



March 8, 2011

**Via Electronic Submission:** <http://comments.cftc.gov>

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

**Re: CFTC Notice of Proposed Rulemaking on Core Principles and Other Requirements for Swap Execution Facilities (RIN 3038-AD18)**

Dear Mr. Stawick:

Managed Funds Association (“MFA”)<sup>1</sup> appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the “**Commission**”) on its proposed rules related to “Core Principles and Other Requirements for Swap Execution Facilities” (the “**Proposed Rules**”)<sup>2</sup> under Title VII<sup>3</sup> of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “**Dodd-Frank Act**”).<sup>4</sup> MFA supports the Commission’s establishment of a comprehensive new regulatory framework for the trading and execution of swaps within swap execution facilities (“**SEFs**”). In addition, MFA strongly supports regulations that permit a broad range of SEF trading platforms because we believe that the proliferation of SEFs will benefit investors and the markets by increasing regulatory and market efficiencies, promoting market-based competition among providers and enabling greater transparency over time and across a variety of products.<sup>5</sup>

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<sup>1</sup> MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately \$1.9 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

<sup>2</sup> Notice of Proposed Rulemaking on “Core Principles and Other Requirements for Swap Execution Facilities”, 76 Fed. Reg. 1214 (Jan. 7, 2011) (the “**Proposing Release**”).

<sup>3</sup> Entitled “The Wall Street Transparency and Accountability Act”.

<sup>4</sup> Pub. L. 111-203, 124 Stat. 1376 (2010).

<sup>5</sup> See also MFA’s comment letter to the Commission dated February 7, 2011, in response to the Commission’s proposed rules on “Real-Time Public Reporting of Swap Transaction Data” (the “**Proposed Reporting Rule**”), 75 Fed. Reg. 76140 (Dec. 7, 2010) (the “**Proposed Reporting Rule Release**”) and “Swap Data Recordkeeping and Reporting Requirements”, 75 Fed. Reg. 76574 (Dec. 8, 2010), in which MFA submits that the Commission’s goal of bringing transparency to the swap markets through the reporting and dissemination of trade-

To that end, we are providing comments to the Commission on the Proposed Rules with the aim of assisting the Commission in adopting final rules that promote SEFs as desirable venues for the execution and trading of swaps. In particular, in this comment letter, MFA:

- recommends that the Commission apply Commission-approved objective, transparent criteria to determine when a SEF can make a swap “available for trading”;
- requests that the Commission encourage competition among trading venues by expanding temporary grandfather relief for venues that seek to become SEFs;
- supports permitting SEFs to use both a request for quote (“**RFQ**”) protocol framework and a variety of order book (“**Order Book**”)<sup>6</sup> systems for the trading of cleared swaps, but encourages the Commission to permit the minimum number of recipients to whom a quote-requesting market participant must send an RFQ to be as low as one, provided the SEF offers the option to submit the RFQ to multiple participants;
- articulates concerns related to the limited number of transactions potentially eligible for treatment as block trades; and
- comments on the fifteen-second timing delay required for crossing and matching of trades.

## **I. Determination of a Swap’s Availability to Trade**

Section 723 of the Dodd-Frank Act<sup>7</sup> provides that all swaps and related transactions subject to the mandatory clearing requirement and that a designated contract market (“**DCM**”) or SEF makes “available to trade” (“**Required Transactions**”) must be traded on a DCM or SEF (the “**Mandatory Execution Requirement**”). In response to Section 723, the Commission issued Proposed Rule 37.10, which requires each SEF to conduct an annual review of swaps trading on its platform to determine whether it has “made available for trading” the swaps that it offers. In completing this annual review, the Commission instructs each SEF to consider the frequency of transactions of, and the open interest in, the swap or similar swaps.<sup>8</sup> If at least one

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related information should be balanced with the equally important goal of preserving market liquidity (the “**Reporting Letter**”). In the Reporting Letter, MFA also makes recommendations as to minimum block and large notional transaction size thresholds, public reporting of bespoke swap transaction data and timing of reporting.

