March 8, 2011

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

Re: Core Principles and Other Requirements for Swap Execution Facilities
        (CFTC RIN 3038-AD18)

Dear Mr. Stawick:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned proposed rules (the "Proposed Rules") of the Commodity Futures Trading Commission ("CFTC"), the purposes of which are to establish rules, guidance and acceptable practices which apply to the registration and operation of swap execution facilities ("SEFs"), all as required by or pursuant to provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

Introduction

The Proposed Rules pose one of the greatest challenges faced by the CFTC as it implements the Dodd-Frank Act. The concept of "swap execution facility" did not exist prior to enactment of the new statutory framework. The Proposed Rules not only define the SEF concept (based on the statute), but also address the registration and operation of SEFs and the listing, trading and execution of swaps on SEFs.

SEFs constitute a critical element of the derivatives market infrastructure envisioned by the Dodd-Frank Act. They are the means for bringing the shadow market into the open.

It is painfully obvious that the financial crisis, which brought us to the brink of international economic collapse, was in large part the result of a "shadow," or non-

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[1]   Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

transparent, financial market. This shadow market emerged largely because of off-exchange trading. Fueled by EnronOnline (before the collapse of the Enron Corporation) and the InterContinental Exchange (owned primarily by large financial institutions and energy companies), the ability of counterparties to meet and match without the use of conventional exchanges grew exponentially.

There were two unfortunate consequences of this "innovation." First, direct counterparty credit exposure, arising because, in this new shadow market, derivatives were not cleared, spawned a tangled web of inter-counterparty obligations, often mismanaged by even the most sophisticated trading operations.[2] Mechanisms for clearing off-exchange trades were later added to some direct matching systems in response to the mushrooming levels of exposures and a series of disruptive bankruptcies. But large volumes of bi-lateral, uncleared transactions continue to dominate the market. (Some evidence of this is found in the vocal and well-publicized efforts to maximize the scope of the end-user exception to clearing, asserting enormous losses in profits from a narrow interpretation of the exception).

Second, the explosive growth of the shadow market, in which uncleared derivatives were transacted, additionally left out the price transparency and discovery provided by designated contract markets.

The challenge for the CFTC, and the focus of the Proposed Rules, therefore, is to adapt the previous systems and practices used in the days of the shadow market into a new marketplace that centers on the new statutory requirements for transparency and prudent risk management in the Dodd-Frank Act.

It is inevitable that some of these shadow market systems and practices will not be adaptable and will not survive. It is obvious from various comments provided by the financial industry and their supporters that they do not yet accept that this financial crisis was an **"extinction event"** for some of these practices. Their starting point is that the Dodd-Frank Act and the CFTC's rules must be conformed to pre-existing market structures. This should not be surprising. Considering the massive profitability of non-transparent and unregulated derivatives trading in the decades before the financial crisis, denial is a predictable response. And for those industry commenters not in denial, framing the issue so that it is premised on doing no harm to pre-existing businesses and outsized profits is a clever tactic. However, such a tactic simply ignores that the Dodd-Frank Act requires that "business as usual" must change.

Therefore, the definition of the concept of a SEF in the Proposed Rules is critical to the realization of the transparent market mandated by the Dodd-Frank Act. Equally important are rules governing trading practices of SEFs.

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[2]   For a remarkable example, *see* Forbes, August 12, 2008, Ruthie Ackerman, "Constellation's Collateral Damage;" and The Baltimore Sun, September 19, 2008, Robert Little, "Collateral, Credit Crunch Took Down Constellation."

However, there is yet another major challenge. In the past, rules and procedures to preserve the orderly operation of markets with minimal disruptions were focused on individual exchanges. That approach is clearly problematic and, in fact, systemically dangerous in the modern environment. Today, electronic and algorithmic trading enables market participants to roam across a landscape populated by multiple DCMs and SEFs. They are able to almost instantly manipulate the relationships among disparate markets, taking advantage of differences in the rules of the road at various trading facilities or platforms. Even ICE Chairman and CEO Jeffrey Sprecher has recently warned of the "regulatory arbitrage" among exchanges (i.e., the exploitation of different rules applied by different exchanges) which may develop in the new environment.[3]

Some large and sophisticated exchanges may bridle at the limitations and requirements which result from the Dodd-Frank Act. While they say that they can handle all that is required on their own, that is clearly not true. Only the CFTC can establish comprehensive risk and manipulation controls and monitoring systems, connecting the SEFs and the DCMs. The Proposed Rules must accomplish this task.

Summary of Comments

Our comments are organized according to several subject matter areas as set forth below:

- Definition of Swap Execution Facility

  o Trading system or platform as used in the definition must be interpreted to mean either a "trading facility" under the CEA; an independent, electronic system serving the purpose of facilitating transactions; or a web-based or similar environment in which market participants can transact (i.e., a platform).

  o Order book systems must be required to use a "best price/first-in-time" rule to sequence the matching of orders.

  o Request for quotes systems ("RFQs") must not be a permitted means of execution under the definition. If the CFTC determines that they are permissible, then

    ▪ RFQs for firm quotes must be disseminated to all members of a SEF rather than a minimum of five.

    ▪ Responses to RFQs must be made available to all members of a SEF.

