markitSERV™

55 Water Street
19th Floor
New York
NY 10041
United States

tel +1 212 205 7110
fax +1 212 205 7123
www.markitserv.com

March 8, 2011

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

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

Dear Mr. Stawick:

MarkitSERV[1] is pleased to submit the following comments to the Commodity Futures Trading Commission (the "**CFTC**" or the "**Commission**") on the proposed rulemaking to implement certain requirements included in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**DFA**")[2] titled Core Principles and Other Requirements for Swap Execution Facilities ("**SEFs**") (the "**Proposed Rule**").[3]

Introduction

MarkitSERV provides trade processing, confirmation, matching, and reconciliation services for swaps and security-based swaps across regions and asset classes. With over 2,000 firms currently using the MarkitSERV platform, including over 21,000 buy-side fund entities, its legal, operational, and technological infrastructure plays an important role in supporting the swaps markets in the United States and globally. As a service and infrastructure provider to the international swaps markets, MarkitSERV supports the Commission's objectives of increasing transparency and efficiency in these markets and of reducing both systemic and counterparty risk.

In our comments below, MarkitSERV wishes to: (a) highlight certain significant market consequences and implementation impacts; (b) identify potential challenges with the Proposed Rule; and (c) propose solutions and recommendations on ways to more effectively implement the Proposed Rule.

Executive Summary

As further explained below, MarkitSERV believes that: (i) execution and confirmation are separate legal, business and operational concepts and the Proposed Rule should not conflate these concepts; (ii) confirmation obligations of swap dealers ("**SDs**") and major swap participants ("**MSPs**") cannot be automatically satisfied by the mere fact of execution of swaps on the SEFs and designated contract markets ("**DCMs**") – SEFs must have adequate confirmation facilities to be able to satisfy confirmation obligations for SDs and MSPs; (iii) because ultimately it is SDs' and MSPs' obligation to confirm and document the trades, SDs and MSPs should be able to choose how to satisfy their confirmation requirements even if the SDs and MSPs had executed the trade on a SEF or a DCM; (iv) SEFs should be permitted to outsource confirmation and trade processing tasks to other qualified third parties; (v) the Proposed Rule should not conflate the requirements of creating an adequate record (an audit trail) of swap trades on a SEF and the full legal confirmation of such trades – these concepts are legally and operationally separate; (vi) the Commission appropriately proposed to exclude entities that

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provide processing, but not execution, services from SEF or any other registration requirements; and (vii) the Commission should clarify what is meant by the requirement that voice-based transactions be entered into an "affirmation system."

1. Current Market Confirmation Practices

The Proposed Rule requires SEFs or parties executing on a SEF to satisfy certain confirmation responsibilities. As a provider of confirmation services, we believe that we can provide useful insights into the confirmation process and provide guidance on how to best achieve the goal of ensuring that transactions are satisfactorily confirmed.

The process of documenting swaps in today's market involves three functions: (i) trade enrichment; (ii) trade affirmation or matching of material trade terms negotiated between the counterparties; and (iii) attachment to a legal framework. These three steps are present in the "confirmation" of the vast majority of all swap transactions, regardless of the execution method (*i.e.*, transactions executed via bilateral paperwork, telephone, voice-brokered, or electronic execution platform), whether or not transactions are centrally cleared, and whether or not they are confirmed electronically or through other means.

a. Trade enrichment

Trade enrichment is the process of adding additional information to the execution details to create complete documentation. Transactions in swaps are typically executed through the agreement on the main economic terms of the transaction (such as price and notional size), with other economic details only explicitly agreed to where they vary from accepted market practice (for example payment frequency, business day conventions, defaults, disruption fallbacks, termination events and termination calculation methodology, and holiday calendars), and additional terms which are specific to the terms of the counterparty relationship (for example master agreement reference or other credit terms). Therefore, parties engage in trade enrichment subsequent to the execution-level agreement being reached in order to agree on the balance of issues. Enrichment can happen through a variety of means, including trade capture systems and automated confirmation services such as the ones provided by MarkitSERV.

b. Trade affirmation and matching

Trade affirmation is the process whereby one party alleges the details of a swap transaction to their counterparty and those details are affirmed by the counterparty if correct. For transactions that are facilitated through an intermediary, *e.g.* an inter-dealer broker or an electronic trading system, the intermediary may propose the transaction details to both parties, who then affirm them with each other. Matching is the process whereby both counterparties to the swap transaction allege the transaction details to each other, which are then compared. Trade affirmation and matching can be used individually or together, where the parties who receive alleged details of the swap transaction will perform a local match to their satisfaction, and then affirm to their counterpart. Automated confirmation services such as MarkitSERV provide these services electronically. Our services can be used as a means for the parties to communicate and rectify any discrepancies prior to completing a confirmation. Notably, MarkitSERV provides notification to both parties when the process of affirmation or matching is complete, thereby completing the confirmation process.