MFA also submitted a comment letter to the Commission dated February 7, 2011 in response to the Commission’s proposed rules on “Reporting, Recordkeeping, and Daily Trading records Requirements for Swap Dealers and Major Swap Participants”, 75 Fed. Reg. 76666 (Dec. 9, 2010).

<sup>6</sup> Proposed Rule 39(a)(i) defines an Order Book system as 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.”

<sup>7</sup> Section 723(a)(3) of the Dodd-Frank Act amends the Commodity Exchange Act (the “**CEA**”) to introduce Section 2(h)(8)(B).

<sup>8</sup> Proposed Rule 37.10(b).

SEF has made the same or an economically equivalent swap available for trading, all SEFs are required to treat that swap as made available for trading, although they are not required to list that swap for trading.<sup>9</sup>

MFA believes that an instrument should only be “made available for trading” once the swap is capable of being effectively traded either through an RFQ system or on an Order Book, as more fully explained in Section III below. Until that moment, the Commission should allow a swap to trade in the many ways that participants to that particular swap market have developed or may develop for that instrument over-the-counter (“OTC”), including bilaterally either on an electronic platform or using one-to-one voice services.

We believe that it should be the Commission’s responsibility to make the “available for trading” determination, rather than permitting individual SEFs to make the determination in their discretion. We are concerned that the Proposed Rules’ lack of mandatory objective and transparent criteria for the determination that a swap is available for trading will create considerable uncertainty among market participants. For example, if a SEF’s listing of a contract for trading were sufficient to satisfy the “made available for trading” requirement, any SEF could establish an overnight monopoly in the trading of certain instruments. Because the determination that an instrument has been made available for trading essentially removes it from the OTC market, it would effectively preclude a significant segment of customers and market makers without connectivity to that relevant SEF platform from entering the market in that instrument. Therefore, market participants would have to seek connectivity with the SEF platform listing that instrument in order to trade it, which would give an advantage to market participants with greater resources to devote to information technology connectivity, operations and document negotiation.

The exclusion from trading of market participants that do not have such resources would be contrary to the equal access considerations of the Dodd-Frank Act.<sup>10</sup> Therefore, we recommend that the Commission establish in its final rule a grace period of 90 days after making a particular swap available for trading before imposing the Mandatory Execution Requirement on market participants. Such a provision would ensure that market participants have an opportunity to access markets and prevent a single SEF platform from disproportionately and anti-competitively benefiting from being first to list a particular swap, while other SEFs determine whether to build the required connectivity.

Furthermore, we request that the Commission set and memorialize in the final rules objective, clearly enunciated and transparent criteria to determine when a SEF has made swaps available for trading. In particular, due to the sporadic or discontinuous liquidity in the swap markets,<sup>11</sup> we recommend that the criteria include global minimum volumes of daily trading over

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<sup>9</sup> Proposed Rule 37.10(c)(1).

<sup>10</sup> See Section 733 of the Dodd-Frank Act, amending the CEA to introduce Section 5h(f)(2)(B)(i), requiring SEFs to establish rules that “provide market participants with impartial access to the market”.

<sup>11</sup> We are specifically referring to the fact that the swap markets feature a broad offering of less-standardized products as well as larger-sized orders that are traded by fewer counterparties.

a sustained time period for each swap, including trades effected both on and off a SEF platform. We also recommend that the Commission impose a requirement that there be resting bids and offers for each swap over a significant percentage of that time period and suggest that swap data repositories could be instrumental in analyzing volume data. In our view, it is extremely important that there be specific criteria for each swap market that match the unique characteristics of that market.