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[3] Reuters, March 1, 2011, Ann Saphir, "ICE Chief Plans to Upend Rival CME's Business."

- Responses to RFQs for firm quotes must be firm as to quantity as well as price.

- When used for large trades, block trading rules and methods should apply.

- When used otherwise, they are the functional equivalent of voice brokers and the rules related to voice-brokered trades should apply.

- The "available to trade" exception to the execution requirement related to the clearing mandate has a plain meaning: the execution requirement should apply to a swap unless there is no legally permissable mechanism to submit the swap for clearing. Nothing is required more than a mechanical capability to trade; in particular, a minimal level of trading activity is not required.

- Access to trading and information flows must be completely impartial. Compensation for preferential access must not be permitted.

- Certain practices associated specifically with HFTs must be included as abusive practices which must be prohibited by SEFs.

- Risk controls must incorporate not only market pauses and halts based on circumstances which indicate imminent threats, but also **"speed limits"** which can prevent those threats from arising in the first place.

- Data recordation and reporting must be broadened to encompass information that is relevant in the world of HFTs, specifically information on order cancellation and time intervals consistent with the capabilities of HFTs to make and cancel orders on the SEF.

- Rules relating to chief compliance officers must increase the role of independent members of boards of directors in their oversight, employment and compensation

- Volumetric fee discounts and rebates are inherently antithetical to fair and impartial access to SEFs. They must be prohibited.

- Rules relating to equity transfers by SEFs must be tightened.

Definition of Swap Execution Facility

In the Dodd-Frank Act, SEF is defined as follows:

> The term 'swap execution facility' means 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
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> > (A) facilitates the execution of swaps between persons; and
> >
> > (B) is not a designated contract market.[4]

The definition is significant because the Dodd-Frank Act requires that swaps subject to the clearing requirement must be executed either on a DCM or a SEF, unless no DCM or SEF makes the swaps "available for trading."[5] Furthermore, no person is permitted to operate a facility for the trading or processing of swaps unless the facility is registered as a SEF or DCM.[6]

Trading System or Platform

Trading system or platform is nowhere defined, except that it obviously includes "trading facility" since that language is included in the statutory definition.[7] Trading facility is defined in the CEA as—

> a physical or electronic facility or system in which multiple participants have the ability to execute or trade agreements, contracts, or transactions (i) by accepting bids or offers made by other participants that are open to multiple participants in the facility or system; or (ii) through the interaction of multiple bids or multiple offers within a system with a pre-determined nondiscretionary automated trade matching and execution algorithm.[8]

The definition encompasses *physical or electronic* facilities or systems. It also clearly requires that multiple participants must have the ability to (a) accept bids and offers made

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[4]   Dodd-Frank Act, Section 721(a).

[5]   *Id.*

[6]   Dodd-Frank Act, Section 733.

[7]   The SEC took this position in the parallel notice of proposed rulemaking, 75 Fed. Reg. at 1218.

[8]   Commodities Exchange Act (7 U.S.C. 1 *et seq*, Section 1(a)(51).

by other participants who are open to multiple participants in the facility or platform or (b) transact through automated algorithmic matching provided by the platform. A physical facility or system which meets these standards (but is not electronic) is an environment in which multiple parties are open to transact with each other without the intervention of electronic systems. This describes a trading pit, but not a telephone. It follows that one-to-one conversations over a telephone, instant messaging or e-mails are not included in this definition.

The CFTC Notice of Proposed Rulemaking ("NOPR"), but not the Proposed Rules, state that, in addition to trading facilities:

> The Commission believes that **any other method** that allows multiple market participants to have the ability to execute or trade swaps by accepting bids and offers made by other multiple participants in the facility or system, through any means of interstate commerce, may qualify as an acceptable trade execution method for an entity that wishes to register as a SEF. [Emphasis Added][9]

This approach ignores the very words of the statute. It incorrectly equates "trading system or platform" to "any method." "Trading system" means an independent, electronic system serving the purpose of facilitating trading. Trading platform means a web-based or similar environment in which market participants can transact. The statutory inclusion of "trading facility" does not expand this phrase to "any means." It is clear that telephonic, instant messaging and e-mail are common means of communication, but they can in no way be categorized as "trading systems or platforms." It is also clear that the "means of interstate commerce" phrase in the definition relates to Federal jurisdiction and is just one required element. It modifies "trading system or platform" and does not expand the basic concept. **The CFTC must define "SEF" to require the use of an independent, electronic system or web-based environment (i.e., a trading system or platform) which facilitates the matching of multiple market participants.**

Multiple to Multiple

The NOPR states that the basic functionality required of a SEF must "allow market participants the ability to make executable bids or offers and indicative quotes, and to display them to multiple parties, including all other parties participating in the SEF, if the market participants wish to do so."[10]

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9   CFTC Notice of Proposed Rulemaking ("NOPR"), Core Principles and Other Requirements for Swap Execution Facilities (RIN 3038-AD18), 76 Fed. Reg. at 1218.

10   NOPR at 1219.

The overly broad interpretation of "trading system or platform" means that a SEF can be almost anything. As a result, it is critical that the concept of "multiple to multiple" in the definition of SEF be sufficiently narrow so that the scope of acceptable methods of execution has rational boundaries.[11]

To meet the requirements for execution of swaps subject to the clearing mandate, the Proposed Rules permit two methods: order books and request for quotes systems.

