ISDA International Swaps and Derivatives Association, Inc.

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Invested in America

March 8, 2011

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

Re: RIN 3038-AD18 – Core Principles and Other Requirements for Swap Execution Facilities

Dear Mr. Stawick,

The International Swaps and Derivatives Association[1] ("ISDA") and the Securities Industry and Financial Markets Association[2] ("SIFMA") (hereinafter referred to as the "Associations") appreciate this opportunity to provide comments to the Commodity Futures Trading Commission (the "Commission") regarding the recently released notice of proposed rulemaking and request for comments ("NPR") concerning the core principles and other requirements for swap execution facilities ("SEFs") and the implementation of the related statutory provisions enacted by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which amends the Commodity Exchange Act (the "CEA").

We respectfully encourage the Commission to take a flexible approach focused on broad principles aimed at risk reduction, increased transparency and market integrity, rather than imposing detailed requirements, to allow for a smoother transition toward use of SEFs and uninterrupted operation of the swaps market within this new context. In its release concerning security-based ("SB") SEFs,[3] the Securities and Exchange Commission ("SEC") has in some areas taken a flexible approach and we note below certain specific examples which we think

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[1] ISDA, which represents participants in the privately negotiated derivatives industry, is among the world's largest global financial trade associations as measured by number of member firms. ISDA was chartered in 1985 and today has over 800 member institutions from 54 countries on six continents. Our members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end-users that rely on over-the-counter derivatives to manage efficiently the risks inherent in their core economic activities. For more information, please visit: www.isda.org.

[2] 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, please visit: www.sifma.org.

[3] SEC release No. 34-63825; File No. S7-06-11.

merit consideration by the Commission. SEFs are new and untested entities and there are distinct differences between the swaps and futures markets. As further described below, the text and goals of the Dodd-Frank Act support a more flexible approach for SEFs.

Our comments below are organized as follows: first, under "Required Transactions", we discuss rules applicable to transactions that must be executed through a SEF (or a designated contract market, a "DCM"); second, under "Permitted Transactions", we discuss rules that are applicable to transactions that may be executed through SEFs (or DCMs); third, under "Exemptions", we discuss exemptions to the rules that require execution of swaps through SEFs (or DCMs); and fourth, we discuss other items.

I. Required Transactions: Transactions that must be executed on a SEF or DCM

1. Request for Quote ("RFQ") systems

(a) The proposed definition of RFQ systems is unnecessarily detailed and unduly limits execution flexibility.

Under proposed Section 37.9(b), Required Transactions (i.e., transactions that are available for trading and which are not block trades), must be executed on an Order Book or through an RFQ system. The level of detail and limitation in the proposed definition of RFQ systems in proposed Section 37.9(a)(ii) is neither mandated by the Dodd-Frank Act nor called for by policy concerns. The Dodd-Frank Act establishes "Core Principles" for SEFs and states that a SEF will have "reasonable discretion" in meeting these core principles.[4]

While RFQ systems are not new per se, they are new within the context of a SEF. Unduly rigid requirements will impair the future development of RFQs in SEFs, will limit competition from other types of RFQ systems and will likely work against the policy objectives set forth in the Dodd-Frank Act. We respectfully recommend that the Commission adopt a more principles-based approach to SEFs and RFQs. As an example, the SEC, in its proposal on SB SEFs, has not imposed detailed requirements on RFQs.

The definition of a SEF itself is flexible: a SEF is "a trading system or platform in which multiple participants have the ability to execute swaps by accepting bids and offers made by multiple participants … through any means of interstate commerce, including any trading facility."[5] The statute further states that the goal of the section on SEFs is to promote the trading of swaps on SEFs and to promote pre-trade transparency.[6] These provisions are consistent with a general, principles-based approach to regulation of SEFs and a more flexible approach to RFQs rather than rigid definitions of either SEFs or RFQs.

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[4] CEA, section 5h(f)(1)(B).
[5] Dodd-Frank Act, section 721, amending the CEA, section 1a(50).
[6] CEA, section 5h(e).

(b) RFQs should not have to be sent to at least five (5) market participants and should be permitted to be sent to as few as one (1) participant.