We also recommend that the Commission view a swap's availability for trading as a fluid determination, where the Commission periodically reevaluates the liquidity characteristics of a swap to determine whether a SEF should continue to make that swap available for trading. In addition, the Commission should tailor the "available for trading" determination to the unique characteristics of a certain product at a given point in time. If that product is no longer trading effectively in a SEF environment, the Commission should consider suspending the Mandatory Execution Requirement for that product, thus removing it from a SEF's RFQ or Order Book frameworks and allowing it to return to a bilateral trading environment until liquidity is suitably re-established in that particular swap.

## **II. Competition among Trading Venues**

MFA is concerned that the procedures for registration of new SEFs under the Proposed Rules will result in a limited supply of trading venues and that incumbent dealer-to-customer platforms and exchanges will dominate.

Since the Dodd-Frank Act did not eliminate DCMs' ability to execute swaps for market participants,<sup>12</sup> following implementation of the Proposed Rules, both SEF registrants and DCMs will engage in swap execution and will have to compete against each other in the markets. Therefore, with a view to ensuring that SEFs are not disadvantaged and can successfully compete as intended under the Dodd-Frank Act,<sup>13</sup> we strongly encourage the Commission to adopt a grace period for existing dealer-to-customer platforms and permit SEFs to operate while they develop the necessary capabilities to fulfill the requirements of registration. Additionally, to promote competition among SEFs, we recommend that the Commission provide a public notice period of at least 90 days between the Commission's determination that a swap is available for trading and the beginning of trade execution in that swap by a SEF.

While we endorse Proposed Rule 37.3(b), which permits the Commission, upon the request of an applicant, to grant temporary grandfather relief from SEF registration for qualifying entities so that they can continue to operate, we feel that it does not go far enough. The proposed temporary grandfather relief requires the Commission to first grant the relief and only allows a qualifying entity to operate without SEF registration on a short-term basis (*i.e.*, during the pendency of the application process). The purpose of providing temporary relief is to ensure continuity of an applicant's business operations during the pendency of the Commission's review

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<sup>12</sup> Section 733 of the Dodd-Frank Act amends the CEA to introduce Section 5h(a)(1), which allows for the trading of swaps on a DCM.

<sup>13</sup> Section 726(b) of the Dodd-Frank Act.

of that SEF's application, especially given that the review period may be lengthy due to the potentially large number of SEF applications the Commission expects to receive.<sup>14</sup> While we support the principle behind the temporary grandfather relief, we are concerned that unless the standards are clear and relief readily available, competition will be stifled. In addition, we request that rather than providing relief solely on a short-term basis, the Commission premise relief on an applicant's need to develop the capabilities required to trade swaps, thus affording an existing platform the time necessary to comply with the Commission's proposed regime.

### **III. Execution Protocols**

MFA believes that a swap should only be subject to the Mandatory Execution Requirement after it has traded in sufficiently large volumes and over a sufficiently extended period of time, regardless of whether or not it is executed on a SEF platform. At such time, we believe bilateral and voice-based trading would no longer be necessary for there to be effective liquid trading of that swap. However, until that time, the Commission should permit all forms of trading on and off a SEF for that swap. We are confident that the market for each swap will naturally move towards the best form of execution over time and agree with the Proposed Rules insofar as they allow market participants sufficient flexibility in their choice of execution protocol.

#### **A. Order Book Systems**

The Proposed Rules provide that all Required Transactions must be traded through either an Order Book or an RFQ system.<sup>15</sup> Proposed Rule 37.9(a)(i) defines an Order Book system as 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". However, the proposal is ambiguous with regard to the intended pervasiveness of the Order Book execution method across markets for swaps that have very different characteristics.

MFA strongly supports the creation of SEFs as multiple-to-multiple trading venues and believes that many permutations of an Order Book system – including limit order and central limit order variants – could serve as suitable execution protocols for effecting multiple-to-multiple trading. Therefore, since the Dodd-Frank Act does not *per se* restrict the methods of execution applicable to swaps with non-continuous liquidity, we believe that the final rules should recognize that swap execution methodologies are many and diverse and we ask the Commission to clarify that the definition of Order Book system conceivably encompasses a variety of multiple-to-multiple execution styles.