Order Books include trading facilities (within the meaning of the CEA) and—

> A trading system or platform in which all market participants in the trading system or platform can enter multiple bids and offers, observe bids and offers entered by other market participants, and choose to transact on such bids and offers . . . .[12]

The Proposed Rules do not address the rules a SEF might use to sequence execution of bids and orders at the same price levels. The subject matter of the definition of "order book" is cleared transactions. Each counterparty should be indifferent to the market participant who constitutes the other side of the match. The sequencing of matching cannot affect the counterparty.

Execution preferences can and must be completely objective. Anything else leaves a door open for unfair results.

Whether in the definition of "order book" or in connection with Core Principle 2 requiring impartial access to eligible contract participants, the CFTC must make it clear that preference within a price level in an order book system must be based on a "best price/first-in-time" rule.

This must apply to trading facilities as well as to other acceptable order book systems. The CEA concept of trading facility did not address the current application of the concept to cleared swaps and cleared swaps alone. Other considerations (primarily counterparty credit) were important to the matching function. That will not be the case for SEFs in which market participants are indifferent to the participants who are matched with them in a cleared trade. If trading facilities or other permissible trading systems or platforms are used for a cleared swap market, an objective standard for sequencing matches must be required.

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[11] Of course, if "trading facility or platform" were interpreted to require a web-based or similar environment which functions to match, or allow participants to hit or lift, bids and offers on an anonymous basis, as we advocate above, the concerns about direct RFQs would be more easily addressed. For example, the RFQ, which is merely a stage in negotiation, would not be a "trading facility or platform".

[12] Proposed Rules, Section 37.9(a)(i).

Request for Quote Systems includes two types of systems or platforms. In one type a market participant can direct a request to a minimum of five participants and the recipients are also made aware of resting bids or offers on the SEF.[13] In the other, market participants are able to view real-time streaming quotes on a centralized screen and can either execute on such streaming quotes, if they are firm, or request quotes from at least five other market participants (who are made aware of resting bids and offers as described above) if the streaming quotes are indicative. [14]

The requirement that recipients must be made aware of resting orders is a sensible provision that enhances pre-trade transparency. However, the concept must not stop there. Firm quotes provide pre-trade transparency as well. As described below, concerns about block trades are misplaced. **All firm responses to an RFQ should be made available to all members of the SEF to assure trading transparency.**

RFQ systems have their uses to market participants, but they also raise concerns. In the Roundtable devoted to SEF issues, one of the panelists was discussing the need for a firm quantity as well as price in RFQ systems. The concern was that price was not reliable if the provider of the quote did not commit to a quantity. He said "people flashing prices on screens not standing behind them I think gives – lends to manipulation and/or misleading information."[15] It is obvious that certain RFQ systems can be used to gather information or distribute inaccurate information rather than for transparent and reliable trading. **For a quote to be considered "firm," it must be firm as to quantity and price.**

Commenters have cited two principal reasons that SEFs need to be allowed to use RFQ systems. The first is to enable staged market access to market participants who seek to buy or sell large quantities and prefer a narrow dissemination of that information. The second is to establish a level of price transparency for illiquid markets.

The first reason describes a block trade. A trading system or platform, since it is a communications link to multiple market participants, can obviously be used to put a buyer/seller in contact with a dealer to get a quote to execute a block trade. The buyer/seller can even communicate with multiple dealers serially or simultaneously to shop the terms of the block trade. Using the trading system or platform this way simply must not qualify that trading system or platform as a SEF. As strongly suggested by common exchange rules related to block trades, the prices are not transparent (they include compensation for the risk of reoffering the position to the market) or useful for price discovery. Inquiries of dealers to execute block trades can be a function that is useful, but such inquiry does not meet the standard for required execution on a SEF. **RFQs to solicit dealers for block trades should not fulfill the execution requirement for swaps**

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[13]   Please note that the NOPR uses the term "potential counterparties" to describe the recipients. This is more precise than the language of the Proposed Rules since, out of context, a reader might interpret "market participant" to refer to individuals employed by potential counterparty.

[14]   Proposed Rules, Section 37.9(a)(ii).

[15]   Joint SEC/CFTC Roundtable to Discuss Swap Execution Facilities and Securities-Based Swap Execution Facilities ("Roundtable"), September 15, 2010, Comments of Richard DuFour, Executive Vice President, Chicago Board Options Exchange at transcript page 39.

subject to mandatory clearing; and block trade limitations and rules as to size and price should apply.

The minimum of five participants required by the Proposed Rules to receive indicative quotes is without justification. The question that must be asked is whether there is any justification for allowing any request to fewer than all participants to qualify under the DCM/SEF execution requirement. Because the Proposed Rules do not include block trade limitations and rules, a narrow requirement for recipients of an RFQ is not justified. **Any RFQ must be made available to all participants on a SEF.**[16]

The other principal reason cited in favor of an RFQ system is low liquidity in certain products. It is important to remember that the subject matter of the Proposed Rules is the category of swaps subject to the clearing mandate. They are by definition relatively liquid.

