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Acting Chairman J. Christopher Giancarlo
Commissioner Sharon Y. Bowen
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Dear Acting Chairman Giancarlo and Commissioner Bowen:

As all parts of the US financial services regulatory system undertake reviewing the effectiveness and appropriateness of current regulation I would like to share my recent observations on implementing Part 37 of the Commodity Futures Trading Commission's ("Commission") Rules at a swap execution facility ("SEF"). Based on those experiences, I would like strongly to recommend that the Commission consider permanently establishing a "lighter touch" temporary registration which would include several modifications to its current Rules which if implemented will foster – or at least not hinder – marketplace innovation.¹

Background

The Dodd-Frank Act seemingly created SEFs as a category of registered swap entity primarily to regulate already active off-exchange markets for a variety of financial swaps, and the Commission's regulations establish a comprehensive regimen that regulates all aspects of SEF business. Until recently many of the ultimately successful and useful derivatives products we are familiar with, however, were first traded unregulated in informal over-the-counter markets before moving into commercially viable dealer and exchange marketplaces, a pathway that has been obviated by the Commission's SEF regulations.² Accordingly, Part 37 now constitutes a critically important portal to innovation in the US derivatives business and the only way to organize a commodity swaps marketplace.³

¹ Having started my career as an economist at the Commission I have worked in both the domestic US and global markets, primarily in business development roles but also in regulatory policy and compliance positions. Looking at it from these different perspectives I remain committed to the vitality and integrity of the US derivatives markets.

² It seems that while eligible contract participants may legally enter into swap contracts without registration, "Any person operating a facility that offers a trading system or platform in which more than one market participant has the ability to execute or trade swaps with more than one other market participant on the system or platform shall register the facility as a swap execution facility under this part or as a designated contract market under part 38 of this chapter." 17 CFR 37.3(a)(1)

³ Other than becoming a futures exchange, that is. The currently available exemptions for trade options and deliverable forwards do not appear to extend to third party market operators.

Commodity derivatives trading in the United States has become concentrated at a few futures exchanges. Market participants worry about sources of innovation and the general vitality of the industry. The Commission should be sensitive to the barriers to entry that its regulations raise and concerned about how they negatively affect innovation.

Last year I was engaged by Seed SEF LLC (Seed), a SEF applicant, as its Chief Compliance Officer. Seed was an early stage start-up focused on industrial hemp swaps.⁴ In addition to working on compliance matters I was directly involved in the structuring of Seed's operations and pursued our SEF registration application. I would like to respectfully suggest that the Commission modify its requirements so that entities are better able to create innovative trading facilities and offer new products without the high cost of complying with regulations designed for high volume credit default, interest rate, foreign exchange, and energy swap markets. The Commission could provide certain new SEFs the opportunity to be registered pursuant to a less detailed set of regulations for a limited period of time.

Agricultural Markets Trading Innovation

As a registered SEF Seed's rules provide for an electronic order book, which was customized to assure that members only traded with other members with whom they have master agreements.⁵ In addition, "block trades"⁶ can be executed by members and reported to the facility. With its industrial hemp swaps, Seed provides an important but unfortunately rare example of a new commodity derivatives market with not only new products but also a new facility. I would like to note that while I worked there, Seed's experience with the Commission's application and review processes was positive.⁷ We found the Commission's Part 37 Rules and its guidance on compliance by and large to be easily comprehensible. Furthermore, during the review process the Commission staff members were conscientious and efficient.⁸

⁴ Cultivation of industrial hemp was legalized by the Agriculture Act of 2014 subject to a pilot program of state regulation. The commercial viability of industrial hemp itself had been demonstrated since at least 2004 when importing edible hemp seeds, fiber and other products into the United States was legally affirmed. Seed was founded to provide risk management tools for an embryonic market stimulated by domestic production. Like other commodity derivatives markets, Seed's business case was built on the idea of providing risk management tools for this incipient marketplace by setting up a swaps market in products where speculators could meet hedgers and merchandisers. The Seed CX website (Seed's parent) indicates both that the SEF has not yet launched and that it has pivoted into non-hemp agricultural commodities.

⁵ Seed does not offer cleared swaps in its infant stage.

⁶ Block trades are simply bilateral trades of any size executed outside of the order book.

⁷ Seed's application was accepted as materially complete on February 5 and Seed was registered on August 23, 2016.

⁸ As a greenfield operation, Seed admittedly could more easily and quickly conform its practices and procedures to the Commission's regulations than trading facilities that already are in operation.

Although Seed was registered fairly painlessly in a reasonably short period of time, I believe that far too much of the required administrative, technical and operational infrastructure required under Part 37 was superfluous to the goals of improving integrity, transparency and safety. Putting it all in place was not only costly in dollar terms but also distracted management attention from relevant commercial issues and for the most part extinguished the appetite for invention. In short, much, maybe even most, of our efforts to comply were a waste of time and resources in light of the high likelihood that even a highly successful launch of trading at Seed would give rise to very little regulatory risk for quite some time.

