SWAPS & DERIVATIVES MARKET ASSOCIATION

March 8, 2011

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

RE: Comments from Swaps & Derivatives Market Association
Regarding Proposed Rule 17 CFR Part 37
Core Principles and Other Requirements for Swap Execution Facilities

Dear Secretary Stawick:

The Swaps & Derivatives Market Association ("SDMA") appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the "Commission") on the Notice of Proposed Rulemaking regarding Part 37 of Title 17 of the Code of Federal Regulation ("Part 37") entitled "Core Principals and Other Requirements for Swap Execution Facilities".

The SDMA is a non-profit financial markets trade group formed in January 2010 of United States and internationally based broker-dealers, investment banks, futures commission merchants and asset managers participating in all segments of the exchange-traded and over-the-counter derivative and securities markets.

The SDMA supports the goals of the Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), and the amendments to the Commodity Exchange Act ("CEA") which creates a comprehensive regulatory framework for the

trading of swaps. We believe the creation of Swap Execution Facilities ("SEFs"), as set forth in the proposed Part 37, will create price transparency, open access to markets, lower trading costs and reduce systemic risk. The key to the success of the regulatory framework proposed in Part 37 is market integrity. Critical to market integrity is trade certainty. As discussed, the SDMA believes that key aspects of market integrity relate to execution methods, pre-trade risk controls, post trade risk controls and regulatory relief for SEFs on certain non-cleared spread transactions.

I. Subpart A Section 37.9 Permitted Execution Methods

To foster competition and improve market liquidity, the regulatory framework for SEFs envisions a system of multiple SEFs, using different methods of trade execution and real time price reporting that forward matched trades to one of several possible clearinghouses. The SDMA agrees with the proposed permissible methods of trade execution set forth in Section 37.9 of proposed Part 37. We believe that all cleared swaps should be executed via an electronic system that is either (1) a central limit order book ("CLOB"), or (2) a request for quote system ("RFQ") that transmits requests for quotes to a minimum of five market participants.

A. CLOB and RFQ Systems

A CLOB enables multiple market participants to trade swaps on a real time basis by accepting bids and offers entered into the system, which then reports trade pricing on a real time basis. It is well established as evidenced in other market contexts that this method of trading provides price transparency, open access to market participants and lower trading costs. The SDMA believes that as a result of being a market open to many market participants, a CLOB is less susceptible to market manipulation than a market where trading is based upon a single or limited request for a quote. Market manipulation undermines market integrity, drives up transaction costs and reduces price reliability.

In contrast, a RFQ system that permits request for quotes from only one market participant would facilitate abusive trading practices such as prearranged trading and "painting the screen". Prearranged trading occurs when a broker executes a trade in a risk free manner by improperly agreeing with their counterparty on the price of the trade instead of exposing the order to the market. As a result, customers typically receive a worse fill than if the order was exposed to the market. In order to prevent this type of abuse, a RFQ system should require that market participants request quotes from more than one participant. Another trading abuse that should be prevented is one in which a trader puts up quotes, or "paints the screen", with prices that inaccurately reflect the current market prices. There is a far greater chance for this to happen in a trading environment where the current snap shot of the market price is based upon a quote from only one market participant.

To ensure integrity and fair dealing, a market should be tested by at least three market participants. The SDMA believes that the optimal practice should be to require that market participants must request quotes from at least five market participants. Regardless of whether all five market participants respond, the responses received from a larger group will have greater reliability as to market value and price discovery, than a price or market received when the quote is solicited from just one market participant. A price quote from one market participant does not make a reliable market. Requiring a minimum of five price quotes promotes fair dealing and creates markets that are less conducive to trading abuses. Markets that are less susceptible to trading abuses have greater integrity and liquidity.

The real time price reporting of completed trades will have a positive effect on market liquidity. As prices become reliable (through requests for quotes from five or more participants) and transparent (through real time trade reporting), market integrity and liquidity will increase, and transaction costs will decrease. It is clearly in the best interest of the public and market participants to encourage trade execution methods that promote liquid and transparent markets.

In addition, the SDMA also supports the proposed standard in Section 37.9(b)(3) that requires that SEFs "… 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". Showing one side of the potential transaction before execution increases price transparency and market integrity. This requirement is not unduly burdensome as similar types of requirements with respect to cross trades are routinely used in other markets.