Nonetheless, it is asserted that the absence of bid and ask orders compels a market participant to initiate the trading activity by asking for quotes. This participant can then transact on firm quotes or respond to an indicative quote with a firm quote. In every real sense, the trading system or platform has just facilitated a price negotiation, while still preserving a level of anonymity.

The best analogy is that the trading system or platform is acting in the role traditionally played by a voice broker. It is an automated middle man who aids in the negotiation and provides some anonymity. Instead of activating a broker who uses a telephone or instant message to solicit quotes, the RFQ system is activated to get the same result in a series of one-to-one communications. On this basis, the execution should be handled in the same way as a brokered transaction:

> Swap execution facilities must require that traders who have the ability to execute against a customer's order or to execute two customers against each other be subject to a 15 second timing delay between the entry of those two orders, such that one side of the potential transaction is disclosed and made available to other market participants before the second side of the potential transaction (whether for the trader's own account or for a second customer), is submitted for execution. [17]

This timing delay must apply to matches made by RFQs.

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[16] However, even though without justification, if fewer than all are going to be permitted (which we would disagree with), the minimum number of recipients must be no fewer than five. A lower minimum threshold is closer to e-mailing to a few familiar bankers than any recognizable form of market activity. It is a convenient communications device, not a trading system.

[17] Proposed Rules Section 37.09(b)(3).

Clearing Mandate and Availability to Trade

An additional issue which is related to, but not part of, the definition concerns the clearing mandate. Under the Dodd-Frank Act, if clearing has been mandated for a category of swaps, all of these swaps must be executed on a SEF or DCM unless there is an exception or no DCM or SEF "makes the swap available to trade."[18]

The Proposed Rules interpret this language to mean that there must be a level of actual trading activity at a SEF to determine if the SEF has made the swap available to trade. Each SEF is required to make an annual assessment of the swaps it has made available to trade, taking into consideration measures of trading activity.[19]

Therefore, a swap may be tradable on one or more DCMs or SEFs; but if there is not some, as yet undetermined, level of activity on at least one of the DCMs or SEFs, the swaps will not be considered to be made available to trade and the DCM or SEF execution mandate will not apply to the category of swaps.

The premise of this entire analysis is that one or more DCOs offer the category of swaps for clearing. Low activity may suggest that the DCO is imprudently clearing these swaps; **but it should not negate the execution mandate under the available to trade requirement.**

Commenters have suggested – incorrectly - that trading activity is an essential element of "available to trade." One of the commenters[20] cites the following statutory language:

> The ... Commodity Futures Trading Commission 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).[21]

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[18] Dodd-Frank Act, Section 723(a).
[19] Proposed Rules, Section 37.10.
[20] Comment Letter from Morgan Stanley to CFTC and SEC re The Definition of Swap Execution Facility in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, November 4, 2010.
[21] Dodd-Frank Act, Section 733.

This commenter suggests that taking into account "price and nonprice requirements" is tantamount to imposing a trade volume requirement when determining if a swap is "available to trade." This reasoning is not only illogical; it flies in the face of the explicitly stated goals of the Dodd-Frank Act. The commenter fails to note that the referenced subsection (e) provides as follows:

> CONSTRUCTION.—The goal of this section is to promote the trading of swaps on swap execution facilities and to promote pre-trade price transparency in the swaps market.[22]

Thus, properly read together these statutory provisions reinforce the concept that the least restrictive meaning of "available to trade" must be adopted.

The "available to trade" requirement has a plain meaning: the DCM/SEF execution requirement should apply to a swap unless there is no legally qualified mechanism to submit the swap for clearing. Nothing is required more than a mechanical capability to trade; in particular, a minimal level of trading activity is not required.

Access Requirements

Core Principle 2 requires that SEFs provide impartial access to market participants.[23] The Proposed Rules interpret this to be satisfied if its procedures provide for "Comparable fees for participants receiving comparable access to, or services from, a swap execution facility."[24]

The CFTC states in the NOPR:

> The purpose of the proposed impartial access requirements is to prevent a SEF's owners or operators from using discriminatory access requirements as a competitive tool against certain participants.[25]

Access is a limited resource, constrained by physical proximity and the capacity of transmission conduits. The Proposed Rules contemplate the sale of superior access through fee arrangements.

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[22]   *Id.*
[23]   Dodd-Frank Act, Section 733.
[24]   Proposed Rules, Section 37.202(a)(3).
[25]   NOPR at 1223.

Privileged access to data feeds is a practice which is massively *disruptive of fair and equitable trading*. It is the modern-day version of front-running which is clearly disruptive.

The increased use of SEFs and DCMs to facilitate transactions opens the door to rapid market data availability for certain privileged market participants. The Chicago Mercantile Exchange is reported to be moving forward with a plan to facilitate limited server co-location with its Globex trading platform systems.[26] Electronic trading actually increases certain trading advantages, particularly relating to algorithmic and high-frequency trading. Purchased preferential access to rapid data feeds, like the Globex trading co-location facility, should be anticipated and prohibited.

Any form of unequal access constitutes an anti-competitive advantage passed from SEFs and DCMs to selected market participants that are in a position to use preferential access to secure a trading advantage. The value of this advantage is enhanced by the fragmented nature of derivatives markets and the likelihood of multiple, market-specific SEFs. Given the extraordinary concentration of trading volumes in a narrow set of large firms in the derivatives market, the potential for conflicts of interest and predatory behavior is great.