Of the twenty-seven swap execution facilities that have applied to the Commission for registration, only Seed plans to offer agricultural swaps. In contrast to commodity swap markets, though, agricultural cash markets – which are not Commission-, or otherwise, regulated – have recently shown signs of considerable innovation. For example, last year Denver-based PanXchange began providing remote access to an electronic trading platform for feed ingredients in the United States and Mercaris, in Chicago, has been successfully offering a US-wide trading platform for organic corn, soybeans and wheat for more than three years (PanXchange, Mercaris or other such markets, “New Cash Markets”). As far as I can tell there are no publicly accessible markets in derivatives on those increasingly important commodities. It is an interesting thought experiment to ask “What would it entail for an operating New Cash Market to extend its business into derivatives – to become a SEF?”⁹ With swaps they would be able to provide more complete markets for their commercial customers and to attract liquidity from public traders to support hedging and price discovery. As SEFs they could leverage their investments in technology, marketing and goodwill. This would almost certainly be a welcome development for the platforms, their customers, commodity markets, the derivatives industry, and the public.

Recommendations

My recommendations below are intended to provoke discussion of potential improvements to the Part 37 and other SEF rules. The following recommendations have three goals:

- Compliance with the core principles for SEFs
- Encouragement for entities to register as SEFs and for entities to transact on them rather than away from them
- Regulation that does not inappropriately restrict nascent business, especially innovative products, services and markets

It should be noted that all SEF participants must be eligible contract participants.¹⁰

⁹ I am not aware that either of these New Cash Markets intends to seek registration by the CFTC as a SEF or designated contract market (“DCM”).

¹⁰ 7 USC 1a(18)

My focus in offering these recommendations is on the benefits they would convey to market entrants like Seed and New Cash Markets. These markets are likely to be exemplified by direct trading (no clearing, limited or no agency), low trading volumes, product experimentation, and heterogeneous participation among other things. A very important self-policing factor in all such SEFs is that the counterparties with whom a party ultimately trades will previously have established master agreements. The process of negotiating and concluding such agreements typically is to educate parties about their own responsibilities under the contracts, the acceptability of each of their counterparties, and their rights under the master agreement.

1. Temporary Registration Proposal

The Commission should adopt rules for granting temporary registrations for infant trading facilities¹¹ that comply with the core principles but not with all of the Commission's regulations. Under such regulations, the Commission should of course preserve the right to require full compliance with established regulations depending on the facts and circumstances of the applicant and its proposed businesses.

Three-Year Registration

For a number of reasons, it has generally taken a while for any new derivatives market or derivatives contract to gain significant trading volume. New marketplaces should not be required before they even begin to operate to have in place the systems, staffing, policies and procedures that are necessary to safeguard the public interest in trading at large, active SEFs that have numerous members. A three-year, less burdensome registration would lower the cost of entry and might encourage experimentation. Three years provides a good planning horizon given the challenges of establishing a market ecosystem.

Extendable

Not all SEFs have the same potential. The Commission should be able to extend the temporary registration for a fixed or indefinite period of time to that even low volume facilities to continue in business and meet their responsibilities under the core principles as the likely alternative would be to cease doing swaps business. This might be especially attractive for a New Cash Market SEF.

Revocable

The Commission should also make clear that a prodigiously successful SEF will be notified that it must begin to comply with the full panoply of SEF regulations and directed to come into compliance within no more than six months.

¹¹ An infant SEF could be defined by regulation as a facility that has not conducted swap business, is not a DCM, and is not an affiliate of a SEF or DCM.

2. Market Structure

A serious impediment for new swap market entrants is the Commission's requirement that a SEF operate an electronic order book. In adopting its requirements for an order book, the Commission noted that there was significant controversy regarding the statutory basis for the order book requirement.¹² Establishing an electronic trading system order book is perhaps the single most complex and expensive component of a trading system and, once deployed, the single riskiest feature of a new market place. The mere existence of an electronic order book, which Commission regulations stipulate, results in demand for (new) markets to demonstrate images of liquidity to their members and potential members which might be impossible to achieve without expensive "market maker" or other incentive programs that falsely populate order books.

Electronic Order Books

Electronic order books offer several unquestionable natural advantages over other trading methods, especially accessibility, transparency and fairness. These benefits are only available to participants in liquid markets. In low volume marketplaces, however, it is very risky for market participants to quote or place limit orders due to operational and other reasons: quotes get stale, other markets move, internal balances shift, etc. A new SEF would be encouraged to use its judgment regarding when and how to deploy an electronic order book.

