NFA

March 15, 2019

Mr. Christopher J. Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re RIN 3038—AE25: Swap Execution Facilities and Trade Execution Requirement

Dear Mr. Kirkpatrick:

National Futures Association (NFA) appreciates the opportunity to comment on the Commodity Futures Trading Commission's (CFTC or Commission) proposal to amend its regulations regarding swap execution facilities (SEFs) and the trade execution requirement.[1] We certainly applaud the Commission's decision to review the SEF trading framework in light of its experience since adopting the Part 37 regulations. The Commission's stated purpose in the proposal to promote SEF trading and reduce unnecessary complexity, costs and other burdens that impede SEF development, innovation and growth is laudable.

As described below, however, NFA has significant concerns with parts of the Commission's proposal. Section I of this letter describes our regulatory and legislative related concerns regarding the Commission's proposal to move swaps activity from NFA Member introducing brokers (IBs) to SEFs, and at the same time permit unregistered SEF employees to arrange and negotiate these transactions. Importantly, Section I.D of this letter offers an alternative regulatory framework that would require SEFs that engage in voice-based and voice-assisted methods to arrange and negotiate swaps to also register as IBs and require their trading specialists to register as associated persons (APs). Section II describes NFA's concerns with the Commission's proposal regarding the qualifications and role of persons providing regulatory services to SEFs.

NFA's comments are based on our experience as a self-regulatory organization (SRO) and the only registered futures association (RFA) for the derivatives industry, as well as our nearly twenty years of experience as a regulatory service provider (RSP) to designated contract markets (DCMs) and our more recent experience acting as an RSP to numerous SEFs. Given NFA's role in overseeing the swaps markets as both an SRO and an RSP, we believe that many key parts of the proposal, if

[1] Swap Execution Facilities and Trade Execution Requirement, 83 Fed. Reg. 61946 (proposed Nov. 30, 2018) (Proposed SEF Rule).

adopted, will significantly alter and may weaken the current regulatory framework governing the intermediated interdealer swaps market. NFA respectfully requests that the Commission carefully consider the following comments.

I. The Proposal's Impact on Registration Requirements to Activity Currently Conducted by Introducing Brokers and their Associated Persons

A. SEF Registration—Proposed Regulation 37.3(a)

The Commission's proposal, in part, seeks to largely replace the current regulatory structure applicable to swaps trading that is facilitated via voice-based and voice-assisted systems outside of a SEF with one that moves this activity on a SEF. The Commission notes that SEFs have allowed market participants to "conduct trading" via pre-execution communications away from their respective facilities and then submit the resulting transaction, with the price, terms and conditions already agreed upon between the participants, to the SEFs' trade capture functionality for execution. Today, most of this activity occurs at entities that are currently registered IBs and NFA Members, commonly known in the swap industry as interdealer brokers (IDBs). These entities currently facilitate swaps trading between two counterparties, usually swap dealers, and the transaction is generally arranged by natural persons who are currently registered as APs and are NFA Associates.

To accomplish its goals of promoting both trading on SEFs and pre-trade price transparency, the Commission proposes that the current arranging, negotiating and order acceptance activities engaged in by swap broking IBs away from a SEF occur on a SEF consistent with the SEF registration requirement. The Commission states that "allowing such activities to occur away from a SEF and submitting any resulting transactions to a SEF for execution effectively makes the SEF a trade-booking or post-trade processing engine, which is inconsistent with the statutory language and goals of the Commodity Exchange Act (CEA or Act) related to SEFs."

At the core of the Commission's proposal is the requirement that a swap broking entity register as a SEF if it offers a trading system or platform in which more than one market participant has the ability to trade any swap with more than one other market participant on the system or platform. The Commission's proposal applies this requirement to swap broking IBs using voice-based and voice-assisted systems to facilitate swaps trading by reasoning that "negotiating or arranging" consists of the interaction of bids and offers, which constitutes "facilitating trading" or "trading." The Commission seeks to move this trading activity within a SEF by proposing to prohibit, with few exceptions, pre-execution communications that occur away from a SEF for swaps subject to the trade execution requirement and prohibiting block trades from

occurring away from a SEF.[2] The proposal is explicit that negotiating or arranging a swap's terms and conditions prior to its execution away from a SEF would be considered prohibited pre-execution communications.

If the Commission believes that the current arranging, negotiating and order acceptance activities engaged in by swaps broking IBs is inconsistent with the statutory language and goals of the CEA related to SEFs, then NFA does not object to the Commission's interpretation that IDBs be required to register as SEFs if they offer a system or platform that allows multiple market participants to trade with each other. NFA contends, however, that this proposed interpretation should not be solely determinative as to the appropriate regulatory framework for SEFs for two important reasons—it ignores other relevant provisions of the CEA including material changes Congress made in the Dodd-Frank Act to the CEA's definition of an IB, and it draws an unwarranted, arbitrary regulatory distinction based not on an intermediary's conduct but on the type of commodity interest product offered.

