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TO:

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

8 March 2011

Dear Mr Stawick

RE: 17 CFR Part 37 RIN Number 3038–AD18

Core Principles and Other Requirements for Swap Execution Facilities

The Global Foreign Exchange Division was formed in co-operation with the Association for Financial Markets in Europe (AFME), the Securities Industry and Financial Markets Association (SIFMA) and the Asia Securities Industry and Financial Markets Association (ASIFMA). Its members comprise 21¹ global FX market participants, collectively representing more than 85% of the FX market.²

The Division is committed to ensuring a robust, open and fair market place. We welcome the goal of the Commission to promote greater liquidity and transparency, reduce transaction costs, and broaden participation through the public dissemination of trade data.

Foreign exchange trading is a 24 hour market, underpinning international trade and investing. The scale of the market at \$4 trillion per day, its ubiquitous nature, and the simplicity of the vast majority of products mean that it has already developed into a highly transparent, liquid and deep marketplace with FX markets being at the forefront of e-trading. This liquidity is a key attribute in ensuring that markets are accessible to end users for hedging commercial exposure.

In relation to the applicability of the proposed swap execution facility (“SEF”) rules to the foreign exchange market, the Commission should take the time to review the foreign exchange market and its products within the context of the Dodd-Frank legislation to assess how best to implement the

¹ Bank of America Merrill Lynch, Bank of New York Mellon, Barclays Capital, BNP Paribas, Citi, Credit Agricole, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan, Lloyds, Morgan Stanley, Nomura, RBC, RBS, Société Générale, Standard Chartered Bank, State St., UBS, and Westpac

² Euromoney 2010

SEF rules without detriment to the existing, high levels of pre- and post-trade transparency and end-user choice. We note that the rules will require significant structural change in a well-functioning market that contains many more transactions and participants than other asset classes. Clear steps need to be taken to ensure that trading in the FX market, and the cross border trade that it supports, is not made more difficult and costly to end users than under the current market structure.

We are aware and supportive of the comments submitted by ISDA and SIFMA in their joint response (the "Joint Response"). In order to minimize duplication, we have sought to focus our comments in this letter to those that we believe are of particular relevance to the foreign exchange market.

1. Scope

- 1.1. We believe the market would benefit from greater clarity on the scope of the legislation with regard to FX instruments. For example, a Foreign Exchange Forward is defined under the Dodd-Frank Act as "a transaction that solely involves the exchange of 2 different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange." Strictly speaking, this definition is broad enough to cover FX transactions settling next day or T+2 (business days), despite the fact that consistent with common market definitions, practice and understanding, FX forwards are transactions with value dates greater than T+2 business days. Accordingly, we would welcome a clear statement from the Commission that transactions with value dates less than or equal to T+2 business days are excluded.
- 1.2. FX trades also act as supporting trades for security settlements, which may occur on a greater than T+2 basis. Such transactions, up to the standard security settlement maturity in the relevant currency and market, which may be up to T+5, should be excluded from the scope of the rules.
- 1.3. We assume that executed spot trades (out of the scope of these proposed rules) amended to a forward date are also outside of the scope of the proposed SEF rules. Many institutional investment managers accumulate their currency activity across all their managed funds and value dates to determine a net spot buy or sell position by currency. The net spot buy or sell position is traded with a dealer. After the spot trade is agreed between the investment manager and a dealer, forward points are agreed for each required value date in order to allocate the trades to individual funds. Netting buys and sells across funds and value dates reduces the cost of trading by reducing bid offer spreads costs. Requiring investment manager to separate their forward and swap activity from their spot activity will reduce the amount of netting and increase trading costs.
- 1.4. We note that one impact of the application of the proposed SEF rules may be to split the trading of certain products. Unlike other asset classes, FX cash and forwards trade closely together. We anticipate that as foreign exchange spot trading is not subject to SEF rules a move to trade forwards and swaps on a SEF as currently proposed will reduce transparency, reduce liquidity and increase costs for end users.

2. Extraterritoriality

- 2.1. It is unclear what the Commission's intentions are as to the jurisdictional scope of the SEF rules. Because the FX market is fundamentally international, any SEF executing FX trades must be able to do so on a cross-border basis and therefore must be permitted to operate in more than one jurisdiction. The Dodd-Frank Act provides (new Commodities Exchange Act

Section 5h(g)) that the Commission may exempt a non-US SEF from registration if the SEF is subject to comparable, comprehensive regulation by a its home country government. We believe the Commission should therefore state what steps it proposes to take to recognize foreign SEFs and should pursue harmonisation with other regulators across jurisdictions. Given the long lead time required to set up a cross-border SEF, it is critical that the Commission and other regulators start this process as soon as possible. Doing so will reduce the potential for conflict, uncertainty and regulatory arbitrage and will reduce the risk that implementing SEF trading for FX will bifurcate the market and, create onshore and offshore markets.