B. Block Trading

With respect to block trading the SDMA believes that no matter what the method of trade execution, all block trades must: (1) be reported within 15 minutes of execution, and (2) contain the time, price and quantity of the instrument traded. This time delay would adequately balance the market's need for information and the need for market participants quoting large size to have sufficient time to trade out of that position. In addition, reporting block trades hours or days later would be disruptive to the market. Market participants should have all the market information available to them – especially block trades that have the ability to move a market - in a timely manner. The reporting of block trades no later than 15 minutes after execution will create enhanced liquidity, strengthen market integrity and promote transparency and fair dealing. The goals of the Dodd-Frank Act cannot be met if market participants are able to use block trading as a method of under-reporting trade activity.

C. Open Access

To fulfill the express condition of Dodd-Frank that all cleared swaps must trade on SEFs there must be open access to all Eligible Contract Participants or qualified market participants. The SDMA agrees with the impartial access requirements set forth in section 37.202 of proposed Part 37, and believes that impartial access for market participants and independent software vendors ("ISV") must be conditioned upon

documentation such as (1) system usage agreements, (2) end user license agreements, and (3) system certification, which are transparent to all market participants and uniformly applied so that anticompetitive advantages are not created. Impartial access to the market does not mean that an ISV or market participants should be permitted to improperly misuse such access. They must abide by the rules set forth by the SEF and must be precluded from misusing data, such as aggregating trading screens or taking market data without payment. In addition, the SDMA believes that neither SEFs nor market participants should be prohibited from trading any swap due to noncompetitive practices related to intellectual property licensing. There must be a level playing field for all market participants and SEFs. The ability to obtain intellectual property licenses and the amount of royalties for intellectual property licenses should be fair and not used to create anticompetitive advantages for a particular swap execution facility or group of market participants.

II. Trade Certainty

The SDMA strongly believes that trade certainty, across the entire regulatory framework of SEFs contemplated by proposed Part 37, is a critical aspect of market integrity. As discussed below, trade certainty is affected by a number of issues which the SDMA encourages the Commission to consider adding to Core Principle 4: Monitoring of Trading and Trade Processing requirements regarding pre-trade affirmation, post trade confirmation, risk controls give-ups for clearing and procedures for error trades.

A. Risk Controls

Trade certainty would be greatly increased if the risk controls contemplated by Section 37.404 included pre-trade and post trade risk control requirements that are uniform across the market. Risk management is important to all trade participants, SEFs, clearing firms and central clearing parties. Failure to have uniform, impartial risk controls across all SEFs will (1) adversely impact liquidity and price transparency, and

(2) increase trading costs. In addition to the proposed requirements stated in Section 37.401 with respect to the monitoring of trades to prevent market abuses, SEFs must have clear authority to request and obtain information, on a real time basis, from the market participants' clearing firms (or FCMs) regarding the market participants' credit and trading limits and the extent to which those limits have been consumed during the trading day. In addition, placing risk control requirements within the requirements of Core Principle 4 would create a much needed single regulatory approach to risk management across the derivatives market, enhance market integrity and decrease systemic risk.

Therefore, the SDMA strongly encourages the Commission include a framework for risk control in the swaps market and provide SEFs with the authority to set pre-trade risk controls on a real time basis for the market participants trading on the SEF. The SDMA agrees with the best practices for pre and post trade risk controls as noted in the Pre-Trade Functionality Subcommittee of the CFTC Technology Advisory Committee's Recommendations on Pre-Trade Practices for Trading Firms, Clearing Firms and Exchanges involved in Direct Market Access, dated March 1, 2011, as well as those contained in the Futures Industry Association reports Market Access Risk Management Recommendations, dated April 2010 and Recommendations for Risk Controls for Trading Firms, dated November 2010. The following is a brief discussion of some of those best practices. The imposition of these requirements would not be unduly burdensome to market participants as the system functionality and recommended risk controls currently operate on a real time basis in other markets.

1. Pre-trade Risk Controls

The SDMA recommends that the following pre-trade risk controls should be imposed on all cleared swaps: (1) risk limits for position and order size on a risk adjusted basis; (2) collars that would set upper and lower limits on order price; (3) 'fat finger' quantity limits; (3) volatility awareness; (4) a repeated automated execution throttle that monitors the

number of times a particular trading strategy is filled and re-entered without human intervention; (5) outbound message rules that limit the number of order messages a market participant can send to SEFs in a predetermined (i.e., short) period of time; (6) market date reasonability on incoming market data; (7) 'kill buttons'; and (8) market maker protections. These pre-trade risk controls would provide SEFs with pre-trade affirmation that market participants and their customers have not exceeded their credit and position limits, thus removing the uncertainty as to whether the trade is "good". Pre-trade trade affirmation would prevent the possibility of a post trade rejection of the trade by the clearing firm due to the market participant's exceeding their credit or position limits. The real time flow of information from the clearing firms, regarding its market participants and customers, is a key aspect of the SEF's ability to monitor the market and maintain market integrity. Without this information the SEF cannot effectively and proactively avoid disruptive trading practices.

