the average daily volume of trades, (ii) the average volume over longer time periods (*e.g.*, weekly, monthly, quarterly and annually), (iii) the size of transactions and (iv) if a limit order book is used in that market, the depth of such book. We believe that thresholds with respect to each of these criteria would need to be satisfied before a swap is truly "available to trade."[5] Lastly, the Commissions should review the liquidity of markets, on an annual or other periodic basis, to determine if liquidity sufficient to meet the "available to trade" criteria continues to exist.

2. Broad Discretion Over the Manner in Which Swaps Will Be Executed

As stated above, in our view, the Commissions have the flexibility to permit different forms of price discovery processes for the swaps that are subject to the Execution Requirement. We also believe that the definition of a "SEF" should be read broadly to embrace a number of trading methods and platforms, all of which allow for price discovery and are effective and efficient, including RFQ platforms, streaming prices, order books and other trading technologies and approaches that are yet to be created. Congress could have specified the types of platforms it considered to be SEFs, forced swap trading to be conducted on exchanges or their functional

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4 Taking this point one step further, there also may be circumstances where a swap is executed on a SEF by choice, but if the Commissions have not required that particular swap to be cleared, then accordingly there is no requirement to clear the swap, even though it has been executed on a SEF.

5 In defining these criteria, and determining whether they have been satisfied, the Commissions will need to proceed with great care. For instance, it's possible that the criteria could be satisfied only during certain parts of the trading day (*e.g.*, only in the morning in New York for a single-name CDS on a European credit). In such a case, a finding that sufficient liquidity exists would require that trades in this swap be executed on a SEF despite the fact that for much of the trading day sufficient liquidity does not in fact exist. Accordingly, it is important that the criteria and their application be sufficiently flexible to ensure that the Execution Requirement applies only to swaps for which true, broad-based liquidity exists.

equivalents, or specified the manner of execution on SEFs, but Congress instead provided broad authority that allows various platforms and methods to be utilized. We believe that the market will and should determine which process or processes are most efficient and provide the best liquidity and price discovery.

A. Definition of a SEF as a Trading System or Platform

Dodd-Frank amends Section 1a of the CEA to add a new paragraph (50) defining "swap execution facility," and Section 761(a)(6) of Dodd-Frank amends Section 3(a) of the Exchange Act to add a new paragraph (77) defining "security-based swap execution facility." We refer to either definition as a "swap execution facility" or "SEF" throughout this letter given the similarity of the definitions and our comments apply to both definitions.

The text below (which reflects the changes that were made to the definition of SEF from the form as it appeared in the base text for the House/Senate Conference to the final text as enacted into law) demonstrates Congress's intent to interpret the definition of a SEF broadly and permit different types of such facilities to exist:

> The term 'swap execution facility' means a ~~trading facility [trading facility]~~ **trading system or platform** 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 [other participants that are open to]~~ 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

By deleting the term "trading facility" at the beginning of the definition of a SEF and referring only to a "trading system or platform," Congress broadened the definition of "SEF" to extend beyond the term "trading facility," which is separately defined under the CEA to mean a system in which multiple participants have the ability to execute transactions against "bids or offers made by other participants that are open to multiple participants." CEA § 1a(51). In fact, the definition of a SEF in the final version of Dodd-Frank indicates that a SEF "include[s] any trading facility," thereby demonstrating that the definition of a SEF is broader than the term "trading facility."

B. The "Multiple-to-Multiple" Requirement

Congress's intent to broaden the definition of a SEF is further demonstrated by the final version of the "multiple-to-multiple" requirement. While the final definition of a SEF retained a requirement that the platform allow for participation by multiple parties generally, Congress eliminated language that would have required involvement of multiple participants on each side of swaps that are executed on the platform.

Specifically, the definition of a SEF set forth in prior versions of the legislation referred to a SEF as a system or platform "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.) In the final version, as shown above, the phrase "other participants that are open to" was deleted. This change is significant and telling. We read this to permit a multiple participant system that provides a client the ability to utilize an RFQ method, so long as, within that SEF, multiple participants have the "ability" to execute or trade swaps by accepting bids and offers made by multiple participants. Clients value this ability, but sometimes they prefer not to use it and instead have a need to request a price from a single dealer or a limited number of dealers. This need arises, for example, where a client seeks to enter into a large or relatively illiquid transaction that can only feasibly be executed with one dealer or a limited number of dealers without materially moving market prices. In such an instance, if the client is forced to display its interest to the entire market, it may have difficulty obtaining an execution with a single dealer or a limited number of dealers, and the resulting transaction could involve greater cost. As a result, some clients will likely refrain from necessary hedging activities.

