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July 8, 2011

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

Re: **(RIN 3038–AC98) Risk Management Requirements for Derivatives Clearing Organizations**

Dear Mr. Stawick:

FX Alliance Inc. ("FXall") welcomes the opportunity to submit its comments on RIN 3038–AC98 Risk Management Requirements for Derivatives Clearing Organizations (the "Proposed Rule"),[1] proposed by the Commodity Futures Trading Commission ("Commission" or "CFTC") to implement certain requirements in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "DFA").[2]

I. FXall Background

FXall operates an electronic trading, execution, trade processing and negotiation system for foreign exchange ("FX") spots, forwards, swaps, options and other FX derivative instruments. Approximately 1,000 institutions globally trade FX derivative instruments in over 500 currency pairs through FXall. These institutions include a range of industrial companies, fund managers, banks, other financial institutions and government and international agencies all over the world. FXall facilitates competitive pricing, internal trading controls, risk management and a granular audit trail. It has succeeded in improving efficiency and transparency and reducing risk for this very important market. As a result, today a large part of the FX market is traded on electronic systems such as FXall – including less liquid or infrequently traded instruments customized by end-users to meet specific commercial requirements.

FXall expects that some FX derivative instruments on the FXall system may qualify as swaps and accordingly some of the FXall system functionality may qualify as a swap execution facility ("SEF"). With respect to those FX derivatives instruments that qualify as swaps, FXall intends to register its system as a SEF.

II. Summary

We are concerned that Proposed Rule 39.13 would provide designated contract markets ("DCMs") with an unnecessary and improper advantage over SEFs. Among other things, the Proposed Rule would require derivatives clearing organizations ("DCOs") to impose significantly higher initial margin requirements on cleared swaps executed on SEFs than on cleared swaps

[1] Risk Management Requirements for Derivatives Clearing Organizations, 76 Fed. Reg. 3698 (published Jan. 20, 2011).
[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (2010).

executed on DCMs. We believe that there is no statutory, policy, or practical reason to impose such a discriminatory margin requirement. Indeed, we believe that this Proposed Rule directly contradicts the DFA, which requires DCOs to provide for non-discriminatory clearing. We therefore believe that the Commission should revise the Proposed Rule to permit DCOs to impose the same initial margin requirements for swaps executed on DCMs and those executed on SEFs.

III. The Proposed Rule

Proposed Rule 39.13(g)(2)(ii) would require that the initial margin requirements imposed by DCOs be based on the amount of time between collection of variation margin and the time that a DCO would be able to liquidate a defaulting clearing member's positions (the "liquidation time").[3] This amount of time would understandably vary based on certain factors. However, the only factor that the Proposed Rule requires DCOs to base the liquidation time upon is whether the transaction was executed on or off of a DCM.[4] Specifically, DCOs must use a minimum of *five* business days for "cleared swaps that are not executed on a DCM" but must only use a *one* business day liquidation time for "all other products that it clears."[5]

Because SEF-executed swaps are obviously not executed on a DCM, DCOs must base their initial margin requirements for SEF-executed swaps on a five day liquidation period. The Proposed Rule therefore requires DCOs to use the same liquidation time for highly bespoke bilateral trades as standardized, SEF-executed swaps.

IV. Discussion

Liquidation Time Should Not Be Different for SEFs and DCMs and Should Not Be Established By the Commission.

We believe that the Commission's use of execution venue as a proxy for a prudent liquidation time unfairly and improperly discriminates against SEF execution. The Proposed Rule states that the intent behind Section 39.13(g)(2)(ii) is to account for different time periods that may be necessary to close out swap positions in a cost-effective manner.[6] We acknowledge that some swaps may take longer to liquidate than others and agree in principle with the Commission's objective. However, for several reasons, we do not believe there is any basis to believe that SEF-executed swaps will take longer to liquidate than DCM-executed swaps. As a result, the Proposed Rule fails to comply with DFA Section 723(a)(3), which requires DCOs to provide for non-discriminatory clearing of swaps executed on a DCM or SEF.[7]

First, the contracts traded on SEFs and DCMs will likely be economically equivalent to each other. The DFA permits swaps subject to the clearing requirement to be traded on either a SEF or a DCM.[8] The primary difference between these execution platforms is that only institutional traders may execute trades on a SEF, while the general retail public (in addition to institutional traders) may execute trades on a DCM. We fail to see why a swap executed by the general

