



State Street Corporation

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March 15, 2019

Mr. Christopher Kirkpatrick  
Secretary  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st St, N.W.  
Washington, DC 20581

Via Electronic Submission

**Re: Swap Execution Facilities and Trade Execution Requirement; Proposed Rule - RIN 3038-AE25**

Dear Mr. Kirkpatrick:

State Street Corporation (“State Street”) appreciates the opportunity to comment on the proposed revisions (“Proposed Rule”) to the regulations of swap execution facilities (“SEFs”) and the trade execution requirement published by the U.S. Commodity Futures Trading Commission (“CFTC” or “Commission”).

Headquartered in Boston, Massachusetts, State Street specializes in providing institutional investors with investment servicing, investment management, data and analytics, and investment research and trading. With \$31.620 trillion in assets under custody and administration and \$2.511 trillion in assets under management as of December 31, 2018, State Street operates in more than 100 geographic markets worldwide. State Street’s primary banking subsidiary (State Street Bank and Trust Company) is provisionally registered with the CFTC as a swap dealer and is a major global dealer in foreign exchange, operating through multiple branches in U.S. and foreign markets. In addition, we have a subsidiary, SwapEX, LLC, registered with the CFTC in the U.S. as a SEF.

Our comments on the Proposed Rule primarily relate to the trading of foreign exchange instruments and the disadvantages that it would continue to impose on U.S. market participants with respect to cross-border trading in foreign markets. In particular, the proposed codification of “footnote 88”<sup>1</sup> will further perpetuate the bifurcation of uncleared swaps markets, particularly with respect to non-deliverable foreign exchange forwards (“NDFs”) and foreign branches of U.S. banks. For the reasons set forth below, we strongly urge the Commission to exempt NDFs

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<sup>1</sup> SEF Core Principles Final Rule at 33481 n.88.

from the proposed codification of footnote 88, or alternatively, to permit foreign branches of U.S. banks to access foreign trading platforms for the trading of NDFs without requiring those platforms to register as SEFs. Given the importance of addressing the bifurcation of the foreign exchange market as a result of the regulatory treatment of NDFs, we also strongly recommend that the CFTC address cross-border reforms, specifically by issuing trading venue exemptive relief for other jurisdictions, prior to expanding registration requirements on cross-border trading.

In addition, we also set forth several other recommendations related to aspects of the Proposed Rule addressing pre-execution communications, error trade reporting requirements and the proposed new annual requirement for SEF operators to submit an updated Exhibit Q (Program of Risk Analysis and Oversight Technology). Finally, we note our support for other aspects of the Proposed Rule, such as the elimination of restrictions on trade execution methods and the expansion of SEFs' discretion in selecting third-party regulatory service providers.

### ***Codification of Footnote 88 and Expansion of SEF Registration Requirements***

The SEF registration requirements applicable to platform providers of uncleared swaps, particularly with respect to NDFs, combined with the CFTC's cross-border rules have led to market fragmentation, increased costs to U.S. investors, and competitive disadvantages for U.S. swap dealers. In connection with their investment activities, U.S. investors manage their currency exposures through the use of foreign exchange transactions. Foreign exchange transactions may be entered into for immediate (i.e. "spot") or future (i.e. "forward") access to currency. NDFs are often used in markets where deliverable forwards cannot be executed, as the transaction involves a currency that cannot be delivered outside of its home jurisdiction. NDFs and deliverable foreign exchange forwards are often viewed as equivalent products by international equity real money managers such as U.S. mutual funds with portfolios across multiple markets because the net value transferred is the same in both structures. The difference relates solely to whether the trade closes out at maturity upon delivery by each party to the transaction of the gross amount (foreign exchange forward) or upon delivery of the net value of the underlying exchange (NDF). As such, prior to the implementation of the SEF rules, foreign exchange spot, deliverable forward and NDFs were commonly traded together on electronic platforms. Although NDFs represent a very small portion (~3%) of the global foreign exchange market, and a much smaller portion than physically-settled foreign exchange forwards represent (~14%)<sup>2</sup>, NDFs are an important tool for market participants, particularly the real money institutional investors served by State Street. The majority of the investment risk associated with both NDFs and deliverable forwards relates to movement in the relevant spot foreign exchange rate.