Moreover, FCMs must make customer credit information available to the SEF so that it can properly enforce trading controls and ensure proactively that trades clear. The Commission should require that FCMs conform to a common protocol and technology standard such that such customer credit information is made easily available to the SEF on a real time or 'event driven' basis.

It is particularly important to reduce systemic risk in the regulatory framework proposed by Part 37 since market participants will have the ability to trade and hold positions on more than one SEF.

2. Post Trade Risk Controls

The SDMA recommends that the following post trade risk controls should be imposed on all cleared swaps: (1) risk limits by asset class, instrument, and market participant that automatically close out positions if those limits are exceeded, (2) order fill validity, and (3) real-time reconciliation of trades through "drop copy" data that would allow

market participants and clearing firms to monitor trades and positions on a real-time basis throughout the trading session. Real-time reconciliation would avoid problems with end of day reconciliation and the "give up" of trades for clearing.

B. Give Up for Clearing and No Fall back to Bilateralism

Section 723 of the Dodd-Frank Act amends the CEA to provide for mandatory clearing. Certain market participants have suggested that if trades are executed on a SEF, submitted for clearing, and rejected by an FCM of one of the trade parties, then it should be ruled settled as an ISDA governed bilateral trade.

The SDMA strongly opposes such an unworkable notion.

This proposal directly contradicts the express language of the Dodd-Frank Act which provides that it is illegal "…for any person to engage in a swap unless that person submits such swap for clearing to a derivatives clearing organizations that is registered under this Act or a derivatives clearing organization that is exempt from registration under this Act if the swap is required to be cleared." Dodd-Frank does not provide for some half measure of an un-cleared trade.

In addition, materially changing the terms of a trade after the fact, creates undue complications and lessens the integrity of the market. Simply put, when two parties agree to a swaps trade, they do so with the expectation of it being cleared at a certain clearing house, based upon certain margin expectations, liquidity and trade pricing. In certain instances, they also trade with the expectation of anonymity.

To then compel both parties to settle the trade in a bilateral, un-cleared manner requires materially different inputs such a new margining, new liquidity expectations, new counterparty credit assumptions, the loss of trade anonymity and most importantly, a

new trade clearing price. Changing these inputs fundamentally changes the terms under which the parties entered the trade.

To force a party to enter a bilateral trade after the fact because one of the trade counterparties is clearly at fault would be to reward improper behavior at the expense of the compliant party.

Indeed, compelling a trade to fall to a bilateral state offers no additional counterparty credit protection. Typically, if an FCM refuses a customer trade and decides against offering the customer short term credit to cover such a trade, it is typically because the FCM believes that the problem customer not only does not have the funds to cover the trade on settlement day, but reasonably believes such a customer never will. Thus, having a settled bilateral trade via an ISDA agreement with a customer who is not credit worthy and may actually be in default or bankruptcy would put the compliant customer in a even worse position—that of perhaps never getting paid.

To compel one party to complete settlement because the other is at fault completely undermines the integrity of the market place. The SDMA believes strongly that there can only be one outcome when an FCM refuses its customer's trade—that the trade be broken. The SDMA encourages the Commission to include best practices for the give up of trades for clearing in Part 37.

C. Error Trades

In addition, the SDMA believes that regulatory framework should provide best practices for the resolution of error trades. It is important to market integrity that error trades be resolved in a uniform and impartial manner for all cleared swaps.

III. Regulatory Relief for SEFs on Certain Spread Transactions

Section 5h(g) of the Dodd-Frank Act provides that “the Commission may exempt, conditionally or unconditionally, a swap execution facility from registration under this section if the Commission finds that the facility is subject to comparable, comprehensive supervision and regulation on a consolidated basis by the Securities and Exchange Commission (“SEC”), a prudential regulator, or the appropriate governmental authorities in the home country of the facility.” The SDMA requests that the proposed Part 37 provide for regulatory relief to SEFs for swap based spread transactions traded on a SEF.

Under the Dodd-Frank Act, SEFs are directly regulated by (1) the SEC in connection with the trading of credit default swaps (“CDS”) and (2) the Commission in connection with the trading of interest rate swaps (“IRS”) and index based swaps. A second, indirect level of regulation exists for SEFs, however, from the SEC and the CFTC via its SROs (FINRA and the NFA), with regard to the execution of certain commonly traded swap based spread transactions. The SDMA believes that such regulatory oversight of the SEF, twice by each the CFTC and the SEC, will be unduly expensive, burdensome and duplicative on the SEF with no clear benefit to the regulator and the marketplace.