3. RFQ – minimum number of respondents

- 3.1. Consistent with the SEC’s current proposal, we believe that the SEF should enable a participant to determine the number of potential respondents that it wishes to RFQ.
- 3.2. For less liquid products the universe of quoting dealers is often limited. Dealers may be reluctant to quote on larger transactions (up to the block trade threshold) due to the likelihood the market will move against them when trying to hedge in a market where trade details are known to other dealers. This will have a detrimental impact on liquidity or will require the liquidity provider to increase the risk premium for the client. We would welcome clarity on whether liquidity providers will be aware that a request has been made to multiple participants.
- 3.3. In addition to deteriorating liquidity, end-clients forced to execute FX products on a SEF under the Commission’s proposals are likely to suffer cost and pricing implications. The multi-RFQ structure will break the dealer-client link and the ability to offer relationship pricing, thereby pushing up costs. At present, participants are able to benefit in a number of ways from dealer relationships. For example, some users benefit from volume-related pricing, which may, as a result of booking a number of e.g. shorter-dated trades characteristic of the FX market, enable certain of them to benefit from a lower or negligible risk premium on certain trades. Costs of execution are also likely to increase if moving to a more standardised, exchange-traded model. By way of example, when trading on the CME, margin and variation margin requirements increase execution fees on a Euro 5m EUR/USD Future to \$1,064 vs \$570 via a multi dealer portal³.
- 3.4. We believe the objectives of Dodd-Frank are best served where the SEF requirements are applied flexibly. Where participants wish to access multiple users they can do so via the order book. Forcing them to access multiple liquidity providers via RFQ execution appears duplicative and restricts the choice available to participants. Indeed, flexibility for the SEF to determine execution methods, whether it be order book, RFQ or some other execution method, should also be allowed.

4. “By any means of interstate commerce”

- 4.1. Any exempt trades, including block trades, swaps not subject to clearing, and bespoke or illiquid swaps, should be capable of being traded by any means that participants choose, including single dealer platforms and voice trading. Indeed, we would question why the Commission should issue implementing rules at all in this regard.

5. 15 second timing delay for executing customer orders

³ Oliver Wyman analysis 2010

- 5.1. The requirement for a minimum pause of 15 seconds between entry of two potentially matching customer to broker / customer trades is not clear and, we believe, not appropriate to the OTC market. We query whether, for example, this requirement is only intended to apply to trades that are matched via voice brokers off exchange or whether it applies to RFQs as well. If the latter, it would appear to undermine the intended RFQ process. The requirement appears to be an extrapolation of a technique used in futures markets designed to expose trades in illiquid contracts in order potentially to increase liquidity. Its introduction would compromise the anonymity of liquidity providers, impacting that provider's ability to hedge. We note that the SEC's proposed rules on SEFs require no such pause and we would recommend that this approach be taken by the Commission.

6. Pre-trade transparency

- 6.1. Further pre-trade transparency will impact major dealers' appetites for risk taking and their pricing strategies. The existence of the RFQ process already implies there is limited liquidity in the product; otherwise it would be traded on streaming prices. The pre-trade price transparency will either cause dealers to pull back on certain types of deals or to widen spreads with a "risk premium" that will factor the rest of the market positioning themselves ahead of the winning dealer covering their risk. This issue is particularly acute for emerging markets which are already thinly traded and where through the introduction of SEF trading a side-effect of reduced capital flows in / out of developing economies can have negative impact on sustained growth.
- 6.2. The CEBR issued a report⁴ in May 2006 examining, in part, the impact of transparency on bond market efficiency. In reviewing major contributions to existing literature on securities market transparency, liquidity and efficiency they concluded that "infrequently traded stocks benefit from some degree of opacity, and that a very transparent B2B limit-order book does not have benign effects on execution quality". Their own analysis goes on to find evidence of the winner's curse⁵ in both Europe and the US, which appears to be more prevalent in markets that are more transparent and less fragmented. They conclude that "[g]reater transparency is associated with lower trade size and possibly higher spreads" and suggest that it is not clear that mandatory transparency could fix the problem of the winner's curse; caution is therefore warranted, in particular in determining what is available to trade or block trade sizing.
- 6.3. Making RFQ responses available to all participants will have a similar effect. In the event that this is mandated, the Commission should only require this *after* execution, and not before or at the time. In making RFQ responses available to requesters, the Commission should take

⁴ CEBR: European Government Bond Markets: transparency, liquidity, efficiency, May 2006 (the "CEBR report")

⁵ "The Winner's Curse is an idea from the theory of auctions which argues that the highest bidder has probably bid too much. If the highest bidder wants to resell the product immediately after the auction, the best price he will obtain is the underbidder's price. Because of incomplete information or subjective factors, bidders will form a range of estimates of the item's 'intrinsic value'. As a result, the largest overestimation of an item's value ends up winning the auction. With perfect information and fully rational participants skilled in valuation, no overpayments should occur.