As stated above, a SEF is defined as a "trading system in which multiple participants <u>have the ability</u> (emphasis added) to execute swaps by accepting bids and offers made by multiple participants". Allowing a requester to direct an RFQ to the number of recipients that it determines, rather than as determined by the Commission, does not deprive the requester of the ability to go to multiple participants. The statute permits the requester to make a request to only one market participant if the requester wishes to do so. The SEC has agreed with this analysis and permits an RFQ to be made to a single recipient, so long as the SEF has the capability of permitting RFQs to multiple recipients.[7]

We agree with the concerns noted in the SEC release that requiring RFQs to be sent to a minimum number of recipients may increase hedging costs and the price offered in response to the RFQ. A pre-trade broadcast of the requester's intent to trade to many participants could artificially affect prices and move the market against the requester, particularly in the case of trades of a large size that do not qualify as "block trades" or of illiquid products. This issue is potentially exacerbated by the fact that the proposed definition of "block trade" (in Proposed Part 43, Real-Time Public Reporting) is too restrictive. (See further discussion below.)

These concerns are magnified in the case of certain products that trade infrequently, such as certain commodity swaps with a particular delivery location. For such swaps, the requirement to advertise a requester's interest to a broad portion of the market (because such a market may have few market-makers) may effectively preclude maintaining confidentiality and risks adversely affecting the price to the customer. In such circumstance, the requirement for a wider broadcast of the RFQ provides pre-trade transparency for market-makers to the detriment of customers, who should be the primary beneficiaries of the regulations and the effort to increase pre-trade transparency. Each requester should, in every case, be entitled to assess the balance between the available liquidity in the market and potential consequences of wide dissemination of the request. In more liquid markets, a requester may wish to send an RFQ to large number of recipients because the markets will not be affected by the request.

(c) Resting Bids and Offers should include only firm, not indicative bids; providers of resting bids/offers should not be informed of RFQs; and requesters should have freedom to accept or reject resting bids/offers.

In our view, the only relevant resting bids and offers in the RFQ responses that should be communicated to market participants are executable bids and offers, not indicative bids and offers. RFQs are intended to provide executable prices; indicative quotes are not useful for this purpose. SEFs should be given discretion to determine what quotes qualify as communicable resting bids and offers and what criteria apply, such as term to expiration and size restrictions; otherwise, requesters may be inundated with stale or possibly misleading information. Also, the information flow between the requester and the SEF should be one-way: the SEF should inform the RFQ requester of the relevant resting bids and offers, but should not inform the participants

7 SEC release No. 34-63825; File No. S7-06-11, pp. 22- 23.

making resting bids and offers of the other relevant RFQs. This will prevent the possible abuse of market participants seeking disclosure of relevant market information by sending RFQs for small transactions or off-market stub quotes.

Proposed Section 37.9 states that resting bids and offers must be "taken into account." The rule should state that "taken into account" simply means that the resting bids and offers are communicated or made available to the requester. The Commission should not impose any hierarchy or preference in execution on the requester. The proposed rule should make it clear that the requester has full discretion to execute trades based on whatever factors the requester deems relevant. In addition to price, this may include factors affecting the "total price" of the transaction, such as execution efficiency and performance reliability.

We believe that only those resting bids and offers that are offered in a size that is at least equal to the quote size requested by the RFQ should be communicated to the requester. Without this limitation, an RFQ may result in resting bids and offers being reported to the RFQ requester that are for transaction sizes smaller than being sought by the requester. In addition to not meeting the requester's desire to execute a particular transaction size, the smaller resting bids and offers may provide the requester with misleading information if the sizes are too disparate. It may also result in a higher volume of trades, which would be contrary to the outcome favored by long-standing regulatory and industry initiatives such as tear-ups and compression.

