SDMA   SWAPS & DERIVATIVES MARKET ASSOCIATION

February 28th 2013

Melissa Jurgens
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

COMMENT

Re: 17 CFR Part 37
RIN Number 3038-AD18: Core Principals and Other Requirements for Swap Execution Facilities

In opposition to RFQ to 1 and other Non-Transparent Execution Methods

Dear Ms. Jurgens,

The Swaps and Derivatives Markets Association ("SDMA") submits this letter in opposition to certain contemplated modes of swaps execution such as Request for Quote to 1 ("RFQ to 1"), Request for Quote to 2 ("RFQ to 2") and other non-transparent modes of execution currently under consideration by Commissioners.

The SDMA is a non-profit financial trade group formed in 2010 to support the goals of the Dodd Frank Act. It believes that systematic risk of OTC derivatives can be mitigated through their regulation, the creation of central clearing, and by ensuring open and transparent access to allow for greater competition, lower transaction costs, and increase liquidity. The SDMA is comprised of many US 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 derivatives and securities markets.

The SDMA opposes *RFQ to 1* and *RFQ to 2* because they fail to meet the *pre trade* price transparency provisions of the *Dodd Frank Act* (2010) and because they will seriously diminish market liquidity, keep transaction costs artificially high, and will result in lessened market competition and integrity.

What is Pre Trade Price Transparency?
To be clear, pre trade price transparency is mandated under the Dodd Frank Act. In fact, Section 733's 'Rule of Construction' for regulators directs the CFTC to pass SEF rules to promote trading on SEFs and rules to "promote pre-trade price transparency in the swaps market."

It is well established that <u>pre trade</u> price transparency is defined as a customer having <u>knowledge</u> and <u>access</u> to price orders <u>before</u> they becomes trades. Equal customer knowledge of a *bid to purchase* or an *offer to sell* is critical if all market participants are to make an informed decision and be treated fairly. Equally important, market participants must have access to trade on such a price to ensure a fair and orderly market. To favor one customer by giving it access to a price ahead of other participants or worse, giving it knowledge of a price while keeping the market ignorant to such a price, decreases transparency, market integrity, and discourages new customers and dealers from participating.

Transparent Modes of Execution
<u>Knowledge</u> and <u>access</u> may only be guaranteed by either *Central Limit Order Books* ("CLOBs") or *Request for Quote to all (RFQ to all)*. CLOBs accept all bids and offers equally. They rank all prices in terms of 'price time priority' where the *highest bid* and *lowest offer* are displayed and trade first. Buyers and sellers have equal knowledge of the highest bid or lowest offer. If the CLOB shows 'market depth,' participants may also see all other bids and offers in the 'stack.' CLOBs permit market participants equal access to trade on the highest bid or lowest offer. It is interesting to note that CLOBs may be electronic or <u>purely voice</u>; such trading occurs over the phone today in the interdealer swap markets. Either way, CLOBs meet the dual pre trade transparency test of equal knowledge and access to prices to all customers. *The SDMA strongly urges the CFTC to require SEFs to facilitate CLOB trading to comply with the goals of the Dodd-Frank Act.*

What about less liquid products or markets?

In circumstances where the product is non-generic or where the product is simply not liquid enough—the execution method of *RFQ to All* may meet the dual pre trade transparency test of knowledge and access. Such a method requires the *requestor* to query *all* other market participants for a quote. Participants may respond if they wish—there is no obligation—and the *requestor* chooses the best price to trade.

RFQ to all certainly accounts for episodic liquidity or more customized products. It is useful in certain less liquid interest rate swaps that fall between the 'on the run' maturity dates on the swap curve, but does it meet the dual test of customer knowledge and access?

RFQ to all <u>does not strictly</u> meet the dual test of knowledge and access. Market participants certainly have *knowledge* that a requestor has sought a price. They may even see the numerous prices returned by market respondents, thus complying with the knowledge test. However, because other market participants may not trade on the price, the *access* test is not fully met. Is this the trade off the market pays for less liquid products, or should the price be available to the entire market if the requestor has declined to trade on respondent prices?

The SDMA believes that either way—RFQ to All may be a permissible trade off or compromise for less liquid products. Any lesser requirement for RFQ exponentially results in lesser market transparency. The

SDMA strongly urges the CFTC to mandate that RFQ to all be the <u>only</u> permissible RFQ method for SEF trading.

Non Transparent Methods: RFQ to 1 or 2.
Neither *RFQ to 1* or *RFQ to 2* meet the pre trade price transparency test of knowledge and access. In either case, only one or two respondents would have knowledge and access to the trade inquiry. To be clear, the <u>balance of market participants</u> would <u>not</u> have equal knowledge and access to the price inquiry and as such neither method is transparent.

The SDMA strongly opposes both methods as a permissible execution method for SEF trading. Simply put, *RFQ to 1* and *RFQ to 2* fail to comply with the express *pre trade* transparency provisions of the *Dodd Frank Act*. These methods foster customer discrimination where certain participants are put ahead of others. Such methods will create 'haves' and 'have-nots' in the marketplace. Participants will be kept in the dark on a pre-trade basis and will be precluded from making informed trading decisions. The market will operate in an inefficient, suboptimal basis where market opaqueness results in less competition, less liquidity, higher transaction costs, and increased systemic risk. *To be clear, the further the CFTC moves away from RFQ to all towards RFQ to 1 or RFQ to 2, the further they move the market away from pre trade price transparency, because the two pronged knowledge and access test is not met.*

Customers Fear of Front Running
Proponents of *RFQ to 1* or *RFQ to 2* argue that customers are disadvantaged by broad RFQ requests to the market, because the greater the number of respondents, the greater the chance of being front run. This is incorrect, front running logically only occurs on trades that move markets by definition. (Otherwise, without a possible market move, there would be no resultant profit from the front running action.) It is well established that market moving trades—are <u>block</u> trades—and, under proposed CFTC rules, are not required to trade on SEFs. Such a fear is therefore unfounded.