c. Attachment to a legal framework

Attachment to a legal framework is equally important. Parties to a transaction typically sign a Master Agreement prior to entering into a trading relationship, and all subsequent transactions to which the Master Agreement is applicable are governed by the terms of this agreement. For some products, such as some credit and equity derivatives, the parties also sign a Master Confirmation Agreement ("**MCA**") which contains those

terms that do not vary across individual transactions within a product or regional sector. The use of MCAs allows individual trade confirmations to reference the relevant MCA and so contain fewer terms that would otherwise be repeated in a standardized form trade after trade. Automated confirmation services such as those provided by MarkitSERV allow participants to agree in advance to rely on master level documentation or commonly accepted industry-wide conventions. This reliance is created by both parties signing operating procedures with the platform providers which evidence that agreement, and which can be relied upon by both parties to a trade being confirmed using the service. Importantly, these platforms afford flexibility related to standardization.

2. Issues Regarding the Confirmation Requirements in the Proposed Rule

a. SEFs' trade execution and confirmation functionalities should not be conflated

Execution and trade confirmation are separate and distinct legal and operational functions. These functions may not necessarily take place at the same time or place or even be carried out by the same parties. The DFA and the Commission rules recognize this by, for example, referring to execution venues as "swap execution facilities" and not as "swap confirmation facilities." Further, the DFA specifically states that trade processing is only one of the functions of the SEF, and that the SEF's core function is execution of swaps.[4]

The Proposed Rule states that confirmation of all terms of the transactions "shall take place *at the same time* as execution."[5] We believe that this statement conflates the concepts of trade execution and confirmation, and is inconsistent with the confirmation rules. The confirmation rules provide SDs and MSPs up to 15 minutes after execution to consummate a confirmation for electronically executed and processed transactions when the other party is another SD or MSP, and do not place any time limit on consummating a confirmation when the counterparty is a non-SD or non-MSP.[6]

Instead of clarifying the latter discrepancy, however, we believe that the Commission should remove the requirement that execution and confirmation take place at the same time because we do not believe it would be feasible in several situations to impose such a requirement. For example, transactions that must be allocated[7] are initially entered into at an "execution" level, for a certain notional size and price, and will only be allocated by the end-user to multiple underlying funds thereafter, usually by the end of the day. Until this allocation has taken place, the counterparties will not have all of the information required to confirm the transaction.[8]

Thus, requiring execution and confirmation to happen simultaneously is not only inconsistent with other rules, it will be impossible in many situations, so the Commission should recognize that execution does not necessarily constitute confirmation. We therefore urge the Commission to eliminate the requirement that execution and confirmation take place at the same time.

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[4] DFA Section 733 (amending Section 5h(b) of the CEA) states that: "… a swap execution facility that is registered under subsection (a) may – (A) make available for trading any swap; and (B) facilitate trade processing of any swap." Note that these functions are listed as two separate and distinct functions.
[5] Proposed Rule, 76 Fed. Reg. at 1240 (to be codified at 17 C.F.R. § 37.6(b)) (emphasis added).
[6] *See id.* at 81531 (to be codified at 17 C.F.R. § 23.501).
[7] Fund managers will often combine the transactions that they want to enter into for the various funds that they manage in one swap transaction which they execute with a counterparty. Following execution, the fund managers will notify their counterparty which of the individual funds will enter into what portion of the notional of the overall transaction.
[8] Middleware providers such as MarkitSERV currently provide electronic allocation delivery (EAD) mechanisms which can reduce the interval between execution and confirmation. However, adoption of EAD by end users is variable.