Inconsistent with All Applicable CEA Provisions. When Congress adopted the Dodd-Frank Act, it expressed its legislative intent that persons acting as an IB with respect to swaps be subject to registration and related requirements by amending the CEA's IB definition. The amended CEA defines an IB as "any person...who is engaged in soliciting or accepting orders for the purchase or sale of any commodity for future delivery, security futures product, or **swap**..." (emphasis added). Moreover, CEA Section 4d(g) makes it unlawful for any person to be an IB unless that person is registered as an IB with the Commission. The Commission complied with Congress' "mandate"[3] to include swaps within the definition of IB by amending Commission Regulation 1.3 to mirror the statutory definition without further interpretation or edit. For the reasons discussed in the section below, NFA believes that the activities of these IDBs clearly constitute soliciting and accepting commodity interest orders. Therefore, in NFA's view it would be contrary to Congressional intent and the CEA, as amended, to no longer require persons (including IDBs) that arrange, negotiate and accept orders for swaps transactions to register as IBs and the natural persons associated with them to register as APs.[4]

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[2] Although the Commission's proposal does not expressly state that IDBs would no longer be required to register as IBs, the Commission certainly suggests that IB registration is no longer necessary. For example, the Commission's release notes that an IB framework is not sufficient in light of the word 'trading" in the SEF definition and these IBs' activities "would be more appropriately subject to a SEF-specific regulatory framework." *See* Proposed SEF Rule at 61959.

[3] *See* Adaption of Regulations to Incorporate Swaps; Final Rule, 77 Fed. Reg. 66287 at 66312 (Nov. 2, 2012) (Commission describing Congress' "mandate" to include swaps within the definition of an IB).

[4] CEA Section 4k makes it unlawful for any person to be associated with an IB in any capacity that involves the solicitation or acceptance of customers' orders (other than in a clerical capacity) unless that person is registered with the Commission. Commission Regulation 3.12 reiterates the statutory requirement and makes it unlawful for any person to be an associated person of an IB, or any other intermediary, without registering. Commission Regulation 1.3's definition of an AP includes, in applicable

Regulatory Distinction Based on Product Type. In NFA's view, the Commission's proposal draws an unwarranted, arbitrary distinction based upon product type with respect to regulating intermediaries engaged in arranging, negotiating and accepting orders for swaps versus futures. This distinction is contrary to Commission staff's prior views regarding this activity, how identical conduct has been regulated for years in the futures industry, and creates anomalies within the proposal itself.

First, as noted above, the Commission premises its proposal, in part, on the rationale that these IBs (and their APs) are not involved in "soliciting and accepting orders" but rather are involved in "negotiating and arranging transactions," which it concludes is "trading" requiring SEF registration. However, in 2012, the CFTC's Division of Swap Dealer and Intermediary Oversight (DSIO) in discussing affiliate support activities for swap dealers, including "soliciting, negotiating, structuring, recommending and/ or accepting as agent, swap transactions" noted that those activities would bring a person within the IB definition, subject to the IB registration requirements.[5]

Second, the Commission and NFA have for years required FCMs and IBs to be registered for engaging in the identical conduct—negotiating, arranging and accepting orders for futures transactions—that the Commission now refers to as "trading." The APs' activities at IBs (*e.g.,* IDBs) engaging in swaps transactions are closely aligned to the activities of APs of IBs (and FCMs) engaging in futures transactions, particularly those APs engaged in block futures trades. Among other things, APs engaging in transactions involving swaps and/or futures may discuss potential trades and specific trade terms (*e.g.,* price, quantity), disseminate trading interests to the market, provide market color and are compensated based on the trade. Additionally, the Commission seems to acknowledge that an IDB's conduct is different than that of other SEFs because it has individuals who exercise discretion. Given this discretion, the Commission is proposing to adopt a requirement that these IDBs, which will be required to register as SEFs, provide specific disclosure regarding the manner in which they use discretion for each execution method. However, the conduct cited by the Commission as discretion, which distinguishes IDBs from other SEFs, is the exact type of conduct engaged in by APs of IBs and FCMs for block futures transactions: (1) exercising discretion on behalf of market participants by determining how, when and with whom to disseminate, arrange and execute bids and offers and determining when to amend and cancel those bids and offers in response to market developments; and (2) exercising judgment by taking different factors into account, like the characteristics and needs of the client, size and nature of the order, likelihood and speed of execution, price and cost of execution and current market conditions.[6]

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part, any natural person associated with an IB in any capacity which involves the solicitation or acceptance of customers' orders (other than in a clerical capacity).