Consider the structure of the secondary bond market. In the B2C market, the seller makes a request for quotes on an electronic platform. A number of dealers submit quotes, and the highest-bidding dealer secures the bonds. Typically, the successful dealer enters the B2B market to hedge his risk. The underbidders are aware of this and can benefit by taking up contrarian positions in the B2B market, thereby making it difficult for the successful bidder to share his position.

The more transparent the B2C market, the more difficult it is for the successful bidder to hedge his risk in the B2B market. Consequently, an increase in market transparency makes dealers more cautious about participating." **Source: CEBR report**

steps to ensure anonymity of providers of respondents in order to minimise concerns around hedging of risk.

- 6.4. The Commission requires all resting quotes to be shown to the requester along with the responses to its specific quote. We believe that only executable resting bids and offers should be communicated to market participants by the SEF. In doing so, the SEF should not inform participants making resting bids and offers of the other relevant RFQs.

7. Availability to trade

- 7.1. There should be objective standards approved by the Commission that define 'available to trade'. These standards should ensure that SEF trading is focused on the most liquid contracts in the most liquid tenors. Rather than SEFs being responsible for determining products to be made available to trade, we recommend a process similar to that proposed by the SEC, and under which the Commission would determine when a swap is made available to trade and also when it should be no longer considered available to trade. Otherwise there is a risk that SEFs may make an instrument available to trade where there is insufficient liquidity in order to capture volume. This will impact liquidity providers' appetites to quote, prices quoted and ability to hedge the trade.
- 7.2. In defining the standards for registering and de-registering the Commission should take account of liquidity on a product by product basis across the foreign exchange asset class. As a starting point, available to trade swaps should be clearing eligible as this suggests a necessary degree of price discovery and transparency. It should then be determined by the existence of two-way market with sufficient open interest and liquidity in any swap.
- 7.3. We believe further research should be undertaken on the following metrics – either by the Commission or other independent body – which could form the basis for setting any available to trade thresholds:
 - Number of active market counterparties
 - Daily notional turnover by tenor and currency-pair
 - Number of daily executed trades
 - Average width of two-way price

Based on these metrics, market depth could be benchmarked for different product groups. This benchmarking should also take into account other considerations; for example, given the 24 hour nature of the market, liquidity in less commonly traded currencies is variable across time zones, with greatest liquidity often during home market trading hours. Additionally, for the minor currencies there should be minimum liquidity benchmarks before a product becomes SEF relevant, as liquidity typically drops off quickly along the curve.

- 7.4. The Global Foreign Exchange Division would be keen to offer its services to work with the Commission in conducting this research. We believe this could (and should) be undertaken prior to the implementation of the SEF rules. The underlying data for these decisions would ideally be provided by historic data available in a swap data repository. This would suggest phasing SEF implementation to follow from any Swap Data Repository ("SDR") implementation to ensure sufficient time series data is available.
- 7.5. The Commission should also be cognisant of the potential dangers of having only one SEF providing a "made available for trading" solution and the market being forced to use the one

SEF. This would serve to concentrate systemic risk. If SEF trading were to be mandated, it would seem sensible to ensure that this be implemented via a number of SEF platforms, particularly given the number of transactions in FX.

- 7.6. Similarly, there should be a phased approach to formally mandating a product as available to trade. Typically, new clearing and exchange products will gradually build liquidity as the market gains confidence and this should be allowed to occur before a product can be deemed 'available to trade'. It would be unprecedented to have a big bang transfer of a huge pre-existing market to unproven platforms. Accordingly, the Commission should administer transition phases, potentially by product, where participants can observe performance over a defined period before compliance becomes enforceable.
- 7.7. We believe that currencies traded outside of CLS should not be eligible for clearing, and by extension SEF trading, due to the systemic risks posed by offering CCP sponsored-settlement. CLS has evolved over a number of years to offer market participants the ability to mitigate settlement risk through well-established and robust mechanisms. It would take time, if indeed it were possible, for CCPs to adequately manage this risk and provide clarity of settlement for market participants.