Finally, we recommend that the Commission recognize in the adopting release that, although an evolution towards trading on an Order Book may be desirable for most swaps, certain products (*e.g.*, credit default swaps) may have liquidity characteristics that are ill-suited

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<sup>14</sup> Proposing Release at 1216-17.

<sup>15</sup> Proposed Rule 37.9(b).

to a multiple-to-multiple trading environment and may be better suited for trading through an RFQ system.

## **B. RFQ Systems**

Proposed Rule 37.9(a)(ii) requires that a market participant transmit an RFQ to buy or sell a specific instrument to no less than five market participants in the trading system or platform. All identified market participants may respond to the RFQ and the SEF must take into account any bids or offers resting on the trading system or platform pertaining to the same instrument and communicate them to the requester along with the responsive quote.<sup>16</sup> We strongly support permitting the use of the RFQ system, along with the Order Book system, as the basis for trading on a SEF.

However, we believe that the mandated minimum number of recipients for an RFQ has no basis in the law and is unnecessary. The Dodd-Frank Act is clear that a SEF is 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”.<sup>17</sup> While participants must “have the ability” to trade in a multiple-to-multiple environment on a SEF, there is no statutory mention of any specific minimum number of participants.

We believe that the mandatory minimum number of required recipients may inappropriately reveal a market participant’s intention to enter into a transaction, which in turn could have negative implications for the ability of customers to efficiently execute these transactions. We would strongly urge the Commission to amend the proposed requirement by permitting quote requesters, who in these markets are sophisticated, institutional investors, to use their expertise to determine how many recipients an RFQ should be addressed to, including as few as one recipient.<sup>18</sup>

## **C. Voice-Based System**

Proposed Rule 37.9(a)(iii) defines a voice-based system (“**Voice-Based System**”) as “a trading system or platform in which a market participant executes or trades a Permitted Transaction using a telephonic line or other voice-based service”. As a general matter, MFA supports the continued use of traditional one-to-one voice services where the bilateral nature of the transaction warrants it, including but not limited to the execution of swaps that are not

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<sup>16</sup> Proposed Rule 37.9(a)(ii).

<sup>17</sup> Section 721(a)(21) of the Dodd-Frank Act, amending the CEA to introduces Section 1a(50).

<sup>18</sup> Our suggestion is similar to the Securities and Exchange Commission’s proposed interpretation of the RFQ model within the context of Regulation SB SEF (as defined below), whereby a security-based swap execution facility (“**SB SEF**”) would be able to offer functionality to a participant enabling that participant to choose to send a single RFQ to any number of specific liquidity-providing participants on that SB SEF platform, including to just a single liquidity provider. See Securities Exchange Commission, Proposed Rule and Proposed Interpretation on Registration and Regulation of Security-Based Swap Execution Facilities, Release No. 34-63825; File No. S7-06-11, RIN 3235-AK93, 76 Fed. Reg. 10948, at 10954 (Feb. 28, 2011) (“**Regulation SB SEF**”).

subject to the Mandatory Execution Requirement, such as block trades and illiquid or bespoke swaps (“**Permitted Transactions**”).<sup>19</sup>

We believe that, so long as a market for a certain swap is illiquid, the Commission should allow that swap to trade in a variety of ways, including OTC. For example, in current OTC markets for less commoditized products where liquidity is not continuous, interdealer brokers provide a range of liquidity-fostering execution methodologies and technologies.<sup>20</sup> All of these technologies and methodologies are well calibrated to disseminate customer bids and offers as broadly as possible and as necessary, thereby fostering the greatest possible degree of liquidity for a swap market.