The Dodd-Frank Act articulates a goal: impartial access to market participants.[27] **This cannot be achieved if access to information flows to and from SEFs are sold to the highest bidder or otherwise granted to a favored few at the expense of all others.**

Restriction of High Frequency and Algorithmic Trading

The CFTC must also address another type of market participant who will transact with SEFs, one that has no interest whatsoever in fundamental price. These are market traders who use high-frequency and algorithmic practices in automated trading systems that respond to objective circumstances in a pre-ordained way and do so in time frames that defy human perception.

A major goal of high frequency traders ("HFTs") is to take advantage of trading rules of SEFs and DCMs, often using order and cancellation strategies to detect the motivations of other market participants and gaming the rules based on this knowledge. If an HFT can detect a large position being piecemealed into the market, it can position itself in front of the trade, buy and immediately sell to the market, all within a very short period of time.

A recent study describes the interaction of high-frequency and algorithmic trading in the marketplace.[28] The study observes that high frequency trading intermediates

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[26] Graham Bowley. "The New Speed of Money, Reshaping Markets," The New York Times, January 1, 2011.
[27] Dodd-Frank Act, Section 733.

between market makers and liquidity traders. It increases the price paid by liquidity traders when they buy and decreases the price received when they sell. High-frequency trading increases price volatility. As a result, market makers enjoy higher liquidity premiums. High-frequency trading increases volume, but is neither driven by fundamentals nor does it constitute noise trading. High-frequency trading is an anathema to the efficient markets paradigm because it actually increases volume but does not provide liquidity or decrease volatility.

This is completely consistent with Dr. Kirilinko's analysis of the interaction of high-frequency trading and algorithmic trading in the May 6, 2010 "flash crash."[29] He points out the key distinction between adding volume and adding liquidity. ***On a net basis, high-frequency traders add no liquidity***. Instead they intermediate in nanosecond intervals between liquidity traders and the true sources of liquidity. Their strategies both add ***and*** subtract liquidity as their programs reverse buy/sell directions and they re-calibrate inventories according to programmed procedures. Liquidity is provided by market makers, who were "run over by the price moves" on May 6, an inherent risk in making a market in a marketplace dominated by high-frequency traders.

High-frequency trading opens the door to schemes which take advantage of market rules and processes which bear no relationship to price. These behaviors and their consequences have already been experienced in the equities markets, which provide fair warning of potential issues as derivatives markets mature.[30] Equities markets have experienced activities such as fake quotes to take advantage of fee credits-for-quotes schemes and programmed direction of volume to various trading platforms to take advantage of liquidity rebates (known in the trade as "rebate harvesting algorithms").[31]

HFT as an Abusive Trading Practice

A number of provisions in the Proposed Rules are relevant to issues raised by HFTs. At the center of these issues is the Proposed Rule which prohibits abusive trading practices:

> A swap execution facility must prohibit abusive trading practices on its markets by members and market participants . . . Specific trading practices that must be prohibited by all swap execution facilities include front-running, wash trading, prearranged

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[29]   Presentation of Dr. Andrei Kirilinko, Technical Advisory Committee Roundtable, October 12, 2010.

[30]   *See* New York Stock Exchange discussion of payment for order flow by the CBOE in comment letter on SEC Release No. 34-62445, *available at*: http://sec.gov/comments/s7-21-09/s72109-163.pdf.

[31]   Fred Federspiel and Alfred Berkely, High Frequency Trading and the Evolution of Liquidity in US Markets, August 25, 2009 *available at* http://www.advancedtrading.com/exchanges/219401479?pgno=1

> trading, fraudulent trading, money passes, and any other trading
> practices that a designated contract market deems to be abusive.
> In addition, a swap execution facility also must prohibit any
> other manipulative or disruptive trading practices prohibited by
> the Act or by the Commission pursuant to Commission
> regulation.[32]

It is unclear whether any of the practices associated with HFT will be prohibited by the CFTC in its final rule on disruptive practices, **although we believe they should be**. We have discussed this extensively in our comment letter on the proposed version of that rule.[33]

If these practices are not dealt with in that rule, they must be dealt with here, or the statutory purpose of SEFs will be defeated.

Described below are four HFT practices that must be included within "fraudulent trading" or added to the above list. Each of these is connected to market intelligence tactics commonly used by HFT to discover hidden liquidity, primarily the intent of market participants to execute plans to acquire or dispose of large positions by a series of smaller trades. A liquidity trader ("LT") wishing to transact a large position may well want to transact in tranches to avoid moving market prices against it. One way that an HFT can detect this is simply to watch for orders that are filled and then re-emerge. The speed of their systems can enable them to perceive this situation and act on it more quickly. Of course, LTs that are aware that HFTs are monitoring the activity employ disguises in the form of random quantities and timing.

But HFTs also use the process of "poking" or "pinging." This tactic involves placing orders, often immediate-or-cancel orders, just inside the bid/ask spread to measure the motivation of LTs in the market. For example, in a market with a spread of 5.00/5.20, an HFT might place an order at 5.01 which is canceled immediately if the ping for information comes back empty.

A variation is to walk orders in a direction from the mid-market for the same purpose. In our same market, the HFT might place the initial immediate-or-cancel order at 5.10 and thereafter at 5.09 and so on until information is received. This would measure the intensity of the motivation of the LT.