Despite their economic similarities, physically-settled forwards and NDFs receive different treatment under current U.S. rules. Foreign exchange dealing firms who trade NDFs in volumes above the *de minimis* threshold are required to register as swap dealers, whereas trading the same volumes but only in deliverable forwards does not require registration. In addition, pursuant to footnote 88, electronic platform operators supporting the trading of spot and forward

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<sup>2</sup> BIS, Triennial Central Bank Survey of foreign exchange and OTC derivatives markets in 2016, <https://www.bis.org/publ/rpfx16.htm>; BIS, Non-deliverable forwards: impact of currency internationalisation and derivatives reform, [https://www.bis.org/publ/qtrpdf/r\\_qt1612h.pdf](https://www.bis.org/publ/qtrpdf/r_qt1612h.pdf)

foreign exchange instruments are required to register as SEFs if the forward instruments they support include NDFs, but are not required to register if those forward instruments are only deliverable forwards. The result of this treatment has led to market fragmentation, with U.S. firms being excluded from foreign trading venues that support NDF trading, increased costs to customers due to a decrease in overall market competition, and a decline in liquidity for NDFs in the U.S.

The Proposed Rule would codify footnote 88 while at the same time expand inter-dealer broker and single-dealer aggregator registration requirements, resulting in a wider range of venues prohibiting access by U.S. firms. The effect of these changes would be not only to perpetuate, but also to exacerbate, the existing market fragmentation that puts U.S. market participants at a disadvantage, particularly with respect to the global foreign exchange market and NDF trading. To address the disadvantages that this would impose on U.S. market participants in the global foreign exchange marketplace, we recommend that the Commission clarify that the obligation of a platform operator to register as a SEF solely with respect to its support of NDF activity does not apply until such time as NDFs become subject to a clearing mandate.

Furthermore, we urge the Commission to not introduce new variances between SEFs and multilateral trading facilities (“MTFs”) through the single-dealer aggregator platform registration requirements. For example, it is unclear how these requirements would relate to technology platforms that provide connectivity between interbank market players. If the new requirements result in technology platforms blocking participation by U.S. firms to avoid registration, this will introduce new competitive issues for U.S. firms and further exacerbate the competitive disadvantages faced by U.S. market participants.

### **State Street’s Recommendations:**

- We strongly urge the CFTC to permit multilateral trading platform operators to be exempt from the requirement to register as a SEF solely as a result of their support of trading NDF instruments prior to the implementation of a clearing requirement for such instruments.
- We urge the Commission to not introduce new single-dealer aggregator platform registration requirements.

### ***Preserving U.S. Access to Non-U.S. Foreign Exchange Markets***

The Commission staff has taken the position that trading platforms located outside of the U.S. are required to register as SEFs if they support NDF or other “swap” trading and permit access by U.S. persons<sup>3</sup>, leading to a bifurcation of the global foreign exchange marketplace with non-U.S. foreign exchange platforms prohibiting U.S. persons from accessing their platforms to the extent they support NDF trading. As an alternative to our recommendation above to exempt trading platforms from SEF registration requirements solely as a result of supporting NDF trading prior to such instruments becoming subject to a clearing mandate, we recommend that foreign branches of U.S. banks be permitted to access non-U.S. trading platforms for the purpose of trading NDFs without requiring those platforms to register as SEFs.

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<sup>3</sup> See CFTC Division of Market Oversight, “Guidance on Application of Certain Commission Regulations to Swap Execution Facilities” (Nov. 15, 2013) at 2.