2. The Commission should not restrict permissible SEF execution methods to Order Book (as defined in the NPR) or RFQ.

As stated above, both the Dodd-Frank Act and the policy behind the creation of SEFs strongly support the view that SEFs should have discretion to develop their trading systems in a way that meets the basic purposes of the Dodd-Frank Act and the core principles. As a result, the Commission should not limit the permissible execution methods to Order Book or RFQ for Required Transactions and should explicitly recognize that other trading arrangements may become available. The Dodd-Frank Act does not require that SEFs only execute transactions by means of Order Books or RFQs. As SEFs evolve, it is critical that they be able to develop other execution methods if their participants want to do so and the methods meet the requirements of the Dodd-Frank Act. Section 733 of the Dodd-Frank Act, creating the core principles for SEFs, adds new Section 5h(e) of the CEA, which states that the goal of the section is to promote trading of swaps on SEFs and to promote pre-trade price transparency. We believe these goals can best be achieved by providing flexibility for permissible execution methods to accommodate market needs and future developments.

Other regulators propose to be flexible in defining execution facilities. In its release on SB SEFs, the SEC stated: "rather than proposing a rule that would establish a prescribed configuration for SB SEFs … the Commission proposes to provide baseline principles interpreting the definition of SB SEF ... . Such an approach is designed to allow flexibility … and to permit the continued development of organized markets for the trading of SB swaps."[8] The SEC also states that other models, such as wholesale brokerage, might meet the execution

[8] SEC release No. 34-63825; File No. S7-06-11, p. 19.

requirement.[9] We agree with the SEC's more flexible approach. The European Commission stated that, in regard to a possible definition of "organised trading facilities": "[t]he definition would be broad and capable of applying to new organised trading facilities that may emerge in the future."[10] The International Organization of Securities Commissions, in its recent report on the trading of OTC derivatives, found that "[b]ased on the benefits to be gained from increased trading on organized platforms, the Task Force recommends that a flexible approach to defining 'exchanges or electronic trading platforms' for the purposes of addressing the G-20 objectives be taken in order to maximize the number of standardized derivative products that can be appropriately traded on organised platforms."[11]

3. Trading should not be restricted to Order Book only for any level of trading activity

The Commission has requested comment on whether swaps that meet a certain level of activity should be limited to trading through Order Books. Our answer is a strong no. In the Dodd-Frank Act, Congress defined SEFs separately from designated contract markets. Had Congress intended swaps to be executed in the same way as transactions in futures markets, which generally use order books, Congress could have required it. The definition of SEF under the Dodd-Frank Act provides that a SEF includes a "trading facility" (as defined under the CEA) but does not limit SEFs to being trading facilities.[12] Proposed Section 37.9 defines an Order Book to include trading facilities and structures that are similar to trading facilities. A requirement that SEFs execute Required Transactions by means of Order Books limits SEFs to trading facilities and similar structures and is therefore inconsistent with the broad definition of SEF adopted in the Dodd-Frank Act.

If market participants prefer to use Order Books for liquid markets, then such markets will migrate to Order Books. Therefore, it is not necessary for the Commission to be proscriptive in this regard. For SEFs to succeed, market participants must be given the discretion to use the execution platform that best meets their needs. Given the flexibility in the definition of the SEF and the need to accommodate changing markets, the market should decide whether SEFs use Order Books, RFQs or other systems for all trading levels.

4. There should be no separate requirement for a SEF to provide firm and indicative quotes on a centralized screen.

Proposed Section 37.9(b)(2) requires a SEF to provide "market participants with the ability to post both firm and indicative quotes on a centralized electronic screen accessible to all market participants who have access to the [SEF]." We urge the Commission to delete this requirement. We agree with Commissioner Sommers, who objected to this requirement on the basis that, "this provision is not mandated by the Dodd-Frank Act and may limit competition by shutting out

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[9] SEC release No. 34-63825; File No. S7-06-11, pp. 27-28.

[10] European Commission, "Public Consultation" on "Review of the Markets in Financial Instruments Directive (MiFiD)" (Dec. 8, 2010), p. 9.

[11] Technical Committee of the International Organization of Securities Commissions, "Report on Trading of OTC Derivatives" (Feb. 2011), p. 48.

[12] CEA, section 1a(50).

applicants who wish to offer request for quote services without this functionality."[13] The Commission has reasoned that this requirement is mandated by the "multiple to multiple" requirement in the definition of SEF in the Dodd-Frank Act, and Core Principle 2, which requires impartial access. We strongly disagree. The definition of SEF requires a system under which multiple participants have the ability to execute or trade swaps by accepting bids or offers from multiple other participants. Congress did not create a system in which all participants always had access to all other participants. Core Principle 2 requires SEFs to " … establish … rules that will … deter abuses … including means … to provide market participants with impartial access to the market … ."[14] Providing impartial access is part of the anti-abuse requirement rather than a prescription for how a trading system must work. A SEF that makes rules giving all qualified participants the right to use an RFQ would meet this "impartial access" requirement.