These and other intelligence gathering tactics are designed to set the stage for HFTs to extract value by using a miniscule speed advantage based on the rules of the trading road, specifically priority given to the first-in-time best bid or offer.

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[32] Proposed Rules, Section 37'203(a).
[33] Better Markets, Inc., Comment Letter dated January 3, 2011 regarding CFTC Notice of Proposed Rulemaking, "Antidisruptive Practices Authority Contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act" (CFTC RIN 3038-AD26).

Exploiting a Large Quantity or Block Trade. The presumption is that an HFT has detected an LT which seeks to transact a large position in small increments. In the following illustration, the LT is assumed to be a seller, but the tactic works in both directions. The HFT also detects that market makers do not have particularly large orders on the books of the SEF. The assumed bid/ask spread is initially 5.00/5.20.

The HFT can exploit its speed to alter market conditions in a way that encourages buyers to accept a slightly higher price and sellers a slightly lower price:

- The first step is for the HFT to cancel all of its buy orders which have not been executed.

- It then posts sell offers (which add to the apparent selling pressure perceived by market participants) to clear all posted buy orders on the book.

- It then positions itself as the first in the queue of buyers at a lower price than the apparent LT limit price. In our case, assume 5.18. All of this happens before market makers perceive the increased selling pressure and adjust prices so that market maker offers will sit behind the HFT offers in the queue.

- LT sees that the market to sell at 5.20 is not available and that it can only sell at 5.18, which it does.

- Because it is at the front of the queue, the HFT is first to perceive when the selling pressure subsides as the LT's need to sell has been satisfied. At that moment, the HFT places a sell order higher than the posted buy price of 5.18, say 5.19.

- The market maker ("MM") perceives a turn in the market and becomes a buyer at, for example, 5.19.

- HFT sells the position acquired at 5.18 to the MM at 5.19.

The HFT has acted on the information that the LT had a position large enough that the profit from the purchase at 5.18 and sale to the MM at 5.19 is greater than the loss on the initial purchase at 5.20 (which allowed the HFT to jump the queue) and sale to the market maker at 5.19. The advantages of the HFT in this case are:

- The information (gathered by pinging at high speed) that the selling pressure was great enough to offset losses anticipated from clearing out all buy orders on the book.

- The ability to clear out all buy orders and jump to the head of the buying queue at a new price before anyone else could act.

- The ability to rapidly place a sell offer that created profit, but would be acted on by market makers before any market adjustments were possible.

This tactic is an analog to traditional concepts of front-running. In the past, front-running was enabled by information regarding a market participant's order which was misused by a trader to position itself in front of the order. The difference here is that the HFT gathers the information by poking and pinging the market to estimate the motivation of the LT rather than getting a tip from a broker or other market participant. The results are the same: the LT and the market maker have received less from their trading than they might have because of the HFT's manipulation of the market's dynamics and trading rules, with no concern for fundamental values. In both cases, the front runner and the HFT depend on the LT behaving as suggested by the information from the tip or the pinging, respectively.

Price Spraying. HFTs use a more aggressive tactic based on information regarding large trades which are transacted in smaller orders. If the HFT detects a series of buy orders, for instance, it may simply buy the market. It then uses a series of sell-or-cancel orders to discover the LT's upper price limits. The HFT then positions itself at the front of the queue at the LT's price limit and simply sells at that price realizing profit between its purchase prices and the LT's price limit.

The same technique can be used against the class of all LTs that are likely to trade in a price direction based on some news or other information. In this case, the HFT uses the spray of orders to detect levels of upper price limits in a more complex, but similar, strategy.

This is also just a form of front-running. The advantages to the HFT are the information on motivation derived from early acquisition of information on the LT's buy orders, the ability to rapidly buy the market before others can react to the information and the use of a spray of sell and cancel orders to find the optimal price level to re-establish the bid side of the market at the point it can then dominate.

The purchase of the market ahead of the LT's price limit is a form of buying the board. And, the exploratory spray of orders is a form of spoofing because, inevitably, some number of the orders are placed with no intention of transacting.

Front-running, buying the board and spoofing, among other tactics, would all be prohibited if individuals were doing them. **The fact that computers (pre-programmed by individual human beings) engage in these practices should not change the legal standard.**

Rebate Harvesting. This tactic may not be designed to be profitable based on price. SEFs (and DCMs) offer rebates based on transacted volume to attract market makers. HFTs

are able to instantaneously transact buy and sell orders at the same all-in price, or even at a loss which is less than the value of the rebate. The HFT earns the rebate by simply turning over the trade in a round-trip transaction. The exchange or SEF has unintentionally paid for volume, but not liquidity. The ultimate buyer and seller would have transacted but for the intervention of the HFT which was able to execute the two trades in "real-time."

The problem is that the market as a whole does not and will not perceive the motivation of the HFT. It appears that the liquidity in the market is extraordinary, when, in fact, the trading by the HFT has no liquidity benefits.

Layering the Market. This involves the placement of multiple bids and offers at different prices and quantities. It generates an enormous volume of orders but has cancellation rates as high as 90 percent. While it can facilitate rebate harvesting, it can also be used to generate phantom depth and liquidity of the market which can induce a belief by other market participants that there is price momentum. Some of the other participants may draw this conclusion based on algorithms of their own.