While a foreign subsidiary of a U.S. bank may not be considered a U.S. person, foreign branches of U.S. banks are considered U.S. persons under staff guidance<sup>4</sup> and have been excluded from accessing foreign trading platforms. As such, U.S. banks, particularly custody banks, conducting foreign exchange activities using a bank branch structure to, among other things, seek to efficiently manage their risk, margin and capital activities, are disproportionately affected by the market fragmentation issues referenced above. Consequently, consistent with Commission guidance permitting foreign entities to trade with foreign branches of U.S. banks without triggering swap dealer registration requirements on those foreign entities<sup>5</sup>, we recommend that the Commission permit foreign branches of U.S. banks to access non-U.S. foreign exchange trading platforms without requiring those platforms to register as swap execution facilities.

### **State Street's Recommendation:**

- As an alternative to our recommendation under the section entitled "Codification of Footnote 88 and Expansion of SEF Registration Requirements", we urge the Commission to permit foreign branches of U.S. banks to access non-U.S. foreign exchange trading platforms to trade NDFs without requiring those non-U.S. platforms to register as SEFs.

### ***Pre-Execution Communications***

The proposed pre-execution communications ban is unnecessary and costly and would likely hinder liquidity and price discovery in the swaps market. Off-SEF pre-execution communications are already subject to regulatory oversight. For example, market participants are subject to reporting and recordkeeping requirements<sup>6</sup> as well as audit trail requirements. In addition, the proposal fails to account for the increased costs for SEFs to develop communications systems and monitoring activities, which will likely lead to a decreased number of SEFs that can meet the new requirements.

Furthermore, the broad scope of the pre-execution communications ban could negatively impact liquidity by limiting market color discussions off-SEF. Market color discussions are mostly accomplished through phone conversations. Requiring these discussions to be completed on-SEF would be counterproductive in terms of efficiency and effectiveness. We agree with many industry perspectives that limiting discussions between dealers and clients will hinder dealers' abilities to provide better pricing to clients and hinder the buy-side's access to important information to evaluate trade decisions to best achieve their investment goals.

We also note the importance to preserving bilateral off-SEF pre-execution communications to pre-arrange block trades, which involve a variety of pricing factors and negotiation elements. If proposed changes are finalized and market participants cannot pre-negotiate block trades off-

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<sup>4</sup> See Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45,292, 45,315 (Jul. 26, 2013).

<sup>5</sup> See Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45,292, 45,324 (Jul. 26, 2013).

<sup>6</sup> Swap dealers are required to maintain records of pre-execution communications under Part 23 of the CFTC regulations. See 17 C.F.R. § 23.201(a).

SEF, it would represent a change in the current business model, as most market participants would not be comfortable with having to request for quote for multiple, block transactions.

In addition to the impact on market liquidity, this aspect of the new proposal would counteract other CFTC efforts to promote cross-border harmonization. The pre-execution communications ban would increase conflict with foreign jurisdictional requirements. For example, it is inconsistent with the rules governing MTFs, many of which have received exemptive relief from the CFTC. Furthermore, it will likely drive market participants to prefer to trade on an MTF, rather than a SEF, to avoid pre-execution limitations when pre-arranging large block trades, creating competitive disadvantages for U.S. persons and U.S. SEFs.

### **State Street's Recommendations:**

- We urge the Commission to not move forward with its proposed framework to force pre-execution communications to occur on SEFs.
- Additionally, we emphasize the importance of permitting block transactions to be executed either on or away from SEFs.

### ***Additional Aspects of the Proposed Rule***

*Requirement for Annual Update and Submission of Exhibit Q.* We recognize the importance of ensuring ongoing monitoring and mitigation of operational risk for SEF operators. We disagree, however, with the proposed requirement for SEFs to annually update and submit Exhibit Q to the Form SEF because the administrative and cost burden imposed by such requirement outweighs the potential benefit of the additional information disclosure.

