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June 13, 2012

The Honorable Scott O'Malia
Commissioner
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

RE: Core Principles and Other Requirements for Swap Execution Facilities, Proposed Rules, **RIN Number 3038-AD18**

Dear Commissioner O'Malia:

This letter is to follow up on the meeting we had with you on May 8, 2012 regarding swap execution facilities ("SEFs") and our December 12, 2011 comment letter on the same topic. We appreciate the opportunity to share our ideas around the effective regulation of SEFs, including the likely impact on the OTC derivatives markets if the Commission were to require a SEF to integrate its request for quote ("RFQ") platform with centrally displayed resting orders by providing those resting orders with price-time priority over responses to an RFQ. We are writing to provide some additional detail on this important topic.

At the outset, we emphasize that, in our experience as an operator of electronic markets for over 30 years, OTC derivative markets are inherently less liquid than equity and futures markets.¹ As a result, trading methods that work efficiently in equity and futures markets, where instruments are standardized and there is substantially greater natural trading interest at any one time, do not behave in the same way as most OTC derivatives.

In particular, mandating that displayed resting orders receive price-time priority is likely to increase costs to end users by facilitating the ability for some market participants to "game" the trading model. It would also prevent an end user from controlling its execution costs by obtaining a single "all-in" price from a price maker for the entirety of its trading interest. The relative illiquidity of the OTC derivatives markets magnifies these issues. To help illustrate this, we set out some examples below.

Scenario 1

¹ In this regard, we note the recent attached paper on non-equity markets transparency which we understand was tabled by a number of EU member states in the context of the discussions on MIFID/MIFIR.



Participant A posts a bid on the SEF's centralized screen in a small amount with the aim of 'sniffing out' any block trade activity. Should a supposition of potential block trade activity result in a trade and reveal block trade activity, then the resulting trade will provide valuable information that allows Participant A to execute more significant volumes to try and profit from this information. This activity will negatively affect the ability of price takers to execute efficiently and negatively affect the ability of a price maker to hedge the block trade into the market – raising cost of execution for all concerned.

Scenario 2

Participant B puts in a two-way price at a non-*bona fide* level in an illiquid market in a small size and then sends an RFQ to other participants. Because the indicated interest is tradeable and interactive, the recipients put credence in the displayed level and respond with a price around that level. Participant B then hits all the participants and, even substantiating its own non-*bona fide* price, achieves an artificially advantageous average price for the overall amount.

Scenario 3

The displayed bids on a SEF's centralized screen are \$3 million / \$4 million. Participant C sends an RFQ to Participant D for a far larger block size and receives a bid/offer that provides a bid lower than the displayed bids. Participant C is happy to execute at the received price, with Participant D as principal. Participant C's cost of execution is controlled with a single trade to send to clearing and processing. Note that cost of processing and post-trade management can be significant. In addition, Participant D has until the end of the post-trade block reporting delay to lay off its risk without alerting the wider market, allowing it to provide a more competitive price to Participant C for the block.

If, instead, Participant C was required to hit the displayed bids before it could interact with Participant D, its cost of execution would increase significantly because it would have to process multiple executions. Similarly, if Participant D was required to hit the displayed bids before executing with Participant C, its processing costs would increase and those costs would likely be passed along to Participant C in the form of a worse price.

Moreover, the displayed liquidity would disappear while Participant D is left with the balance of the overall trade. At the same, other participants would see the disappearance of the displayed bids and recognize that a block trade was being executed. This would force the other side of the market to move away from Participant D even before post-trade reporting occurs. To address this, Participant D would need to provide a worse price to Participant C or be forced to hold onto the balance of the trade with no possibility to cover the risk in an economic fashion.

It is worth noting that in the normal market reaction to a block trade as illustrated in Scenario 3 above, any bids or offers that are already being shown in the market at the time of trade will be executed upon in the normal course of risk hedging that results from the execution of the block trade. Whilst not currently a legal requirement, the smaller players who may post a relatively smaller interest to trade into the market are already able to trade alongside the larger risk-takers on an equal basis, even if they are not interested in competing directly for the same block trade.

These differences illustrate important distinctions in market structure between more and less liquid instruments. More liquid instruments, such as futures and equities, tend to operate through an agency market structure in which end users access the market through brokers that pass most execution costs onto their end user clients, and where bid-ask spreads are tight



because of the higher degree of standardization, natural trading interest and volumes. Less liquid instruments, including most OTC derivatives and many fixed income securities, tend to operate through a principal market structure in which dealers as intermediaries are willing to bear most of the cost of execution in return for earning a potentially greater bid-ask spread. Mandating price-time priority for displayed orders on a SEF would move the OTC derivatives market closer to an agency market structure under which end users bear most of the cost of execution even as there is insufficient standardization, trading interest and volume to drive down spreads.

* * *

In conclusion, we propose that the Commission should not require that displayed orders receive priority over responses to an RFQ. Any participant already has the ability to trade with any other participants who may be posting a pre-trade interest. The participant who is requesting a price within the RFQ system is entirely capable of executing against any displayed firm pricing should they so wish. This may be for a partial fill of their overall interest or to complete their interest. This is their existing ability. Enforcing an interaction between displayed orders and RFQ executions will only drive execution into a restrictive model, increasing execution costs for the end user while providing little identifiable cost benefit.

We thank you for considering these comments. Please do not hesitate to contact the undersigned if you have any questions on this matter.

Sincerely,

Jas Singh
Managing Director, Marketplaces

cc: Gary Gensler, Chairman
Jill Sommers, Commissioner
Bart Chilton, Commissioner
Mark Wetjen, Commissioner