Dealer's fear of Winner's curse
A red herring is the supposed fear of 'winner's curse.' The so called 'winner's curse' argues that the RFQ should be to *one* or *two* respondents because the more dealers that hear of the winning trade in the RFQ the greater the chance such a dealer may get picked off as it attempts to trade out or hedge its newly won position. Such an argument pre supposes that the winning trade is a 'market moving trade.' As previously mentioned, it is well established that market moving trades –are <u>block</u> trades-- and, under proposed CFTC rules, are not required to trade on SEFs. This fear is therefore unfounded.

Customers fear on Information Leakage
Proponents of *RFQ to 1* and *RFQ to 2* also argue that oftentimes they do not wish the market to know their trading strategies—for fear of replication. This argument also rings hollow.

Customers may split orders across multiple platforms and may trade anonymously in CLOBs to protect against information leakage.

Within the RFQ context, the customer may shield its identity by executing an *anonymous RFQ*, thus limiting the possibility of a participant replication of a trading strategy. Likewise, a customer may also shield its direction—either buyer or seller—by initiating a *Request for Market* ("RFM"). With a RFM, the customer gives its name, and its size, it does not reveal whether it is a be buyer or seller—and instead requests both a *bid* and *offer* (or 'market') from the respondent market participant group. Respondents cannot replicate strategy because of their basic ignorance of customer trade direction.

RFQ to 1 or RFQ to 2 is transparent because CFTC requires CLOBs for SEFs

There are those who argue that *RFQ to 1* or *RFQ to 2* meet the pre trade transparency requirements, because CFTC SEF rules will also require CLOBs. Without *order interaction* between the CLOB and the RFQ, pre trade transparency will not result and the CLOB will quickly fail.

Order books exist based on *price-time priority*. The book shows the *highest bid* and *lowest offer* to trade *first*. For two sellers at the same price, its 'first come first served.' Such a system is merit based and is fundamental to the orderly functioning of a CLOB. It incentivizes participants to leave resting bids and offer in the system—because they trade first.

Permitting a participant to 'jump the line' ignoring *price-time priority* destroys such an incentive.

RFQs to 1 or RFQ to 2 would permit participants to jump the line. For example, if a USD IRS 5YR was offered at 1.0025 in the CLOB and a RFQ to 2 respondent also showed an offer at 100.25, and the customer ignored the CLOB 1.0025 offer to trade with the RFQ offer at 1.0025, then the CLOB participant is passed over and has little incentive to leave any prices on the CLOB in the future.

Arguably, because a resting CLOB order has higher risk associated with it (it is 'good till canceled') than an RFQ quote (that is 'subject' in moments), the CLOB participant is naturally dis-incentivized to leave a resting order. The user does this however because he has the expectation of trading first. Remove that expectation and the CFTC will remove the incentive for a CLOB.

Such a conflict may only be neutralized if the RFQ is forced to consider the CLOB's 1.0025 offer first and then the RFQ's 1.0025 offer second. This *order interaction* preserves price time priority and the incentive to leave resting bids and offers that result in CLOB success with more liquid and transparent markets. Order interaction is something that the SEC required with its proposed RFQ to 1 SEF requirement and it is something that should be mandated by the CFTC.

D. Stawick
February 28th, 2013
Page 5

RFQ to 1 & 2 Prone to Abuse

With limited RFQ contexts, 'painting the screen' can occur that can quickly destroy market integrity and cost customers money. In an RFQ to 1, two parties can conspire to initiate two simultaneous RFQ to 1's with each other at prices well away from the market. Each would have bought and sold their position— at the predetermined price—have no market risk and post two trades at false prices to the market. The purpose would be to fear an unwitting third party to unwind its position at the 'new' price as a response to the two last trades. The result is pure market manipulation with the third party being harmed. This could not occur if both offenders were forced to add more players to participant in the RFQ.

Conclusion

The SDMA opposes _RFQ to 1_ and _RFQ to 2_ because they fail to meet the _pre trade_ price transparency provisions of the _Dodd Frank Act_ (2010). Permitting them to exist alongside CLOBs in SEFs without <u>order interaction</u> destroys price time priority, the fundamental tenet for a functioning CLOB. _RFQ to 1_ and _RFQ to 2_ will seriously diminish market liquidity, keep transaction costs artificially high, and will result in lessened market competition and integrity. The CFTC should be mindful that SEF existence does not by itself translate into transparent trading of swaps.   To comply with the Dodd Frank Act, Commissioners should ensure that SEF rules permit <u>only</u> _central limit order books_ and _RFQ to All_ execution methods with _order interaction_.

Sincerely,

/s/ James Cawley

James Cawley
Board Member
The Swaps & Derivatives Market Association

cc: The Hon. Gary Gensler, Commission Chairman
        The Hon. Bart Chilton, Commissioner
        The Hon. Scott D. O'Malia, Commissioner
        The Hon. Jill E. Sommers, Commissioner
        The Hon. Mark Wetjen, Commissioner