The documentation requirements for completion of Exhibit Q are extensive and detailed. Therefore, annually reviewing and confirming this information will require expenditure of significant resources of SEFs without regard to the materiality of the information being reviewed and updated. Current rules already require SEFs to periodically test operational systems and prepare written enterprise technology risk assessments (the "ETRA"), which identifies and prioritizes operational risks based on the results of such testing. The current rules also require the annual report of the Chief Compliance Officer submitted to the CFTC to include a discussion of the operational resources dedicated to the SEF's compliance with regulations. Furthermore, SEFs are already obligated under § 37.1401(e) to report events and planned changes that materially impact or are expected to impact the SEF's systems and operations. The CFTC has broad authority to request documentation and information from SEFs, including with respect to operational and technological systems of the SEF. Therefore, the annual update and submission of Exhibit Q will not result in provision of substantial, material, new information to that which is already required to be provided to regulators under the current regulations.

### **State Street Recommendation:**

- We urge the CFTC to not move forward with the requirement to annually update and submit Exhibit Q.

*Error Trade Reporting.* We support the proposal to allow each SEF to establish its own error trade protocols and processes that are customized and appropriate in consideration of each SEF's market and operational processes and capabilities. However, we do not support adoption of the requirement to provide notification to all market participants of review of, and determination with respect to, error trades. Instead, we would propose that SEFs should be

allowed discretion to determine their own error trade reporting policies as appropriate for their markets, provided that such policies must be disclosed and transparent to market participants.

**State Street Recommendation:**

- We support allowing SEFs to establish error trade protocols and processes while allowing SEFs discretion to determine their own policies.

*Elimination of Permissible Methods of Execution:* We support the elimination of restrictions on permissible methods of execution for SEF transactions. The proposal to allow SEFs flexibility in establishing trading protocols will allow SEFs to establish and develop execution methods that are appropriate for the market for the swap and the SEF's participants.

**State Street Recommendation:**

- We support eliminating restrictions on permissible methods of execution for SEF transactions.

*Selection of Regulatory Service Providers:* We support the proposed expansion of SEFs' discretion in selecting third-party regulatory service providers. We concur with the CFTC that this proposed amendment encourages expansion of the service provider market which may also result in more competitive rates for regulatory services and resultant reduction in operational costs for SEFs<sup>7</sup>.

**State Street Recommendation:**

- We support expanding SEFs' discretion in selecting third-party regulatory service providers.

**Conclusion**

State Street appreciates the CFTC's interest in attracting greater liquidity formation on SEFs. We appreciate the Chairman's comments in his 2018 Cross-Border White Paper: "End the current bifurcation of the global swaps markets into separate U.S. person and non-U.S. person marketplaces by exempting non-U.S. trading venues in regulatory jurisdictions that have adopted comparable G20 swaps reforms from having to register with the CFTC as swap execution facilities, thereby permitting such jurisdictions to each function as a unified marketplace, under one set of comparable trading rules and under one competent regulator."

State Street views addressing the treatment of NDFs as critical to ending the current bifurcation of the market. We urge the CFTC to address cross-border reforms, specifically by issuing trading venue equivalence or exemptive relief for other jurisdictions, prior to expanding registration requirements on cross-border trading. Rather than issuing trading venue exemptions by listing specific platforms, we recommend issuing equivalence determinations on a jurisdictional basis. We recommend that the CFTC explore issuing equivalence in the following jurisdictions: Australia, Canada, European Union, United Kingdom, Switzerland, Hong Kong, Japan, Singapore, and Korea.

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<sup>7</sup> See proposal 62004.

## STATE STREET.

We look forward to providing additional background and perspectives related to the impact of the proposed approach on the foreign exchange market. Please feel free to contact me or Joe Barry at [jjbarry@statestreet.com](mailto:jjbarry@statestreet.com) should you wish to discuss State Street's submission in further detail.

Sincerely,

A handwritten signature in black ink, appearing to read "Stefan M. Gavell". The signature is fluid and cursive, with the first name being the most prominent.

Stefan M. Gavell