We respectfully recommend that the proposed rules should not have a requirement that SEFs post quotes on a centralized screen (although SEFs should be allowed to do so). If a market participant posts quotes on a centralized screen, it should be able to do so only to a limited group of recipients.

With respect to indicative quotes, SEFs should be required to establish policies, systems and procedures to monitor the posting of indicative quotes of individual participants. If, over time, participants post indicative quotes that deviate significantly from execution prices, a SEF should prevent such participant from posting indicative quotes. Misleading, stale and off-market indications are counter-productive to the aims of increased transparency and market integrity.

5. The "15 second delay" requirement needs clarification and should not apply to RFQs.

Proposed Section 37.9(b)(3) requires a SEF to provide for a 15-second timing delay between the entry of two orders if one order is from a trader and the other from the trader's customer, or the orders are between two customers. This requirement should be clarified as to when it is applicable. We believe it should only apply in the limited circumstance when a dealer is contacted by one of the dealer's customers with an order to execute a trade on an Order Book and it should only apply to two orders being entered on the same Order Book.

For any execution platform other than Order Book, it is not clear how the requirement would work or whether it would benefit customers. Specifically, the delay requirement should not apply to an RFQ. For an RFQ, the requester is specifically asking for quotes from specific market participants. It would serve no purpose to require market participants to delay in responding to the RFQ.

Also, a strict time delay of 15 seconds will not be appropriate for all Order Books or all markets. For very liquid markets with very rapid execution, 15 seconds is likely to be too long. The Commission should hold discussions with SEFs and market participants to jointly determine the appropriate duration of a required delay, if any, for different Order Books and different markets.

[13] 76 Fed. Reg. 1259, col. 2.

[14] CEA, section 5h(f)(2).

6. The SEF regulations should permit a SEF to develop protocols for swaps that cannot be cleared and should permit differential pricing for swaps using different derivative clearing organizations ("DCOs")

Parties who execute swaps through a SEF will do so in the expectation that the swap will settle through a particular DCO. The proposed rules do not address what will happen if a swap fails to clear through the relevant DCO after the swap is executed on a SEF. We recommend that the Commission allow a SEF, together with its participants, to develop protocols to address the failure of a swap to clear after execution. These protocols should address the processes to be used if a swap fails to clear, including legally sufficient documentation (such as confirmations) and credit requirements.

Also, if a swap can clear on more than one DCO, the market value of the swap may vary depending on the DCO that will be used. This variation could occur because of differences in costs of clearing, in execution capabilities, or in creditworthiness of different DCOs. The Commission should therefore permit SEFs to allow differential pricing for swaps using different DCOs.

II. Permitted Transactions: Transactions that may be executed on a SEF

The Commission should not require or suggest execution methods for transactions that are not subject to the "trading requirement".

Proposed Section 37.9(c) sets out methods by which a Permitted Transaction (one that is not required to be executed on a SEF, block trades and illiquid or bespoke swaps) "may" be executed. It is not clear whether the Commission intends to require that Permitted Transactions be traded in this way or whether this is simply a permissive provision allowing Permitted Transactions to be traded in this way if the parties wish. There is no statutory basis for imposing or suggesting an execution method for transactions that are not required to be centrally executed ("non-required swaps") because CEA Section 5h(d)(2) provides that non-required swaps "may be executed through any other available means of interstate commerce." Even if the Commission intends to indicate that non-required swaps may, at the choice of the parties, be executed in the ways specified, there is no need to provide such language in a regulation. The market should decide how such swaps will be executed within the regulatory parameters.