[5] *See* CFTC Letter No. 12-70 (Dec. 31, 2012).

[6] Proposed SEF Rule at 61983.

Third, NFA believes the Commission's proposal also creates several internal anomalies and opportunities for regulatory arbitrage. Specifically, the CEA, as amended by the Dodd-Frank Act, explicitly allows swaps to be executed on either a SEF or DCM. To the extent the CFTC creates a flexible trading and regulatory structure for swaps traded on a SEF but not a DCM, NFA is concerned that the CFTC has by regulation created a two-tiered market that favors swaps trading at SEFs over DCMs. The CFTC's proposal creates a further anomaly relating to IB registration itself. For swaps traded on a SEF, a SEF employee as discussed below may arrange, negotiate and accept an order for a swap transaction between two counterparties because this transaction is considered "trading" and must occur on a SEF. However, if a person engages in these same activities for only one counterparty to a swap transaction then this activity must be conducted in an FCM or IB by a registered AP.[7]

The Commission notes in the proposal its view that the current IB requirements are neither intended nor sufficient for the regulation and oversight of IDBs that arrange, negotiate and accept orders for swap transactions. In NFA's view, any deficiency in the current regulatory structure will not be addressed by adopting a regulatory structure that removes a layer of self-regulatory oversight over this conduct, leaves SEFs to supervise their few thousand unregistered employees (*i.e.*, SEF trading specialists) engaging in this activity and places the Commission in a front-line regulatory oversight role via rule enforcement reviews (RERs) to ensure SEFs are properly discharging their supervisory obligations over their employees. IB registration provides important regulatory safeguards and, in part, ensures that these firms' activities are subject to consistent regulatory standards overseen by NFA.

NFA acknowledges that existing Commission and NFA requirements for IBs were developed and implemented prior to the Commission's and NFA's oversight authority over the activities of these IDBs. However, many of the Commission's and NFA's rules are principles based and although adopted many years ago apply to these IBs' activities. For example, all IBs engaging in swaps activities are currently subject to a number of NFA requirements that are not only applicable to their activities, but form the bedrock of any regulatory framework, including NFA Compliance Rules 2-2 (Fraud and Related Matters), 2-4 (Just and Equitable Principles of Trade) and 2-9 (Supervision). We are certainly supportive of a continuing review of the current regulatory requirements to ensure that they adequately address these IBs' activities.

Historically, NFA has provided the derivatives industry the benefit of consistent regulatory standards adopted after engagement with Members, the CFTC and other stakeholders. As the swaps market continues to evolve, NFA is well suited to work with the Commission and IBs to address regulatory needs and adopt additional regulatory requirements that are directly applicable to IBs that arrange, negotiate, and accept orders for swap transactions. NFA is concerned that the Commission's

[7] Proposed SEF Rule at 61959 n.94.

proposal, which folds the IDBs into SEFs and permits each SEF to adopt its own rulebook will result in inconsistent requirements across SEFs. In contrast to having each SEF oversee compliance with its own rulebook and their SEF trading specialists as discussed below, NFA strongly favors the status quo in which IBs and their APs are subject to NFA's oversight and examinations, which provides an independent, consistent level of oversight and spares scarce Commission resources.

B. SEF Trading Specialists—Proposed Regulation 37.201(c)

The Commission's proposal also creates a new category of persons who engage in swaps transactions, SEF trading specialists. The proposal defines a SEF trading specialist as a natural person employed by a SEF, or acting in a similar capacity as a SEF employee, to perform various core functions that facilitate trading and execution, including discussing market color with market participants, negotiating trade terms, issuing RFQs and arranging bids and offers. Individuals currently engaged in these activities at registered IBs (*i.e.*, the IDBs) are registered as APs[8] and subject to various NFA and CFTC regulatory requirements. The Commission acknowledges that these individuals exercise a level of discretion and judgment in facilitating interactions between bids and offers from multiple market participants. Under the Commission's proposal, it appears that these SEF trading specialists will not be subject to any registration requirement, including registering as an AP.[9]

For the reasons discussed above, it is evident that these individuals engage in virtually identical conduct as registered APs of an IB or FCM engaged in futures transactions. Therefore, NFA firmly believes that there is no regulatory purpose for treating any of the above activity differently, and those individuals should be subject to the same registration requirements and regulatory oversight by the CFTC and NFA. Moreover, NFA believes a lack of registration requirement for SEF trading specialists is inconsistent with Chairman Giancarlo's views expressed in his 2018 Whitepaper where he notes the value of focusing on "licensure" when regulating the swaps market.