[3] *See* Proposed Rule, 76 Fed. Reg. at 3704.
[4] *See id.*
[5] Proposed Rule, 76 Fed. Reg. at 3720 (to be codified at 39.13(g)(2)(ii).
[6] *See id.* at 3704 ("The Commission believes that a minimum of five business days is appropriate for cleared swaps that are not executed on a DCM in that such a time period may be necessary to close out swap positions in a cost-effective manner.").
[7] *See* DFA Section 723(a)(3) (adding CEA § 2(h)(1)(B)).
[8] *See* DFA Section 723(a)(3) (adding CEA § 2(h)(8)).

retail public would have a shorter liquidation time than a swap executed between two swap dealers if the two swaps are economically equivalent.

Second, we believe that trades executed on SEFs are, in fact, likely to be relatively liquid. For example, under the Commission's proposed rule regarding core principles of SEFs, swap dealers will be able to trade any illiquid, bespoke, or block-sized swaps off of a SEF.[9] Because we believe that swap dealers will often seize this opportunity to transact bilaterally, SEF-executed trades will not likely include many of the illiquid or block-sized swaps which may take longer to liquidate. Moreover, we note that the Commission is mandated to consider a swap's liquidity before determining that such swap should be subject to the clearing requirement (and hence subject to mandatory SEF- or DCM-execution). Therefore, we do not believe that highly illiquid swaps will be subject to mandatory SEF execution and, as a result, such swaps will most likely continue to be traded bilaterally. For these reasons, we do not believe there is any reason to assume that SEF-executed swaps will have a greater liquidity time than DCM-executed swaps.

Instead of basing liquidity time on the execution venue, we believe that it is more accurate to base liquidity time on the product being traded and characteristics of the particular swap being traded. The liquidity of different products varies widely. CPSS/IOSCO recently acknowledged this fact, and stated that margin requirements should be established to account for the liquidity of different *products* as well as the *characteristics* of individual swaps.[10] Because SEFs and DCMs will, for the most part, be free to facilitate the trading of the same products, we believe that DCOs should be free to calculate their initial margin requirements based on the product itself and the characteristics of the individual swap being traded.

We note that DFA Section 733 specifically states that the goal of that Section is to "promote the trading of swaps on swap execution facilities. . . ."[11] We believe that the Proposed Rule would frustrate this goal because swap dealers faced with posting significantly higher margin for executing on a SEF than for executing on a DCM may well choose to execute on a DCM, even if SEFs offer better execution. This higher margin cost will diminish SEFs in favor of vertically-integrated DCMs and DCOs and will result in lower liquidity, higher transaction costs, and decreased competition.

We therefore believe that the Proposed Rule is arbitrary and that it violates specific mandates that Congress imposed on the Commission. As a result, we believe that the Commission should revise the Proposed Rule to permit DCOs to require the same initial margin for the same products executed on a SEF as those executed on a DCM. Alternatively, we believe that the Commission should provide some rationale for its disparate treatment of SEFs and DCMs and provide additional time to comment on the Proposed Rule.

V. Conclusion

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[9] *See* Core Principles and Other Requirements for Swap Execution Facilities, 76 Fed. Reg. 1214, 1240 (published Jan. 7, 2011) (to be codified at 17 C.F.R. § 37.9(a)(v)) (defining "Permitted Transactions" to include block trades and "illiquid or bespoke swaps."); *id.* (to be codified at 17 C.F.R. § 37.9(c)) (stating that Permitted Transactions may be executed via methods that include but are not limited to Order Book and RFQ systems).

[10] *See* CPSS/IOSCO Guidance on the application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties to OTC Derivatives CCPs at 15 (May 2010) ("The appropriate liquidation time horizon may vary among products."); *id.* at 14 ("In setting margin requirements, a CCP should use models and parameters that capture the risk characteristics of the products cleared (including historical price volatility, market volatility, and whether the products exhibit non-linear price characteristics).").

[11] DFA Section 733 (adding CEA § 5h(e)).

As discussed above, FXall believes that the Proposed Rule must be revised to permit DCOs to use the same initial margin requirements for SEF customers as DCM customers.

FXall appreciates the opportunity to provide the Commission with its perspective on the Proposed Rule. If you have any questions regarding our comments, please contact the undersigned at 202-261-6538.

Thank you for the opportunity to comment on the Proposed Rule.

Respectfully submitted,

Wayne Pestone
Chief Regulatory Officer