Once trading behavior is induced, the HFT can use other tactics similar to those used in the case of large positions transacted in a series of orders to buy or sell ahead of the direction of the momentum.

The HFT's advantages are to be able to place and cancel multiple orders quickly and to position itself as first in the queue at a strategic price level ahead of the momentum.

This is a direct analog to spoofing. The HFT has no intent or desire to transact on the multiple bids and offers. It is very certain that most (say 90 percent) will be cancelled. The purpose is to induce price momentum and suggest a depth of liquidity which simply does not exist.

Risk Controls for Trading

The Proposed Rules mandate certain risk control mechanisms:

> The swap execution facility must establish and maintain risk control mechanisms to reduce the potential risk of market disruptions, including but not limited to market restrictions that pause or halt trading in market conditions prescribed by the swap execution facility.[34]

These requirements are extremely useful, but incomplete. They are designed to act as stop lights to regulate trading flows based on circumstances which indicate imminent

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[34] Proposed Rules, Section 37.405.

danger. The addition of a "speed limit" is required to serve as a buffer against the potential for an uncontrolled spiral of disruption fueled by HFT.

The CFTC should start with requiring that bids be for minimum durations and that positions be held for minimum durations. For instance, these rules might vary depending on asset class and market structure, but the variation should range between 5 and 10 seconds at a minimum. Legitimate algorithmically-driven trading strategies can then be implemented in this environment; but high-frequency volume that benefits only the trader and adds minimal value, if any, to the marketplace, while subjecting the market to tremendous risks, would be curbed.

Trading Records and HFT

The Proposed Rules include a number of provisions relating to records that must incorporate concepts related to HFT.

Automated Trade Surveillance. The Proposed Rules require the maintenance of an automated trade surveillance system which records orders, modifications of orders and cancellations.[35] Each of these items of data must be time-stamped at intervals consistent with the capabilities of HFTs that use the SEF's systems to transact.

Real-time Market Monitoring. Each SEF is required to conduct real-time market monitoring under the Proposed Rules.[36] This process must include monitoring of orders and cancellations, each time-stamped at intervals consistent with the capabilities of HFTs which use the SEF's systems to transact. This will enable the SEF to monitor the implementation of HFT strategies which are abusive.

Audit Trail. The Proposed Rules require maintenance of records of customer orders and their disposition, whether filled, unfilled or cancelled.[37] Each of these items of data must be time-stamped at intervals consistent with the capabilities of HFTs which use the SEF's systems to transact. This is especially important for reconstruction of problematic episodes, like the recent "flash crash." It is critical that all of these reports can be quickly and easily compiled into a format allowing critical analysis by regulators.

Chief Compliance Officers

We propose that the role of boards of directors relating to chief compliance officers ("CCOs") as set forth in the Proposed Rules be expanded, clarified and made more specific.

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[35] Proposed Rules, Section 37.203(d).
[36] Proposed Rules, Section 37.203(e).
[37] Proposed Rules, Section 37.205(b).

The Dodd-Frank Act changes the fundamental regulatory approach to derivatives market participants. For many years, market participants operated in an environment in which regulation was viewed as an obstacle to doing business. Changing this corporate culture requires attention from the highest levels of the corporate entity, and that means the Board of Directors generally and the independent members of the Board in particular.

Affiliates. The Proposed Rules must address the issue of affiliates and controlled groups. Compliance should be addressed based on the entire group. An affiliated organization should not provide a vehicle for avoidance of compliance with rules. A single senior CCO should have overall responsibility of each affiliated and controlled entity, even if individual entities within the group have CCOs. The annual report on compliance should likewise address both group and individual entity compliance.

The Role of Boards of Directors and Conflicts of Interest. The business realities of SEFs are unique. Their business model depends on capturing volume for fee income. **Inherently, they will be subject to the influences of their major customers, the large financial institutions generating the trading volume which is their life blood.**

The duties of a CCO will often come into conflict with the perceived interests of powerful participants. One duty specified in the Proposed Rules is resolution of conflicts of interest, which will be particularly contentious.[38] In these businesses, the express and implicit barriers to independent judgment related to compliance (which often is a perceived obstacle to profitable trading by participants) are unusually large.

The independent members of the boards of directors are, by design, independent from senior management. Compliance is less likely to be viewed by them as an obstacle and more likely to be viewed as an independently significant goal.

We propose the following provisions be added to the Proposed Rules to address the need for independence of a CCO from traders and managers:

1. The decisions to designate or terminate a CCO (or to materially change the CCO's position or responsibilities) should be the sole responsibility of the independent members of the board of directors acting by majority vote.

2. The CCO **must not** be an attorney representing the board of directors or executive management in legal matters. The potential for conflict of interest is inherent in this relationship.

3. While day-to-day reporting responsibility of a CCO will inevitably be to an executive officer, the CCO must also have a direct reporting line to the independent directors or Audit Committee and the CCO should meet with and report to that Audit Committee no less than once a quarter.

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[38]   Proposed Rules, Section 37.1500(b)(3).

4. Compensation of a CCO should be the *sole* responsibility of the independent members of the board of directors, and not the responsibility of a senior officer.