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[8] Based on staff's most recent review, there are approximately 2,800 individuals registered as APs with IBs commonly known as IDBs. Approximately 25% (800) of those APs have taken the Series 3 examination. Therefore, it appears that approximately 2,000 of those APs engage in swaps transactions exclusively. Series 3 registered APs may also engage in futures transactions while registered as APs at an IB. However, if those individuals become SEF trading specialists (who are not registered in any capacity under the proposal) and are no longer registered APs, then they will no longer be permitted to engage in futures transactions.

[9] By way of example, if an individual arranges and negotiates a block futures trade (on a DCM) versus a swaps trade (either bilaterally or on a SEF) between two counterparties, then the individual does so away from a contract market and would have to be a registered AP of an FCM or IB. On the other hand, for the swaps trade that is arranged and negotiated in exactly the same way, the individual may be an unregistered employee of a SEF, or a SEF trading specialist.

In the preamble of the Proposed SEF Rule, the Commission questions whether the current IB requirements adequately address the activities of APs registered at IDBs. The Commission notes that the regulatory approach relating to SEF trading specialists should aim to enhance professionalism, enhance market integrity and address in particular the integral role that these individuals play in exercising discretion in a multiple-to-multiple market. To achieve this, the Commission proposes a number of requirements including that each SEF establish and enforce a code of conduct for its SEF trading specialists and diligently supervise their activities.

At the outset, NFA believes the Commission should clarify whether a SEF's supervisory obligation to ensure that its trading specialists are complying with its code of conduct falls within the SEF's SRO responsibilities or under an employer/employee (or other)[10] relationship. A SEF's SRO responsibilities (*e.g.,* rule enforcement program) generally cover prohibiting abusive trading practices on its market by trading participants. The Commission's proposal does not appear to specifically address whether SEF trading specialists are market participants, and in the event this is somehow the case, if a SEF's SRO responsibilities extend (and in what manner) to monitoring these specialists' activities. This distinction is extremely important in the context of a SEF's obligation to comply with various core principles under Section 5h of the CEA. Moreover, it is equally important to regulatory service providers that commit resources and expertise to assist SEFs with their SRO responsibilities but do not supervise SEF employees. Moreover, regardless of whether SEFs are acting as SROs or employers in supervising their SEF trading specialists, NFA is concerned many SEFs themselves currently do not have the infrastructure to conduct the reviews that would be required to adequately supervise their SEF trading specialists, especially given the likely increase in the number of individuals who may become SEF trading specialists at each SEF.

Further, although the Commission's proposal identifies certain standards that may be addressed in a SEF's code of conduct to govern SEF trading specialists' activities,[11] the Commission clearly states that these are not required items. As a result, the Commission leaves open the possibility that each SEF will develop different standards of conduct based on the varying resources available to the SEF to supervise its swaps trading specialists' compliance with its code. More importantly, it is not clear what consequences exist if a SEF trading specialist violates a SEF's code of conduct. At most, it would appear that a SEF would be able to terminate its relationship (employment or otherwise) with the SEF trading specialist but would not be able to

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[10] The Commission notes that SEF trading specialists include persons directly employed by the SEF and persons who are not directly employed, including independent contractors and persons serving as SEF personnel pursuant to an arrangement with an affiliated broker employer.

[11] The Commission's examples include that SEF trading specialists act in an honest and ethical manner and observe high standards of professionalism, handle orders with fairness and transparency and not engage in fraudulent, manipulative or disruptive conduct.

impact his/her ability to become employed in the same role at another SEF, or his/her ability to become registered as an AP.[12] Moreover, there certainly would be no public disciplinary information available if a SEF trading specialist engaged in wrongful conduct unless the CFTC filed an enforcement action against the individual.

NFA believes the opportunity for fraud and deceptive trading practices certainly exists when an individual handles both sides of a transaction, and should be addressed through a registration scheme that allows for the ability to impact an individual's registration for wrongdoing. In fact, utilizing the current registration scheme, and requiring these individuals to be registered APs (and NFA Associates) of an IB is the best way to achieve the Commission's stated goals of enhancing professionalism and market integrity and addressing in particular the integral role that SEF trading specialists play in arranging and negotiating swap transactions, including exercising discretion, in a multiple-to-multiple market. As APs of NFA Member IBs, NFA has the ability to develop specific requirements addressing the activities of these individuals, impose proficiency and ethics requirements and importantly, take enforcement actions if necessary against them for rule violations, which can impact their NFA membership and ability to work in the industry, as appropriate.[13] Without this registration scheme, NFA believes it will be much more difficult to achieve the Commission's stated goals and will result in less individual accountability and inconsistent oversight.