In our view, the definition of "Permitted Transaction" is confusing. It seems that a Permitted Transaction is a swap that is not required to be centrally executed, yet, the definition is not mandated by the Dodd-Frank Act, and if it is to be used, it should state this intent clearly. Proposed Section 37.9(a)(1)(v)(B) of the current definition refers to swaps that are not subject to clearing and execution requirements. We believe the Commission's intention is that if a swap is subject to clearing but not execution, because it is not "available to trade", it would be a Permitted Transaction, but the current drafting is not clear. Proposed Subsection (C) does not use the expression "available to trade" though it seems clear that an illiquid or bespoke swap would not be "available to trade."

If the parties choose to execute a permissible transaction on a SEF, then none of the requirements applicable to Required Transactions should apply. CEA Section 5h(d)(2) provides that non-required swaps may be executed through any means of interstate commerce (which would include SEFs and non-SEFs), and as a result a SEF should be able to execute permissible swaps in any manner that generally meets the core principles. Specifically, the proposed rule should provide that, in executing a Permitted Transaction, a SEF may use any execution platform. There is no need for a list of specifically permissible execution platforms. In addition, the following requirements should specifically not be applicable to Permitted Transactions under proposed Section 37.9: (i) a minimum number of RFQ recipients; (ii) taking into account resting bids and offers; and (iii) the 15-second execution delay.

III. Exemptions: Transactions exempt from the SEF requirement

1. A swap should not be "available to trade" merely because it is listed on a SEF and whether a swap is "available to trade" should be determined by the Commission, not the SEF.

We believe that the Commission should adopt a clear definition of "available to trade" which excludes illiquid swaps, even if listed on a SEF. If a swap type is listed on a SEF (such as, for example, a 2-year CDX credit default swap) but there are no buyers and sellers on the SEF for a particular swap of this type (such as, for example, an "off-the-run" 2-year CDX credit default swap), then it does not make sense to require execution through the SEF. The Dodd-Frank Act in section 2(h)(8)(B) of the CEA uses the terms "available to trade" rather than "accepted by a SEF" and the common sense meaning of "available to trade" would be that there is a liquid market. We ask that the proposed rules clarify that a swap that is not "available for trading" (as described in the proposed rules) will not be "available to trade."

Senator Lincoln stated in a colloquy that the Commission should consider "not just whether the [SEF] permits the swaps to be traded ... but also whether, as a practical matter, it is in fact possible to trade the swap ... ."[15] The ISDA/SIFMA Block Trading Study determined that "[l]iquidity in OTC derivative markets is fragmented and varies considerably depending on the specific product and terms of the contract … traded … ."[16] The study found that the markets for interest rate and credit derivatives are characterized by low volumes concentrated in large transaction sizes, across a large number of available instruments.[17] Accordingly, a swap of a type that is listed may actually rarely be traded. Therefore we request that the parameters of what is "available to trade" reflect measures of liquidity on a product-specific basis. At a minimum, a particular swap should trade multiple times daily with multiple distinct swap counterparties in order to be considered "available to trade." We urge the Commission to perform an in-depth study of the markets on a swap-specific basis, in conjunction with market participants, to

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[15] Congressional Record, 111th Congress (2009-2010), July 15, 2010, p. S5923.

[16] Referenced in and copy attached to ISDA and SIFMA joint comment letter on proposed regulations: (1) RIN 3038-AD08 – Real-Time Public Reporting of Swap Transaction Data; (2) RIN 3038-AD19 – Swap Data Recordkeeping and Reporting Requirements; and (3) RIN 3038-AC96 – Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants, dated February 7, 2011 ("ISDA/SIFMA Letter"), p. 2.

[17] ISDA/SIFMA Block Trading Study, attached to ISDA/SIFMA Letter (see fn. 16), pp. 15-22.

determine the appropriate criteria for "available to trade" in addition to the minimum requirement described above.