The Proposed Rules must require that the CCO meet with the board of directors *and* the senior officer to discuss the effectiveness of compliance policies at least once each year. As suggested above, a meeting once a year will be clearly insufficient for the independent members of the board of directors to become adequately and reasonably familiar with the compliance issues faced by the CCO. Thus, the CCO should meet at least quarterly with the Audit Committee. This will provide the foundation for the independent members of the board of directors to become truly effective protectors of the CCO and it will make it much less likely that the CCO will succumb to the pressure to permit risky and inappropriate practices that serve the interests of powerful customers.

The Proposed Rules specify several activities relating to conflicts of interest which are to be undertaken in consultation with the board of directors "or" the senior officer.[39] In each of these cases, the consultation should be with **both** the independent members of the board of directors **and** the senior officer.

Finally, the duty of the CCO to prepare an annual report as to compliance, certify the report and furnish the report to the CFTC is central to the efficacy of the Proposed Rules. Under the Proposed Rules, the report must be furnished to the board of directors.[40]

We propose that the CCO present his or her finalized report to the board of directors and executive management prior to its submission to the CFTC. In addition, we propose that the independent directors and/or the Audit Committee as well as the entire Board be required to review and approve the report in its entirety or to detail where and why it disagrees with any provision. The CCO should be required to then file the report with the CFTC, either as approved or with statements of disagreement.

Volume-Based Fee Discounts

When a SEF provides financial incentives based on volume of trades to a member, the cost of the service is shifted onto other members. The SEF is merely buying volume and arranging for a class of its customers to pay for it. The obvious business plan for a SEF targeting a specific market is to strike a volume-for-cash deal with the market makers in the sector, regardless of the cost. But market participants must have access to market makers to reliably execute transactions and to discover bid/ask spreads. In fact, market participants depend on the reliable price quotes provided only by market makers. **Therefore, if the SEF can capture the volume of all or a substantial portion of the market makers, the rest of the market will be compelled to use the SEF regardless of the quality of service or cost (even though it is allocated disproportionately to them).**

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[39] Proposed Rules, Section 37.1500(d)(2).
[40] Proposed Rules, Section 37.1500(e).

Rebates and discounts for trading liquidity or volume result in variations in transaction value based on the particular fee concession that applies. **Inevitably then, prices will be distorted.** With multiple SEFs and DCMs, market participants will game the structure to take advantage of rebates and discounts to the detriment of the greater marketplace. These behaviors and their consequences have already been experienced in the equities markets, which provide fair warning of potential issues as derivatives markets mature.[41] Equities markets have experienced activities such as fake quotes to take advantage of fee credits-for-quotes schemes and programmed direction of volume to various trading platforms to take advantage of liquidity rebates (known in the trade as "rebate harvesting algorithms," and described above).

A group of market makers has every incentive to behave as an oligopoly. They are benefited by a marketplace (*i.e.,* a SEF or DCM) with a broad participation by price takers. The composition of the oligopoly in any circumstances will be those market makers required to force volume through the trading venue, and no more. In this circumstance, the control of a SEF or exchange by its shareholders is illusory. Quality and cost of service are far less important to the success of a SEF or DCM than the secure posting of transactable bid/ask prices. The market makers control without equity investment; and their incentive payments are borne by the captive market participants.

However, exclusionary behavior has been a pernicious, embedded part of this sector for much of its history. Market practices and commercial realities, as well as rules which appear to serve the interest of sound credit practices, just mask anti-competitive realities. **The only way to address this persistent issue is for the Proposed Rules to prohibit volumetric fee discounts and rebates by SEFs.**

Notification of Transfers of Equity Interests

The Proposed Rules require notification of the CFTC by a SEF in connection with the transfer 10 percent or more of its equity interests on the business day following the day the SEF enters into a firm obligation to make the transfer.[42]

The Proposed Rules properly recognize the important implications of such a transfer. These transactions will be infrequent and will clearly demand the attention of SEF management.

However, the threshold must be lowered to 5 percent. The CFTC should look to the rules of the Securities Exchange Commission addressing reporting thresholds for acquisition of interests in reporting companies. Acquisition of beneficial ownership of

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[41]   *See* New York Stock Exchange discussion of payment for order flow by the CBOE in comment letter on SEC Release No. 34-62445, *available at*: http://sec.gov/comments/s7-21-09/s72109-163.pdf.

[42]   Proposed Rules, Section 37.5(c).

5 percent of a class of shares triggers reporting obligations.[43] Because of the unique position of SDRs in the derivatives marketplace, the reporting threshold must be no higher than 5 percent.

In addition, requirement of disclosure after the obligation is entered into is inadequate. To allow the CFTC to make comment on the transaction, notice should be given on the day that the SEF becomes aware that a transfer is reasonably likely, but no later than the day the obligation is entered into.

Conclusion

The SEFs' role is to bring the markets out of the shadows, which is crucial to the success of the Dodd-Frank Act. We commend the CFTC for establishing a comprehensive framework for SEFs, a completely new concept in the regulations. We have offered the foregoing comments in order to provide constructive views of the issues raised.

We hope these comments are helpful in your consideration of the Proposed Rules.

Sincerely,

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[43] Securities Exchange Commission, Rule 13d-1.