C. Proposed Regulatory Standards for SEF Trading Specialists and the Commission's Reliance on NFA for their Administration

In addition to requiring a SEF to adopt a code of conduct and diligently supervise its SEF trading specialists, the Commission also proposes certain requirements, short of registration, designed to enhance professionalism and market integrity. Under the Commission's proposal, each SEF will be required to ensure that each of its SEF trading specialists is not subject to a statutory disqualification and has met certain proficiency requirements. While NFA supports the Commission's efforts to enhance professionalism and market integrity, we have a number of concerns regarding the specific proposals as discussed below.

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[12] Currently if a registered AP and NFA Associate is withdrawn/terminated from an NFA Member, the NFA Member (*e.g.*, IB) is required to file a Form 8-T with NFA indicating the reason for the withdrawal/termination, including if that AP was terminated for cause. NFA, as an SRO, then has the ability to conduct a follow-up investigation to determine if NFA rules were violated during that individual's time as an NFA Associate, which could have a bearing on an individual's ability to become registered in the future. If SEF trading specialists are not required to be registered APs and NFA Associates, NFA would have no similar recourse, nor would SEFs have any obligation to report the reason for a termination for cause to any regulator.

[13] Approximately 25% of the individuals who are registered as APs with IBs that engage in swaps trading have passed the Series 3. Therefore, NFA assumes that these individuals engage in both swaps and futures activity and these individuals would need to remain registered as APs and NFA Associates. As NFA Associates, NFA has jurisdiction over these individuals' commodity interest activities and they would be required pursuant to NFA Compliance Rule 2-5 to comply with any inquiry, investigation or examination related to their swaps activities conducted in their capacity as a SEF trading specialist.

Reviewing Fitness for SEF Trading Specialists and NFA Liability Concerns—Proposed Regulation §37.201(c)(2). As noted above, the Commission's proposal does not include a registration or NFA Membership requirement for SEF trading specialists. The proposal, however, seeks to leverage NFA's resources to ensure SEF trading specialists' fitness. Under the proposal, a SEF is prohibited from permitting any person subject to a statutory disqualification under CEA Sections 8a(2) or 8a(3) to serve as a SEF trading specialist if the SEF knows, or in the exercise of reasonable care should know, of the person's statutory disqualification. The proposal contains two exceptions to this prohibition. In particular, the prohibition does not apply if a person is listed as a principal, or is registered with the Commission as either an AP of a Commission registrant or as a floor trader or floor broker. This exception is based on the premise that NFA has reviewed the person's statutory disqualification when the individual became a listed principal and/or registered AP and determined that the incident giving rise to the statutory disqualification is insufficiently serious, recent or otherwise relevant to pose a substantial risk to the public. NFA makes these registration determinations regularly and has no objection to this exception.

In the second instance, the Commission proposes an exception from the prohibition if a person subject to a statutory disqualification who is not registered with the Commission provides a written notice from an RFA (*i.e.,* NFA) stating that if the person were to apply for AP registration NFA would not deny it based on the statutory disqualification. NFA has concerns with this exception because it would require NFA to establish a process to conduct these reviews, and we would conduct these reviews for non-Members of NFA. The Commission appears to have suggested this process based on the review NFA conducts for Swap Dealer (SD) Members with respect to individuals acting as APs[14] of SDs who may be subject to a statutory disqualification.[15]

NFA is concerned about establishing an analogous process for SEFs for two reasons. First, unlike SDs, SEFs are not Members of NFA and do not pay dues or other fees designed to cover NFA's regulatory costs. Second, and more importantly, NFA is concerned about potential liability in performing these reviews. For example, a SEF trading specialist might attempt to sue NFA in light of an adverse determination by NFA or a person might attempt to sue NFA claiming that NFA made a mistake in a determination and thus permitted a person to act as a SEF trading specialist who later engages in serious misconduct. To compound these liability concerns, it is not clear that NFA would be afforded the liability protections available to SROs when performing these reviews on behalf of non-Member SEFs for unregistered, non-Member SEF

[14] Individuals acting as APs of registered swap dealers are not required to be registered.

[15] Specifically, an SD is able to file a statutory disqualification form with information regarding an SD's AP's statutory disqualification through NFA's Easy File system. NFA reviews this information and, without any additional independent review and following prior specific CFTC guidance on statutory disqualifications, informs the SD whether NFA would have granted the person registration as an AP despite the statutory disqualification.

trading specialists. Therefore, if NFA were to provide this service to SEF trading specialists, NFA would have to work with the Commission and SEFs to address these cost and liability concerns. Of course, in lieu of NFA performing this service, the Commission itself could perform these reviews.