The definition of SEF in Dodd-Frank supports our interpretation. As discussed above, a SEF 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…." (Emphasis added.) On its face, the definition only requires that more than one participant have the ability to solicit quotations from more than one participant. The definition does not require that more than one participant have the ability to execute or trade swaps based on particular bids and/or offers provided by other participants. If Congress had retained the phrase "other participants that are open to," then the definition would require that all bids and/or offers be open to multiple soliciting participants. Because Congress omitted that phrase, under the definition as enacted, quotations made at the request of a particular participant are *not* required to be open to any other participants. All that is needed to satisfy the first reference to "multiple participants" in the definition of SEF is the ability of multiple participants to solicit quotations.

C. The Omission of Core Principle 9

Finally, the omission of Core Principle 9 with respect to SEFs was clearly intended to mean that SEFs can vary the manner in which swaps are executed for particular markets and participants. The core principles for SEFs are substantially similar to those for designated contract markets; however, Core Principle 9 is notably and intentionally inapplicable to SEFs, clearly reflecting Congress's intention that bids and offers of a SEF need not be open to all market participants.

Core Principle 9 states that a DCM "shall provide a competitive, open and efficient market and mechanism for executing transactions that protects the price discovery process of trading in the centralized market of the board of trade." CEA § 5(d)(9)(A). Accordingly, not only can SEFs vary their execution processes, but a SEF is not required to be constructed in a manner that provides for all bids and offers to be made available to all other participants.

D. Request-For-Quote

As mentioned above, we believe that the definition of a SEF should be interpreted to permit an RFQ trading method. RFQs would provide necessary liquidity and transparency, which are the primary goals of a SEF. Not only does Dodd-Frank permit RFQs, but there also are several practical reasons why an RFQ system should be permitted as a trading method. First, this system is well established and understood by the market and market participants. It has been widely implemented and accepted for over 10 years in electronic over-the-counter markets and is broadly supported by both the buy-side and sell-side of swap transactions. The currently existing major RFQ platforms provide high quality pre-trade transparency, as each provides indicative levels at which standard lot size trades can be executed. Furthermore, records show that most transactions on these platforms occur at prices at or better than the pre-trade indicative levels.

In addition, as noted above, from time to time clients may want to request a quote from a single counterparty (while retaining the *ability* to request a quote from multiple counterparties). An RFQ system allows customers to choose the desired degree of exposure of an inquiry. Lastly, in our experience, electronic systems that require full competitive execution among all participants can potentially present a number of problems, including the potential for system glitches and disputes. The RFQ system provides for automated execution for standard trades in normal markets, as well as human involvement in other circumstances.

We believe that for some products an RFQ system will be the only price discovery method that works. Therefore, it is imperative that the rules do not mandate that SEFs adopt particular price discovery methodologies. We believe that the Commissions have the statutory authority to allow exchanges and SEFs to develop the type of methodology that works best for their markets, provided that the systems are within the parameters specified by the Commissions.

3. Block Trades

We believe that SEFs should be permitted to establish rules regarding block trade size thresholds based on the needs and circumstances of each market, as the markets for particular swaps evolve. Dodd-Frank mandates that SEFs establish block trading exemption rules with respect to swaps, subject to minimum size requirements that reflect market liquidity and the needs of market participants. CEA § 5h(f)(2)(C) and Exchange Act § 3D(d)(2)(C). We believe that each SEF's definition of a block trade should satisfy two criteria as to size: (i) it is large enough to move the market price in normal conditions were the trade known to the market and (ii) it is larger than the majority of the transactions for similar swaps. Swaps on different products should require different block sizes. For example, the block size for a 5-year interest rate swap should be larger than the block size for a 7-year credit default swap on a high-yield credit. Also, as SEFs mature and swap liquidity moves and grows, the sizes that meet this definition will change. Accordingly, SEFs should be granted flexibility in defining their block trading rules.

4. Position Limits

Sections 737 and 763 of Dodd-Frank direct the CFTC and SEC, respectively, to establish position limits for the size of the positions in certain swaps and security-based swaps that may be held by any person.

We believe that position limits will be monitored more efficiently and effectively "downstream" at the central counterparty (the "*CCP*") and/or repository level, and therefore, position limits should be enforced at those levels as opposed to the SEF level. Position limits are an important component of systemic risk reduction; however, to be effective, position limits must apply to the total position of a swap market participant, which may reside in two or more CCPs and/or repositories. Unless provisions are made for SEFs to have real-time reports of gross and net exposures in multiple CCPs and repositories, it is not feasible for SEFs to enforce position limits that are meaningful. In other words, in the absence of such information, the only positions limits that SEFs could enforce would bear no necessary relationship to the true exposure of the swap participant. For these reasons, we recommend that position limits be applied only at the clearing house level.

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We appreciate the opportunity to comment to the Commissions on the definition of a SEF and the Execution Requirement and would be pleased to discuss any questions either Commission may have with respect to this letter. Any questions about this letter may be directed to Dexter Senft (dexter.senft@morganstanley.com; 212-761-2466).

Very truly yours,

Dexter Senft
Managing Director