Proposed Section 37.10 requires a SEF to determine which swaps are "made available for trading" on the SEF on at least an annual basis. However, a SEF will have an economic incentive to determine that a listed swap is available to trade. An approach under which SEFs are allowed to determine what is "available for trading" could encourage SEFs, out of competitive concerns, to prematurely determine that a particular category of swap is "available for trading", develop liquidity and thereby concentrate its market power in that swap, rather than allowing the market to determine in a more orderly manner the appropriate terms and conventions for such category of swap. This is not in keeping with the intent of the Dodd-Frank provisions applicable to SEFs to foster a marketplace where (i) SEFs compete with one another; (ii) swap trading is encouraged on SEFs; and (iii) pre-trade price transparency exists. As a result, and in view of the broad significance of this determination, we believe the Commission, rather than the SEFs, should make the determination subject to requirements of notice, public comment and opportunity for a hearing. The SEC has stated that "it would be appropriate that the decision as to when a [security-based] swap would be considered to be 'made available to trade'…should be made pursuant to objective measures established by the [SEC] rather than by one or a group of SB SEFs."[18]

Proposed Section 37.10(c) should be clarified. This provision requires all SEFs to "treat" a swap as made "available for trading" on all SEFs if at least one SEF has made the same or an economically equivalent swap "available for trading." This provision should be clarified to avoid any misimpression that all SEFs must actually provide for trading in any swap that any SEF has made "available for trading." This is not required by the Dodd-Frank Act, is inefficient, does not improve transparency or liquidity in the markets and undermines the ability of SEFs to specialize in executing specific classes or categories of swaps if they choose to do so. Rather, it should be made clear that Section 37.10(c)(1) is merely an exception to Section 37.11(a)(3) which would otherwise permit SEFs to facilitate bilateral trading of swaps that have not been made "available for trading." We note here our earlier position that the Commission ensure that the standards employed to determine whether a swap is "available for trading" be developed through a market study engaged in by the Commission in collaboration with market participants, and that the Commission rather than the SEFs make the determination of which swaps are "available for trading."

In any event, any determination that a swap is "available for trading" on a particular SEF which takes into consideration any "economically equivalent swap" on another SEF should be premised on carefully defined parameters of an "economically equivalent swap" which should align with the market's understanding of economic equivalence (i.e. the market risk of the swap and the economically equivalent swap can be entirely offset such that the two swaps are strictly fungible).

[18] SEC release No. 34-63825; File No. S7-06-11, p. 78.

2. Block Trades should be consistently defined and the proposed definition is too restrictive.

We believe that the rule should state that the definition of "block trade" in Part 43 applies for purposes of the SEF rules. In addition, the rules governing block trades should have each SEF determine whether a trade is a block trade or not. The SEF is best placed to review the swap and the block trade requirements and to make a determination about a block trade. The Commission apparently shares this view, as stated in footnote 37. Section 37.200 should make this clear.

We reiterate the position taken in an earlier ISDA/SIFMA comment letter,[19] that the definition of "block trade" proposed in Part 43 is too restrictive when applied to the swaps market. Trading in the swaps market is fragmented, product-specific and concentrated in larger transaction sizes, as shown in the ISDA/SIFMA Block Trading Study.[20] If applied as proposed, without modification and further study of market and product characteristics, the definition of "block trade" has great potential to adversely affect the ability of end-users and others to execute and hedge large transactions because informing the market of a potential large transaction may move the market against the person seeking the transaction. Market-based research and analysis should be employed to provide the basis for the determination of well-calibrated block trading exemption rules, and these rules should be updated quarterly.

Neither the distribution test nor the multiple test in the definition of block trade in proposed Part 43 is appropriate for the swaps market. The distribution test is inadequate because swaps trading does not follow a smooth, normal (bell-curve) distribution pattern. Rather, the distribution of the size of swaps trades is disjointed and concentrated in a smaller number of trades in larger sizes. We believe that an in-depth study of the swaps market at the product or instrument level would show that a relatively high percentage of swaps are sufficiently large that neither real-time disclosure nor SEF trading is appropriate. The multiple test is inadequate because it relies on factors of "social size" (defined as the maximum of the mean, mode or median of transactions sizes for all swaps in a category of swap instrument) and a multiplier of five (5). Neither the concept of social size nor the multiplier of five have a clear foundation in the swaps market. Therefore, a definition of block trades that artificially and arbitrarily limits them to the 5% largest in the market is not appropriate.

3. The definition of Required Transactions should exclude "combination trades" and inter-affiliate transactions.

(a) Combination trades

Combination trades are transactions in which parties concurrently trade a Required Transaction and another transaction on an integrated basis. For example, two parties may trade a bond and an interest rate swap as part of one unified package with a single price. After the Dodd-Frank Act becomes effective, some trades may also involve combinations of two swaps, one of which is a Required Transaction, which is subject to the execution requirement, and another of which is a Permitted Transaction, which is not subject to the execution requirement.