Administering Proficiency Examinations for SEF Trading Specialists—Proposed Regulation §37.201(c)(3). The CFTC also proposes to require SEFs to establish and enforce standards and procedures to ensure that their SEF trading specialists have the proficiency and knowledge necessary to fulfill their responsibilities to the SEF and to comply with the CEA, applicable Commission regulations and the SEF's rules. The proposal mandates that a SEF require its trading specialists to take and pass a swaps proficiency examination administered by an RFA. Although the proposal does not specifically require SEF trading specialists to take and pass NFA's proposed swaps proficiency requirements, the preamble notes that SEFs will not have to comply with the examination requirement until an RFA, such as NFA, completes development of an exam and establishes an administration process.[16]

As we have publicly announced, NFA is currently developing proficiency requirements for swap APs of NFA Members that will focus on applicable CFTC and NFA requirements. NFA's proficiency requirements are not specifically tailored to individual SEF trading rules, or designed primarily to address requirements stemming from the Commission's Part 37 rules applicable to SEFs or SEF trading specialists. The proficiency requirements, however, include a track that is designed for APs affiliated with NFA Member intermediaries, and NFA could make this portion of the program available to SEFs for their SEF trading specialists (at the appropriate fee), particularly since these individuals would act almost identically to registered APs at our intermediary firms.

Importantly, at this time, NFA does not support developing a separate SEF core principles based proficiency exam for non-Member SEF trading specialists given that they would not be NFA Members and the resource intensive nature of this effort. Moreover, NFA questions whether it is even feasible to develop a proficiency exam for SEF trading specialists that covers SEF rules given that under the Commission's proposal each SEF has the flexibility to adopt its own trading rules and code of conduct. The development of large-scale proficiency requirements is significantly assisted by the uniformity of regulatory subject matter to be tested. NFA is concerned that the Commission's proposed regulatory structure for SEFs will result in varied rules among SEFs, and those rules will lack the uniformity necessary to develop a single test for the trading specialists.

D. An Alternative Regulatory Framework

If the Commission is committed to moving the current arranging, negotiating and order acceptance activities engaged in by swaps broking IBs to within

[16] The Commission's release also notes that in the absence of an available examination SEFs would still be required to ensure that their SEF trading specialists meet general proficiency requirements under proposed Regulation 37.201(c)(3)(i).

SEFs, then NFA strongly advocates requiring an entity to register as both a SEF and as an IB if it meets the statutory definition of each category. A firm would have to register as a SEF if it operates a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system. This same firm would also have to register as an IB (and be an NFA Member) if it also offers voice-based or voice-assisted methods to arrange and negotiate swaps transactions. Importantly, the individual persons engaged in this voice activity on behalf of the firm would have to be registered as APs and be NFA Associate Members. Under this framework, NFA will be able to provide consistent oversight over IB activity (rather than through individual SEF codes of conduct) and ensure the fitness and proficiency of the individuals engaged in this activity.

NFA recommends, however, that prior to adopting regulations aimed at moving the IDB activity on a SEF, the Commission consider whether it can achieve its goal to promote SEF trading and pre-trade transparency by focusing on the portions of its proposal relating to trading structure issues. NFA believes these issues are more appropriately addressed by market participants and SEFs, and we encourage the Commission to carefully consider these comments. The Commission may be able to achieve its overall goal of bringing more swaps trading on SEFs and further increase transparency in the market by addressing the inefficiencies in the current trade and execution structure and by codifying existing no-action relief while leaving in place other key components of the regulatory structure, including the swaps broking conduct of IBs and their APs, that have worked extremely well over the years.

In NFA's view the proposed changes, if implemented, will further strain the Commission's already scarce resources. If the Commission instead implements NFA's alternative structure of requiring IDBs to register as both a SEF and an IB, where appropriate, or leaves the current regulatory structure as is and achieves its goal by addressing trading and execution issues, the CFTC can continue to leverage NFA's regulatory competencies to help relieve the Commission of any undue or unintended regulatory burden.

II. SEF SRO Functions and Relationship with Regulatory Service Providers

A. SEF Regulatory Service Providers Permitted—Proposed Regulation 37.204(a)

The Commission's proposal makes substantial changes regarding the qualifications and role of an RSP. NFA is concerned that these proposed changes may weaken the regulatory framework and introduce uncertainty to areas that have worked effectively over time.

The Commission proposes to expand the scope of entities that may provide regulatory services to SEFs to include any non-registered entity approved by the Commission. The Commission considered this same question when it adopted final

SEF rules in 2013 and chose not to broaden the entities eligible to act as RSPs. NFA does not believe that the Commission has demonstrated any reason to modify that decision.