8. Block trades

- 8.1. As with the approach on making products available to trade, we propose that the Commission works with the industry to decide on an objective model for defining block trades.
- 8.2. Setting an appropriate regime for determining block sizes is critical to preserving liquidity for end-users. It cannot be stressed enough how some corners of the FX market have very low liquidity. The implications of sub-optimal sizing and consequently disclosure may hinder a market maker's ability to hedge, impacting liquidity and ability to make reliable markets or increasing end-user costs to compensate for increased risk. Moreover, the transparency proposed by the current rules may conflict with the requirements of the Dodd-Frank Act not to identify market participants' positions and to preserve their anonymity.
- 8.3. Consistent with our response to the Commission on the proposed rules relating to recordkeeping and reporting requirements, we believe that any block trading regime should be tailored not just to asset classes but to categories of types of swaps within those asset classes. A one-size-fits-all approach based on notional is almost certain to be inappropriate given the different levels of liquidity in different markets. There will be material differences between products which have a direct impact on the market's ability to absorb hedge activity and therefore should affect block size determinations. For FX, dynamic block sizes based on liquidity factors and taking into account size to average notional in the market is clearly appropriate when considering different types of transaction and the full range of currency pairs.
- 8.4. To ensure a more efficient and effective market for end-users, we believe it is critical for the Commission to mandate further analysis and research before determining the block size regime and to work with both industry and independent analysts to decide on an objective model. Otherwise there is a significant risk of disruption to the commercial activity that the FX market supports as part of the global payments system. The Global Foreign Exchange Division would be keen to offer its services to work with the Commission in conducting this research.

9. Core principles for registration

- 9.1. We note that the SEF rules as currently proposed present a high barrier to entry. This runs the risk of restricting SEF provision to a limited number of providers, with commensurately reduced choice for market participants. We are concerned that the registration requirements are currently skewed in favour of existing exchange type organisation and that this may create monopoly situations.
- 9.2. The Commission should therefore consider some discretion so as to allow potential SEFs to register even if they do not strictly meet all of the requirements and there should be a period of phasing (in addition to the grandfathering clauses) to allow SEFs to develop.
- 9.3. In addition, we have some concerns about the requirements for SEFs to implement rule enforcement programs. We recommend that such cases be referred to the Commission for investigation to avoid any potential for market abuse. For example, given the link between spot FX, which is currently exempt from the requirements, and any products that would be traded on a SEF, there is likely to be an incentive for the SEF to offer trading in exempt FX products as a convenience to its users. Whilst this creates competition, it may also create conflicts of interest and therefore we believe that enforcement programmes should at least be carefully monitored but better yet dealt with by the Commission.
- 9.4. We are also concerned that execution venues that also own clearing houses may be in a position to incentivise market participants to both execute and clear with them. For example they may be able to offer reduced execution fees provided a trade was also cleared with them. This model could be used to attract unrelated business to their platform i.e. for FX this might include spot trading, to the disadvantage of other market participants. It also has the potential to create organisations that are 'too big to fail'.

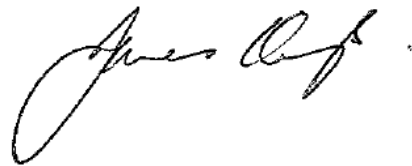
10. Implementation and infrastructure interdependencies

- 10.1. The phasing and implementation of the SEF regime clearly needs to take into account of the time taken for Treasury to determine exactly which foreign exchange products are subject to the regime, and in particular the decision regarding the clearing exception of FX forwards and swaps. It would be unrealistic to expect the market to invest the significant amounts required given the uncertainty surrounding this point.
- 10.2. Implementation of the SEF regime as currently envisaged would imply significant restructuring of the FX market. Greenwich Associates estimates that more than 50% of total FX trading volume is now executed electronically through electronic brokers, multi-dealer platforms and single-dealer platforms. A major change to existing execution channels requires time to allow restructuring or else risks impacting available liquidity. In a similar fashion, the ownership rules prescribed elsewhere under the Commission's rulemaking require time to allow existing platforms to enable them to become SEF compliant.
- 10.3. Finally, the proposed rules have been issued understandably as discrete papers for comment. However, the interdependencies between, in particular, the three major infrastructure elements – relating to execution, clearing and reporting – and the timing of each are significant. As we have previously stated in our responses to the Commission in relation to SDRs alone, the magnitude of this infrastructure build out cannot be underestimated for a market with as many participants and transactions as foreign

exchange. Ideally, the deadlines for each infrastructure element should be co-ordinated. We believe that at the core of this, SDRs will be necessary to allow the objective data analysis needed to determine areas such as 'block' definition and 'availability to trade'.

We appreciate the opportunity to share our views on the proposed rules relating to SEFs. Please do not hesitate to contact me at +44 (0) 207 743 9319 or at james.kemp@afme.eu should you wish to discuss any of the above.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'James Kemp', with a large, stylized flourish at the end.

James Kemp
Managing Director
Global Foreign Exchange Division