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[19] ISDA/SIFMA letter, fn. 16.
[20] See fn. 16.

Because the price for the non-swap leg of the trade (or the Permitted Transaction) is dependent on the price of the Required Transaction, requiring the Required Transaction to be traded on an Order Book or RFQ system would effectively prevent these trades. To avoid this result, swaps involved in these combination trades should not have to be executed through a SEF. Combination trades like these could be executed as packages, similar to exchanges of futures for related positions, with the Required Transaction leg submitted to a SEF post-trade, thereby satisfying clearing, reporting and other related regulatory obligations.

(b) Inter-affiliate trades

Inter-affiliate trades should also be excluded from the category of Required Transactions. Swaps between persons under common control simply represent allocations of risk within a corporate group.[21] The size, frequency, and in certain instances, pricing levels, of inter-affiliate swaps will likely have no informational value for the broader market and the reporting of such swaps could have the unintended result of confusing market participants as to the true depth and liquidity of the market. As a result, executing these swaps through a SEF will not assist pre-trade price transparency. Moreover, requiring SEF execution of inter-affiliate trades will reduce a company's ability to accomplish risk management objectives on a cost effective basis. In the futures markets, despite the general rule that futures contracts must be executed through a DCM, there is a longstanding practice of affiliates trading among themselves outside DCMs.

IV. Other

1. SEFs should be able to limit access to professional market participants while fulfilling the access requirements.

Proposed Section 37.202 requires that SEFs provide "impartial access" to its markets and market services to all eligible contract participants ("ECP") and independent software vendors. We believe that SEFs should be able to limit access if such limitation serves a business purpose for the SEF and is established and implemented on a fair and reasonable basis. Core Principle 7 for SEFs (CEA Section 5h(f)(7)) requires the SEFs to establish rules to ensure the financial integrity of swaps. Core Principle 14 (CEA Section 5h(f)(14)) requires a SEF to maintain a program to minimize operational risk. A SEF may well determine that limiting access to certain types of market participants may significantly further the goals of financial integrity (Core Principle 7) and operational safety (Core Principle 14). The SEC recognizes that the requirement to maintain financial integrity may result in a limitation on access and provides in its Proposed Rule 809(a) that a SB SEF may "choose to not permit any [ECPs] that are not registered with the Commission as an SB swap dealer, major SB swap participant, or broker…to become participants in the SB SEF."[22]

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[21] See "Further Definition of 'Swap Dealer', 'Security-Based Swap Dealer', 'Major Swap Participant", 'Major Security-Based Swap Participant' and 'Eligible Contract Participant'", 75 Fed. Reg. 80183.

[22] SEC release No. 34-63825; File No. S7-06-11, pp. 52-53.

2. **The Commission should adopt a staged implementation of the proposed rules.**

Many of the proposed rules will pose significant operational and administrative challenges for market participants and SEFs. We strongly suggest that SEFs be allowed to adopt the rules on a staged basis so that the basic functioning of the SEF and the market can be established before all requirements are imposed. For example, the access requirement under proposed Section 37.202 (as discussed above) requires SEFs to give access to eligible ECPs and independent software vendors. It will be more difficult operationally for a SEF to give access to this broad audience as opposed to giving access only to dealers and market professionals because the technological capabilities of ECPs and vendors may differ significantly from those of SEFs and market professionals. As a result of these difficulties, and similar issues for other requirements, a SEF should be given time to phase in compliance.

3. **The Commission should indicate what process will be used for recognizing foreign SEFs.**

Section 5h(g) of the CEA permits the Commission to exempt a foreign SEF from Commission regulation if it is "subject to comparable, comprehensive supervision and regulation on a consolidated basis by the . . . appropriate governmental authorities in the home country of the facility." It is critical that SEFs be able to operate cross-border; many swap markets, such as markets in foreign exchange options, are predominantly international and will be constrained if they cannot continue cross-border transactions. The European Commission is considering its proposed approach to organized trading facilities and is considering generally the issue of access of non-European Union firms to European Union markets.[23] The Commission should engage in direct discussions with the European Commission (and other foreign regulators) with respect to cross-border SEFs, it should state explicitly that it will consider exemptions for non-US SEFs; and it should set out a process for non-US SEFs to obtain an exemption.