NFA believes the Commission should only allow entities over which a federal financial regulator has jurisdiction to serve as an RSP. The Commission's current framework permits a SEF by contract to engage an RSP, and requires that an RSP be an RFA, FINRA[17] or another Commission registrant. This requirement is important because it helps to ensure that the Commission has the appropriate authority over an RSP to verify that it has the capacity and sufficient expertise to appropriately carry out its responsibilities, while at the same time ensuring that the entity's activities are subject to continued oversight by the Commission or another financial regulator. Moreover, the jurisdictional nexus between the CFTC and an RSP allows the Commission to ensure that it will be able to obtain and share confidential information (*e.g.*, investigatory matters) with an RSP. This type of jurisdictional nexus is lacking if an RSP is not subject to a federal financial regulator's oversight and it is not clear if the Commission could share this type of information with such an entity.

B. Duty To Supervise an RSP—Proposed Regulation 37.204(b)

NFA also has concerns regarding several proposed amendments relating to a SEF's relationship with and supervision of its RSP, which according to the Commission are designed to provide SEFs with greater flexibility and streamline requirements. Although not intended, it is important that the Commission not inadvertently facilitate a race to the bottom to regulating the swaps market, where potential RSPs compete to provide as little as required, in as minimal a way as possible. The Commission instead should recognize the significance of current industry practices, memorialized in established contractual relationships between SEFs and NFA as an RSP, and at the very least codify in any final rulemaking that SEFs and their RSPs are not prohibited from contractually adopting more stringent practices and requirements than contained in proposed Regulation 37.204(b) if adopted.

For example, NFA acting as an RSP would seek to contractually adopt more stringent practices in several areas in which the Commission's proposed regulations attempt to provide greater flexibility. Based upon our almost twenty years of experience acting as an RSP for DCMs and over five years doing so for SEFs, NFA finds the following proposed provisions problematic: (i) A SEF would no longer be required to hold regular meetings and conduct periodic reviews of its RSP as part of its obligation to supervise its RSP; (ii) a SEF may allow its RSP to make substantive decisions (*e.g.,* trade adjustments/cancellations, decisions to issue disciplinary charges,

[17] In adopting final SEF rules in 2013, the Commission included FINRA in the list of potential entities that may act as an RSP after it determined that FINRA likely has the "qualifications, capacity, and resources" to conduct these services. *See* Core Principles and Other Requirements for Swap Execution Facilities, 78 Fed. Reg. 33476 at 33516 (June 4, 2013).

and denials of access to the SEF) as long as the SEF remains "involved";[18] and (iii) a SEF would no longer be required to document where its actions differ from its RSP's recommendations.

Our experience shows that regular meetings between NFA and those SEFs for which we act as an RSP are critical to ensure transparency, the timely sharing of information and the SEF's active participation in regulatory oversight. Moreover, we believe that a SEF should be solely responsible for all substantive decisions and should not be allowed to delegate such important functions to a third-party. Staff also believes that it is important for both a SEF and its RSP to maintain documentation if the SEF's actions differ from the RSP's recommendation, and we believe that the Commission would find this information useful in conducting reviews of not only the SEF but the RSP. NFA has always had terms in our regulatory service agreements[19] covering these practices that govern our relationship with DCMs and SEFs. Therefore, we believe it is critical that if these provisions are adopted the CFTC explicitly recognize that SEFs and RSPs have the ability to contractually alter their terms.

C. Audit Trail Reconstruction—Proposed Regulation 37.205

Although NFA believes that the Commission should clarify current SEF audit trail requirements, we are concerned that the proposed changes may result in less clarity and have the potential to diminish important audit trail regulatory requirements.[20] Currently, under the Commission's SEF Core Principles, the SEFs' obligation to perform an audit trail review falls under the SEFs' SRO function. Therefore, the SEFs for which NFA acts as an RSP have contracted with us to carry out their audit trail annual review enforcement programs. Subsequent to the issuance of SEF final rules in 2013, the SEFs and NFA worked with DMO staff to develop concrete guidance as to the elements of an audit trail annual enforcement program.

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[18] Although the proposal indicates that a SEF has to be "involved" in any substantive decision, the proposal also allows each SEF to determine how they are "involved" in each decision and provides no guidance as to what is acceptable.

[19] These proposed changes are not consistent with the RSP requirement for DCMs, and no explanation is provided as to why the standards should be different for SEFs versus DCMs. NFA is concerned that two different frameworks create inefficiencies for NFA, or any other entity, that acts as an RSP to both SEFs and DCMs.