> b. Creating a record of swaps executed on a SEF for audit trail purposes is a separate and distinct function from requiring a full legal confirmation of a swap trade

With respect to confirmations of transactions executed on a SEF, the Proposed Rule states that "a transaction entered into on or pursuant to the rules of a SEF shall include written documentation that memorializes all of the terms of the transaction …" and that "for swaps executed on a SEF, the SEF will provide the counterparties with a definitive written record of the terms of their agreement, which will serve as a confirmation for the swap."[9] Further, the Proposed Rule states that: "[SEFs] that permit intermediation must require that all orders or requests for quotes received by phone that are executable be immediately entered into the trading system or platform."[10]

Again, we believe that the Commission is conflating two separate matters in these statements – (i) confirmation of trades and (ii) creation of the record or audit trail of trades. While we support the Commission's goal of requiring swap transactions to be reduced to a reliable and verifiable audit trail record, we note that the "audit trail" and a "confirmation" are not one and the same. The DFA and the Commission separately recognize this notion by providing separate duties and requirements applicable to recordkeeping and to confirmation of trades. The Proposed Rule should also recognize these separate concepts and by requiring creation of an adequate audit trail of swap trades, should not automatically equate proper recordkeeping with confirmation.

> c. SDs and MSPs should be able to choose how to satisfy their confirmation requirements even if the SDs and MSPs had executed the trade on a SEF or a DCM and SEFs should be able to delegate confirmation and trade processing functions

We argued in an earlier comment letter[11] that we do not believe that execution on a SEF can be a *per se* satisfaction of the confirmation requirement. We believe that confirmations should provide the counterparties with best evidence of the agreement between the parties and the terms applicable to that agreement, but do not believe that execution on a SEF will necessarily do so. In order to provide best evidence, a confirmation process must entail: (i) trade enrichment, (ii) trade affirmation or matching of material terms negotiated between the counterparties, and (iii) attachment to a legal framework. While SEFs might possess or acquire the capabilities necessary to confirm transactions by incorporating all three of these important components, we do not believe that execution on a SEF, in and of itself, will do so. Because SEFs may be unable to provide adequate confirmations in some circumstances and because of the additional reasons explained below, we believe that counterparties should have the option to have their trades legally confirmed on the SEF (if such SEF offers adequate confirmation and trade processing functionality) or to meet their obligations themselves or use a qualified third party service provider (even if the SEF is able to offer adequate confirmation services).

A transaction that is not required to be cleared but is entered into a SEF's systems provides a noteworthy example of why execution on a SEF should not be presumed to generate an adequate confirmation. As explained above, confirmation must entail attachment to a legal framework. For transactions that are expected to be cleared, legal attachment to the SEF's terms and conditions might provide sufficient confirmation because the parties likely only anticipate having a short term relationship before the trade is novated to a derivatives clearing organization ("**DCO**"). However, where a swap transaction is not expected to be cleared, the parties will require a framework that anticipates a long-term credit relationship between two parties and is tailored to the specific circumstances of the trade.

Parties today typically rely on an ISDA Master Agreement, or other standard master agreement, for this purpose. SEFs' terms, however, may not be able to accommodate this kind of specificity or individual need (for example master agreement dates specific to bilateral trading relationships), and it would create an additional

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[9] Proposed Rule, 76 Fed. Reg. at 1218.
[10] *Id.* at 1244 (to be codified at 17 C.F.R. § 37.205).
[11] *See* Letter from MarkitSERV to the Commission, Section 3(b)(i) (February 28, 2011).

burden on parties to the execution to maintain at or communicate this type of information to every SEF they use to execute transactions with every other party. In these situations, SEFs may be unable to produce an adequate confirmation, and the parties may desire to use outside sources for confirmation as a result.

Parties may also desire to use sources other than SEFs for confirmation services because tying the execution and confirmation requirements to the SEF used for execution may increase the burden on all participants in the market. For example, if market participants executing a transaction on a SEF were required to use that SEF for confirmation services, members of a particular SEF would need to perform legal and operational reviews not only on the trading rules and procedures but also on the legal framework for confirmations on that SEF. Market participants have in other comment letters to the Commission requested that manual confirmation be allowed because legal review of even one electronic confirmation platform is too costly. Tying confirmation to SEF execution might limit the number of execution venues that market participants will use because of the increased legal risk and cost associated with review and maintenance, thereby reducing the overall liquidity in the market and decreasing competition among SEFs.

Further, market participants may find it to be operationally inefficient to confirm a transaction on the SEF used for execution. For example, as discussed above, trades which must be allocated require allocation information to be communicated between parties prior to confirmation. Parties may find it burdensome to be required to use the same SEF they executed a transaction on to act as the conduit for allocation information. Additionally, Counterparties' ability to execute a termination or novation of a swap on a different SEF ("*SEF2*") to the one used to execute the original swap transaction ("*SEF1*") would be limited if the confirmation of the termination or novation on SEF2 relied on the operating procedures of SEF1 to describe the trade being terminated/novated. The use of bilateral documentation between the parties to trades, or the use of an independent confirmation platform with common operating procedures which are located outside SEF1 and SEF2, would create better conditions for competition, fungibility and efficiency. Given that swaps, unlike futures, have a "life" of their own, particularly the swaps that are not cleared, the Commission should recognize that execution of these life cycle events may not necessarily take place on the same SEF (even if they are reported to the same swap data repository).