4. **The Commission, the SEC and foreign regulators should ensure harmonization and flexibility amongst their rules.**

The Dodd-Frank Act puts the Commission, the SEC and foreign regulators in the position of regulatory pioneering and designing the structure of significant and novel market architecture in the swap markets. For this reason, we urge the Commission, the SEC and foreign regulators to take a flexible, harmonized approach towards devising the new market rules. Because swaps in one market are often hedged in or linked to other markets, it is critical that SEFs (or their equivalents) in different jurisdictions operate in a compatible manner. This need for compatibility is another factor favoring flexibility in SEF regulation. Overly rigid regulation by the Commission will inevitably result in significant differences between Commission-regulated SEFs and other SEFs. We note that, to date, both the SEC and the European Commission have indicated their intention to be flexible in their SEF regulation.[24]

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[23] European Commission, "Public Consultation" on "Review of the Markets in Financial Instruments Directive (MiFiD)" (Dec 8, 2010), p. 78.

[24] See discussion in I.2., on p. 4 above.

5. Any ability of the SEFs to modify trades under Section 37.203(e) or Core Principle 8 must be subject to clear guidance and oversight by the Commission.

Proposed Section 37.203(e) will give SEFs the authority to adjust trade prices or cancel trades when necessary to mitigate market disrupting events caused by malfunctions in its electronic trading platforms or errors in order submitted by members and market participants. We urge the Commission to adopt a uniform standard to determine "market disrupting events." Market participants expect that the terms of their swaps will not be subject to change at the discretion of a SEF except in very limited circumstances. These circumstances should be defined by the Commission, and not by each SEF acting independently. The rules should, among other things, specify the time frame in which such adjustments and cancellations can occur. In the absence of a uniform standard applicable to SEFs, disparities between SEFs could worsen disruptions by making coordination among SEFs more difficult and by requiring market participants to grapple with different rules and procedures at times of stress.

The Commission is proposing to implement Core Principle 8 by requiring SEFs to adopt rules that allow them to take emergency actions. The Commission has included imposing special margin requirements, ordering the fixing of a settlement price and altering the contractual settlement terms or conditions as types of emergency action that could be subject to SEF rule-making. We urge the Commission to adopt standards governing such provisions and to impose uniform standards for SEFs and other entities involved in centralized execution and clearing. It would not be feasible, for example, for a SEF to alter settlement terms for a cleared swap unless the relevant DCO made the appropriate adjustments. Thus, these uniform standards must, among other items, consider the interaction between SEFs, DCMs, clearing organizations, swap data repositories and other market-wide institutions in emergency situations.

6. Section 37.701 should not prevent the use of "exempt" DCOs.

Proposed Section 37.701 would require transactions executed on or through the SEF to be cleared through a Commission-registered DCO. Section 2(h)(1) of the CEA provides that swaps subject to the mandatory clearing requirement must be submitted for clearing to a registered DCO or a DCO <u>that is exempt from registration</u> (emphasis added). The rule should be amended to permit use of exempt DCOs.

7. Section 37.702 should not impose margin requirements on end-users.

Under proposed Section 37.702, for uncleared trades, each SEF member must demonstrate that it has entered into credit arrangement documentation and have the ability to exchange collateral. It is our understanding that, under the Dodd-Frank Act, swaps by end-users that meet certain conditions will be exempt from the obligation to post collateral. The Commission should not create new collateral requirements for eligible end-user swaps if an end-user transacts through a SEF. Consistent with the statements of Chairman Gensler, the proposal should be amended to provide SEFs with sufficient flexibility to satisfy the core principles without prescribing that end-users be subject to margin requirements.

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The Associations appreciate the opportunity to comment on the proposed requirements for SEFs. We trust this submission is helpful to you. Please feel free to contact us or our staff at your convenience.

Sincerely,

Robert Pickel
Executive Vice Chairman

Kenneth E. Bentsen, Jr.
Executive Vice President
Public Policy and Advocacy