[20] The proposed changes will require a SEF to capture and retain audit trail data necessary to reconstruct all trading on its facility, detect and investigate customer and market abuses and take appropriate disciplinary actions. The proposal narrows the scope of the audit trail data that a SEF must capture in a its electronic history database by no longer requiring SEFs to capture oral communications, electronic instant messages and/or emails in this database, apparently based on the technological challenges of doing so. SEFs are nonetheless required to keep a record of all orders entered by voice or other electronic communications.

The Commission proposes to eliminate the existing audit trail annual review enforcement program and replace it with a general audit trail reconstruction requirement. Specifically, the Commission proposes that SEFs be required to create an annual audit trail reconstruction program to review an adequate sample of executed and unexecuted orders and trades from each offered execution method to verify compliance with CFTC Regulation 37.205(c). In proposing this general requirement, the Commission did not acknowledge the current practices as to the elements of an audit trail review program. Instead, the Commission's proposal injects new uncertainty as to what it considers the appropriate components of a review program by merely providing in Appendix B that each SEF should maintain reasonable discretion in determining what constitutes an adequate sample for purposes of its audit trail reconstruction program.

Given the proposal's uncertainty, NFA believes SEFs, and their RSPs, will need to obtain further guidance from Commission staff on the components of a program that will meet Regulation 37.205(c)'s standard. Additionally, based on the proposed requirement that a sample of executed and unexecuted orders and trades for each type of execution method be reviewed as part of a SEF's audit trail reconstruction program, it is unclear to NFA, without additional guidance, what responsibility a SEF as an employer would have to reconstruct trades arranged and negotiated for counterparties by its employees (*i.e.*, SEF trading specialists).[21]

D. Disciplinary Program—Proposed Regulation 37.206(b) and Proposed Regulation 37.201(c)

The Commission also proposes a number of changes that NFA believes may diminish the SEFs' SRO obligations and are inconsistent with self-regulatory principles in the derivatives and securities industries. The Commission should, instead, recognize the importance of these principles and consistently applied standards for SRO administration across the industry.

By way of example, NFA wanted to highlight one proposed change in particular in this area. Consistent with the requirements applicable to other SROs, the current SEF rules require that SEFs have one or more disciplinary panels that meet certain requirements, and prohibit SEF compliance staff from being part of a disciplinary panel. The Commission proposes to amend these requirements to specifically allow a SEF to administer its disciplinary program through its compliance staff. The significance of this change cannot be understated because any claim that SEFs act as SROs rings entirely hollow. Disciplinary panels consisting of other members/market participants that judge their counterparts and that are independent of the SRO staff are the essence of self-regulation. A disciplinary panel independent from SEF staff is necessary to

[21] For SEFs that only offer electronic trading methods and not voice-based or voice-assisted methods, NFA assumes the Commission will maintain its position that these SEFs have an obligation to perform an audit trail review under the SEFs' SRO responsibilities. NFA, as an RSP, would be able to conduct this review of market participant activity for the SEF.

eliminate the inherent conflict of interest that stems from compliance staff investigating and recommending disciplinary action and then acting as the final adjudicator in determining if a rule violation occurred and the appropriate penalty.

Although one of the Commission's stated goals is to provide more flexibility to SEFs, NFA is concerned that the net effect of these changes is to lessen SEF oversight responsibilities with the outcome being less effective enforcement programs. NFA clearly supports principles based regulation, but there must be minimum standards that ensure consistent oversight by SEFs in order to avoid the possibility of regulatory arbitrage by market participants. NFA notes that the Commission also indicates that this rulemaking is intended to provide greater customer protection and market integrity. We encourage the Commission to strike the appropriate balance with any changes to the SEF disciplinary program requirements because too much flexibility in this area may actually diminish customer protection and market integrity.

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NFA requests that the Commission carefully consider the concerns raised above. NFA also encourages the Commission to consider the comments it receives on trade structure and related regulatory requirements designed to promote trading of swaps on SEFs. NFA is not specifically commenting on these topics because in our view they are more appropriately addressed by market participants and SEFs. However, we believe the Commission may be able to achieve its overall goal by addressing these issues, while maintaining the current regulatory structure involving registered IBs. We look forward to continuing to work with the Commission, NFA Members and the SEFs on this extremely important rulemaking. If you have any questions concerning this letter, please do not hesitate to contact me at 312-781-1409 or cwooding@nfa.futures.org or Ed Dasso, Vice President of Market Regulation at 312-781-1677 or edasso@nfa.futures.org.

Very truly yours,

Carol A. Wooding

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Vice President,
General Counsel and Secretary

/caw/comment letter: NFA Comment Letter_RIN 3038AE25_Swap Execution Facilities and Trade Execution Requirement