#### **IV. Block Trade Thresholds**

Under the Proposed Rules, block trades are Permitted Transactions not subject to the Mandatory Execution Requirement through the Order Book or RFQ systems described above.<sup>21</sup> The Commission has defined block size as the greater of: (a) the 95th percentile of transaction size in that category of swap in the past calendar year; or (b) the largest of five times the mean, median, or mode of transaction sizes for that swap category over the past calendar year, whichever is the largest.<sup>22</sup> The Commission also requires swap data repositories to perform the data analysis.<sup>23</sup>

In its Reporting Letter, MFA set forth certain considerations regarding the determination of block size. We specifically recommended that the Commission tailor the proposed distribution and multiple tests in such a way as to construct minimum block sizes that would not disrupt markets or reduce liquidity, and we encouraged the Commission to conduct a preliminary empirical study to identify the appropriate minimum block size.<sup>24</sup> We also expressed certain concerns regarding the relationship between public dissemination of transaction data regarding both large notional trades and block trades and the preservation of market liquidity.<sup>25</sup>

We would like to reiterate the importance of defining the notion of block size in a way that allows a sufficient number of Permitted Transactions to continue to take place. We believe that the Commission’s proposed definition of block trade would result in very large block sizes, and therefore, would greatly limit the number of transactions qualifying as block trades. As a

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<sup>19</sup> Proposed Rule 37.9(a)(v).

<sup>20</sup> These methodologies and technologies include: (i) hybrid modes of execution that broadcast completed trades and attract others to “join the trade”; (ii) auction-based methods, such as matching and fixing sessions; and (iii) execution environments that are similar to traditional “open outcry” trading pits where qualified brokers communicate bids and offers to counterparties in real time through a combination of electronic display screens, always-open phone lines and other email and instant messaging technologies.

<sup>21</sup> Proposed Rule 37.9(a)(v).

<sup>22</sup> Proposed Reporting Rule 43.5(g)(1).

<sup>23</sup> Proposed Reporting Rule Release at 76161-63.

<sup>24</sup> Reporting Letter at 3-4.

<sup>25</sup> *Id.* at 3-6.

result, we recommend that the Commission's determinations relating to block size take into account the varying characteristics of liquidity of the market for a particular instrument and the characteristics of the relevant class or product.

The impact of a restrictive definition of block trade on transaction liquidity is significant, in and of itself, especially when combined with the requirement to report any non-block transaction, regardless of size, as soon as technologically practicable.<sup>26</sup> The Commission would further decrease transaction liquidity if it were to require a quote-requesting participant to send an RFQ to more than one – and indeed five – recipients. Alerting the market place to a significant transaction can impact a market maker's ability to hedge out of the risk, which in turn may lead to widened bid/offer spreads and diminished liquidity.

Finally, we respectfully recommend that the Commission expand the definition of Permitted Transactions to include, in addition to block trades, other transactions, the characteristics of which may not be suitable for execution on a SEF. For example, exchanges for physical<sup>27</sup> and exchanges for swaps<sup>28</sup> should continue to be executable as off-market transactions. The Commission should also consider exempting from the Mandatory Execution Requirement "linked" or "packaged" transactions.<sup>29</sup> While a linked transaction may include individual segments which, independently considered, may be sufficiently liquid to be considered Required Transactions, a linked transaction as a whole is often illiquid and the Commission should not mandate its execution (in whole or in part) on a SEF. In other words, when it makes commercial sense to execute these segments together in a single joint transaction, it is the linked transaction (and not its components) that the Commission should take into account for purposes of the Mandatory Execution Requirement.

## **V. Fifteen-Second Timing Delay for Crossing and Matching Traders**

Proposed Rule 37.9(b)(3) provides that traders who have the ability to execute against a customer's order or to match two customers must be subject to a fifteen-second delay before they can match the two trades. MFA believes that this portion of the Proposed Rule does not advance any of the core principles for SEFs outlined by the Dodd-Frank Act.<sup>30</sup> We believe that fifteen

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<sup>26</sup> Proposed Reporting Rule Release at 76174-75.