For these reasons, and because under the DFA the ultimate responsibility to confirm rests with SDs and MSPs, [12] we believe that SDs and MSPs should have the choice of how to satisfy their confirmation responsibilities. Parties making the choice not to confirm on the executing SEF could, for example, satisfy their confirmation obligations themselves or by using a qualified third party service provider. Qualified third parties such as the various providers of confirmation platforms have become very effective at providing detailed and accurate confirmations through services which facilitate all three components of the confirmation process in a consistent manner, independently of the execution process. Whatever approach is used, we believe that the Commission should require that confirmations be legally binding and provide best evidence of the transaction and its terms.

Finally, even when the parties choose to satisfy their confirmation requirements by using the SEF, we recommend that the Commission additionally allow SEFs to outsource their confirmation and trade processing functionalities to provide confirmations to qualified third parties. As discussed above, it should not be presumed that SEFs will be well-equipped to confirm all types of trades. We therefore believe that permitting SEFs to outsource their confirmation and trade processing tasks to qualified third parties would best ensure that confirmation services are available to provide legal certainty related to swap transactions.

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[12] *See* DFA Section 731 (amending the Commodity Exchange Act Section 4s(i)).

3. Entities Providing Processing Services Are Properly Excluded from Mandatory SEF Registration Requirements

The Proposed Rule explicitly declines to require entities that operate exclusively as swap processors to register as SEFs,[13] but requests comment on whether these entities should be required to register.[14] We believe that the Commission correctly decided that entities operating exclusively as swap processors (facilities for trade processing of swaps) should not be considered SEFs because these entities do not provide any services relating to execution of swaps.

In support of the Commission's proposal, we note that, while "swap processors" have not been defined by the Commission, "processed electronically" has been defined as "to be entered into a swap dealer or major swap participant's computerized processing systems to facilitate clearance and settlement."[15] This definition correctly refers to "processing" as being a post-execution activity, thereby removing entities providing processing services from any relationship to the execution process. Therefore, we request that the Commission codify the final rule so as to exclude entities providing only processing services from the SEF definition and clarify that these entities should not register.

4. The Affirmation System Requirement Should Be Clarified

Finally, we request that the Commission clarify any requirements regarding the use of affirmation systems. In the preamble, the Proposed Rule states that "[v]oice transactions must be entered into some form of electronic *affirmation system* immediately upon execution."[16] Rule 37.205(b)(1), however, states that "[s]wap execution facilities that permit intermediation must require that all orders or requests for quotes received by phone that are executable be immediately entered into the *trading system or platform.*"[17]

"Affirmation" is commonly understood as one step in the process of confirming swaps transactions.[18] Because of provision 37.205(b)(1), however, we believe that the reference to "affirmation systems" is meant to refer to electronic trade capture systems of brokerage firms. We believe that these types of systems should be described as "electronic processing" systems rather than "affirmation systems." Also, as noted above, the Proposed Rule should differentiate between the concepts of recordkeeping (entry of trading records into an electronic audit trail system) and affirmation or confirmation. These concepts carry different legal and operational meaning.

Thus, we request clarification from the Commission as to what "electronic affirmation system" means in this context and how it relates to counterparty obligations.

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[13] *See* Proposed Rule, 76 Fed. Reg. at 1219.

[14] *See id.* at 1221.

[15] Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants, 75 Fed. Reg. 81519, 81530 (to be codified at 17 C.F.R. § 23.500(j)) (proposed Dec. 28, 2010).

[16] Proposed Rule, 76 Fed. Reg. at 1221.

[17] *Id.* at 1244 (to be codified at 17 C.F.R. § 37.205(b)(1)).

[18] *See* Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements, 75 Fed. Reg. at 81530 (to be codified at 17 C.F.R. § 23.500(a) ("*Acknowledgment* means a written or electronic record of all the terms of a swap signed and sent by one counterparty to the other.").

MarkitSERV appreciates the opportunity to comment on the Proposed Rule, and would be happy to elaborate or further discuss any of the points discussed.

In the event you may have any questions, please do not hesitate to contact the undersigned or Gina Ghent at gina.ghent@markitserv.com.

Sincerely,

Jeff Gooch
Chief Executive Officer
MarkitSERV