To remedy such a situation, the SDMA respectfully asks that the license given to SEFs include authorization to affect certain futures and securities trades when done in combination or offset with an interest rate or credit default swap trade as are commonly executed as ‘spread’ trades in the market.

SEFs should be exempt from also maintaining a Broker Dealer (“BD”) or Introducing Broker (“IB”) license normally required were such futures or securities transactions be done without a simultaneous offsetting swap trade.

The rates and credit swaps markets routinely transact swap based ‘spread’ transactions. In the rates market, market participants routinely trade interest rate swaps on ‘spread’ by simultaneously executing an interest rate swap with an opposing trade of US Treasuries of a similar maturity. Market participants also trade interest rate swaps on ‘invoice spread’ by simultaneously executing an interest rate swap with an opposing trade of US Treasury futures offset. Similarly, in the credit markets, participants routinely trade credit ‘basis’ trades where parties bundle both the credit default swap and the corporate bond of the same credit of a like maturity.

Such swaps trades are commonly traded, and involve a hedged or offsetting and simultaneous cash or futures transactions.

Without regulatory relief, SEFs will be required to maintain a (1) CFTC/SEC granted SEF license for the swaps leg of the spread transactions (2) FINRA granted Broker Dealer license for the US treasury and corporate bond leg of the spread transaction, and (3) NFA granted Introducing Broker license for the futures leg of any ‘invoice’ spread transactions.

Such a regulatory regime subjects SEFs to two layers of regulation by the same co-regulators. The first, or direct, layer of regulation is by the SEC and CFTC and the second, or indirect, layer of regulation is by FINRA and the NFA. As a result, SEFs would be under the regulatory oversight of a total of four regulators – the SEC, CFTC, FINRA and NFA.

The SDMA believes that since FINRA and the NFA are SROs and act as regulatory agents for the SEC and the NFA, holding all three licenses to effect such swap related transactions would be overly burdensome, costly and complex to administer by the SEF. This framework will significantly increase compliance costs, and has the potential to create conflicting compliance requirements. Increased compliance costs or conflicting requirements may result in SEFs ceasing to offer such spread transactions

which could result in an adverse effect on liquidity, lessened availability of hedging tools and potentially increased systemic risk to the system. Again, the SDMA respectfully requests certain relief for SEFs in this regard under the Act

IV. Core Principle 13 Financial Resources

The SDMA supports the financial requirements proposed in Core Principle 13. As a central venue for the trading of cleared swaps, SEFs play a key role in the interconnected series of events and parties involved in cleared swaps trading. There must be certainty that SEFs can meet their financial obligations. It would be very disruptive to the market if a swap execution facility went into bankruptcy. Therefore, we believe that 12 months of working capital is the absolute minimum amount of financial resources that SEFs should have, and recommend that the Commission require that SEFs have 18 months of working capital, with at least 12 months of that capital unencumbered.

V. Implementation of Proposed Core Principles and Temporary Grandfather Relief

The SDMA supports the Commission proposal to make the final regulations regarding core principles for SEFs effective 90 days after the final rules are published in the Federal Register. However, the SDMA does not believe there should be any further delay in the effective date of these rules. It has already been two years since the financial crisis and the systemic risk that led to that crisis still exists. Under the Commission's proposed effective date, it will be almost three years after the financial crisis before regulations needed to implement the Dodd-Frank Act go into effect. The SDMA believes that the additional 30 days is reasonable, but urges the Commission to be vigilant in preventing further delays that undermine the realization of the goals of the Dodd-Frank Act and its subsequent rulemakings.

Conclusion

The mandate of the Dodd-Frank Act is to reduce risk, improve market integrity and provide price transparency. To comply with that mandate the method of trade execution should appropriately test markets and provide real time pricing reporting on block trading. It is critical that trade certainty is enhanced through (1) use of pre-trade and post trade risk controls, (2) best practices regarding the give up of trades for clearing, and (3) uniform handling of error trades. Swaps subject to mandatory clearing must be either cleared or broken. SEFs must be adequately capitalized. Lastly, SEFs should be granted regulatory relief in connection with the execution of certain spread transactions.

Thank you for the opportunity to comment during this period. We welcome any further discussion with you, other regulators, the government or any other market participants regarding these critical issues.

Sincerely,

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