<sup>27</sup> Exchanges for physical involve the simultaneous exchange of a futures position for a corresponding physical (cash) position at a price privately negotiated between the counterparties.

<sup>28</sup> Exchanges for swaps involve the simultaneous exchange of a futures position for a corresponding OTC swap.

<sup>29</sup> For example, the execution of a swap that is linked with a debt instrument, a physical contract or another discreet transaction.

<sup>30</sup> Section 733 of the Dodd-Frank Act, which adds Section 5h(f) to the CEA, sets forth the following fifteen core principles with which SEFs must comply: (1) complying with the CEA and the Commission's rules, (2) enforcing trade processes for market participants that will deter abuses, ensure impartial access to markets and capture information on rule violations, (3) preventing swaps from being readily susceptible to manipulation, (4) monitoring trading to prevent manipulation, price distortion and disruptions of the delivery or cash settlement processes, (5) establishing rules to obtain information to provide to the Commission, (6) establishing position limitations and accountability to prevent market manipulation or congestion, (7) establishing mechanisms for



seconds is too long of a time delay and that the imposition of such a delay will severely impair the ability of customers to see a trade through to execution.

Swap markets are often characterized by sporadic liquidity.<sup>31</sup> Customers often look to dealers to undertake the liquidity risk of trading in swaps for which there is limited liquidity. One potential negative effect of the proposed timing delay would be that a dealer who places both the customer's sale order and the dealer's buy order into a SEF for execution would not know until the expiration of fifteen seconds whether it would have completed both sides of the trade or whether another market participant will have taken one side. Therefore, at the time of receiving the customer order, a dealer would not know whether it would ultimately serve as its customer's principal counterparty or merely as its executing agent. This ambiguity may lead to unwillingness on the part of dealers to provide liquidity to the swap markets, with detrimental results for customers and end users.

In conclusion, we suggest that the length of the proposed timing delay should vary according to the liquidity of the swap being executed and that shorter delays should apply to more liquid transactions. We respectfully invite the Commission to consider the proposed fifteen-second timing delay in the context of the unique characteristics of each particular swap.<sup>32</sup>

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ensuring financial integrity of swaps, (8) establishing an emergency procedure to liquidate or transfer open positions in a swap or suspend trading on the swap, (9) publishing trading information such as public information on price, trading volume and other data, (10) maintaining records of activities, including a "complete audit trail" for a five-year period, (11) not unreasonably restraining trade, (12) establishing rules for minimizing and resolving conflicts of interest, (13) providing adequate financial resources, (14) establishing system safeguards and (15) assigning a chief compliance officer who reviews compliance with core principles and Commission rules.

<sup>31</sup> See e.g. ISDA and SIFMA, "Block Trade Reporting for Over-the-Counter Derivatives Markets" (Jan. 18, 2011), at 2. Available at <http://www.isda.org/speeches/pdf/Block-Trade-Reporting.pdf>.

<sup>32</sup> By way of analogy, on the CBOE Futures Exchange, the RFQ response period before the initiation of a cross trade is five seconds. Following the RFQ, a trader must expose to the market one of the original orders that it intends to cross for at least three seconds. See CBOE Futures Exchange, LLC, Rulebook, contract specifications implementing Rule 407, available at <http://cfe.cboe.com/general/CFERuleBook.pdf>.

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MFA thanks the Commission for the opportunity to provide comments regarding the Proposed Rule. Please do not hesitate to contact Carlotta King or the undersigned at (202) 730-2600 with any questions the Commission or its staff might have regarding this letter.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell  
Executive Vice President & Managing  
Director, General Counsel

cc: The Hon. Gary Gensler, CFTC Chairman  
The Hon. Michael Dunn, CFTC Commissioner  
The Hon. Bart Chilton, CFTC Commissioner  
The Hon. Jill E. Sommers, CFTC Commissioner  
The Hon. Scott D. O'Malia, CFTC Commissioner