Block Trades

The Commission currently permits block trading for not just extraordinarily large orders (relative to market liquidity) but also for illiquid markets. The Commission could simply recognize that, provided it is truly a New Cash Market or other new SEF applicant, an infant SEF's products are likely to be illiquid or otherwise thinly trading and not likely to benefit from order book listing.¹³

Alternatives

Cash markets have historically evolved from voice principal-to-principal trading to voice brokered trading to other paradigms before getting to electronic principal trading. SEFs should be allowed to develop their markets by allowing different forms of transaction. In fact, infant SEFs subject to temporary registration should be encouraged to find the most appropriate means for their participants to transact business including voice brokerage and RFQs. The Commission should be confident that once these become liquid marketplaces that the efficiency of electronic order books will lead electronic order matching to dominate.

¹² 78 FR 33479-85; June 4, 2013.

¹³ Relief does not need to be offered product by product because the cost of developing and deploying an order book is largely a one-off. In other words if a SEF applicant is going to have an order book for one product then it fulfills the current regulation anyway and would not need relief.

3. Swap Data Repository (“SDR”) Reporting

In accordance with Parts 43 and 45 of the Commission’s Rules comprehensive data regarding swaps transactions must be transmitted to an SDR. Integrating with an SDR is cumbersome and expensive for any SEF but it does bring the benefits of regulatory transparency and assurance of timely dissemination of information; in the case of low volume swaps, however, the benefits of such reporting are muted because it is probably less convenient for members of the public and certainly for direct SEF participants to search out price and transaction data from an SDR than from a SEF’s data feed or website. Furthermore, the trading volume and open interest in the types of contracts that I am referring to would certainly not give rise or otherwise add to concerns about market-wide or systemic risk.

The Commission should allow a SEF’s own record keeping and public reporting of SEF trading data substitute for SDR reporting while the SEF is temporarily registered. To allay concerns about permitting any significant loopholes, the Commission could continue to require and registered Swap Dealer to report creation and relevant continuation data to an SDR.

4. Financial Standards

The current Rule 37.1301(c) states, “Financial resources shall be considered sufficient if their value is at least equal to a total amount that would enable the swap execution facility to cover its operating costs for a period of at least one year, calculated on a rolling basis.” This calculation sets a high financial requirement. The Wholesale Markets Brokers’ Association of the Americas (“WMBAA”) made a very important point in its letter to Chairman Timothy Massad on March 11, 2016¹⁴ regarding the Commission’s financial requirements for SEFs when it noted that the statutory requirement is directed toward assuring a SEF’s financial wherewithal for a wind down of business. The Commission currently more or less requires a SEF to have sufficient funds to maintain operations for another 12 months from any point in time.

The WMBAA notes that SEFs do not generally have the same market oversight or financial fulfillment obligations that derivatives clearing organizations and DCMs have. In the case of uncleared swaps, the SEF does not have a direct interest in fulfillment of the contract since it was not a party to the Master Agreement between the participants. With limited exception the disappearance of the SEF should have no material effect on the ultimate satisfaction of any contract concluded under its rules.¹⁵ At any rate, as a market winds down, the SEF will have fewer staff and will use fewer other resources than 12 times the currently monthly expenses.

The Commission should consider different measures that reflect an individual market’s business realities yet comply with the statutory requirement. For example, if a

¹⁴ http://www.wmbaa.com/wp-content/uploads/2016/06/WMBAA_Letter_to_CFTC_031116.pdf

¹⁵ Participants would have a direct dependency on the SEF surviving in cases where the SEF itself establishes settlement or interim payment values or is involved in supervising or serving deliveries.

SEF only offers contracts with a six-month term, then its operating obligations might well be close to zero for the second six months in the year. Or the Commission should allow a SEF's calculations to incorporate the reality that many staff will depart well before a year during a wind down.

5. System Safeguards Requirements

For a New Cash Market or an infant SEF the Commission's requirements set forth at §37.1401 may be daunting and expensive to adhere to due to their detailed comprehensiveness. They imply establishment of a very extensive bureaucratic approach to systems change and innovation that is probably far more appropriate for large and sophisticated operations.¹⁶ Furthermore, the change management procedures as set forth in the rules and guidance would likely chill innovative impulses. The SEFs have sufficient business incentive to solve technical problems, assure availability and scale operations in a timely way.

The downside risks of systems failures in any illiquid market are limited not only because the affected persons are few but also the values at risk are usually small. The likelihood of systemic spillover from a technical problem at a low volume SEF is very narrow.

The principles articulated in §37.1400 are appropriate for any marketplace, and embryonic trading systems and facilities should be permitted to manage their own system development more flexibly than required by §37.1401.

* * * * *

I would welcome the opportunity to discuss these comments with you at your convenience. Please contact me with any questions you may have on my comments.

Best regards,

(signed)

Thomas G. Thompson

cc: Chris Kirkpatrick, CFTC
Julie Lerner, PanXchange
Kellee James, Mercaris
William Shields, WMBAA
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¹⁶ I recently had a conversation with a senior manager at a sizable and successful (unregulated) proprietary trading firm who acknowledged that, among other things, the provenance of specific lines of code in their in-house trading systems was unknowable at this point. She told me that developers and coders simply do not have the time to document fully all of the decision-making around patching and repairing systems.