



March 15, 2019

Mr. Christopher Kirkpatrick, Secretary
Commodity Futures Trading Commission
1155 21st Street, NW
Washington, DC 20581

RE: Proposed Rule #RIN 3038–AE25 – Swap Execution Facilities and Trade Execution Requirements

Dear Mr. Kirkpatrick:

Derivative Path, Inc.¹ (“DPI”) appreciates the opportunity to submit comments to the Commodity Futures Trading Commission (CFTC or “Agency”) on the proposed rule for Swap Execution Facilities (SEFs) and Trade Execution Requirements.² We commend the Agency for reviewing and considering changes to the current SEF rules and trade execution requirements post adoption. We appreciate and support the Agency’s main goals of promoting competition, transparency, fairness, liquidity and efficiency. However, we believe that an overhaul of the SEF rules, as proposed, will negatively impact swaps-only Introducing Brokers such as DPI along with non-Swap Dealer banks because the Proposed Rule will complicate and make more expensive the delivery of simple, small volume interest rate derivatives for regional and community banks. Therefore, we ask the Agency to consider our views expressed here, and implore you to consider market participants like us along with the often-forgotten regional and community banks’ participation in the derivatives market when drafting the final rules, ensuring that you provide clarity for ease of compliance with the upcoming regulation.

I. Background

DPI is a swaps-only Introducing Broker and a member of the National Futures Association (NFA). As such, DPI engages in soliciting or accepting orders for the purchase or sale of swaps and does not accept any money, securities or property to margin, guarantee, or secure any trades or contracts that result or may result therefrom.³ DPI, as a swaps-only Introducing Broker, provides a critical function to the regional and community banking industry by supporting the banks’ execution and management of over-the-counter interest rate transactions. Not only does DPI help facilitate a bank’s direct access to some of the largest Swap Dealers in the United States, we also provide a critical service to assist the small financial institution in administering back-to-back swaps programs so that the institution can

¹ Derivative Path, Inc. is headquartered in the San Francisco Bay area, with additional offices in New York City and Chicago. We provide a solution to assist financial institutions end users in executing and managing their over-the-counter interest rate derivative transactions. The team is comprised of derivative industry veterans who have worked for some of the world’s largest capital market firms.

² *Swap Execution Facilities and Trade Execution Requirements*, 83 Fed. Reg. 61946 (Nov. 30, 2018). (“Proposed Rule” or “Proposal”)

³ See CEA Section 1a(31).

provide derivatives access to their commercial borrowers in need of interest rate risk protection products. In our role, we help new and existing swap participants understand how to use derivatives to accomplish their risk management objectives, ensure that the institution and their clients understand the risks inherent in derivatives transactions, train banks on the swap execution process, help banks monitor and evaluate market movement to better manage their own balance sheet, and aid the banks and their commercial borrowers with understanding and complying with swaps regulations. The majority of regional and community banks we service fall under the small financial institution exemption from clearing.⁴ According to the Agency, 99% of small banks, savings associations, farm credit system institutions and credit unions are eligible to elect against clearing swaps that hedge or mitigate their commercial risk.⁵ Our financial institution clients utilize derivatives exclusively to help their eligible commercial borrowers manage interest rate risk or to manage their own balance sheet. They do not enter into derivatives for speculative or trading purposes. The types of transactions DPI is facilitating for regional and community bank execution typically trade in small lots relative to the institutional market, typically with starting notional amounts varying from \$1mm to \$50mm. These hedging transactions also often have non-standard tenors, amortization and sometimes option-based features, reflecting the terms of the underlying loan being hedged, that make them off-the run transactions and therefore reduce their liquidity and ability to be standardized in the market. For this reason, the largest SEFs in the industry have not invested in accommodating these transactions on their platforms. As such, DPI services a unique, and often overlooked segment of the market for execution and product support. The type of client DPI assists is not the mainstream derivatives participant that brings large volume and increased risk to the market.

The existing rule related to SEF requirements does not currently require DPI to register as a SEF. Under the existing rule, no person may operate a facility for the trading or processing of swaps unless the facility is registered as a swap execution facility.⁶ CEA Section 1a(50) defines the term “swap execution facility” as a “trading system or platform in which multiple participants have the ability to execute trades or swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility, that (a) facilitates the execution of swaps between persons and (b) is not a designated contract market.”⁷ Any entity that fits within this definition must register as a SEF with the CFTC, unless the CFTC grants an exception.⁸ When the Agency adopted the existing SEF rule, it determined that voice brokerage services were not required to register as a SEF because such telephonic negotiations do not provide for multiple-to-multiple execution or trading; therefore, Introducing Brokers such as DPI were not in scope for the regulation as it was intended in 2011 since we operate as a voice platform.⁹ There, the existing SEF rules intended to capture multiple participants’ ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system.¹⁰ The existing rule was not intended to encompass single-dealer platforms, many of which service the regional and community bank community.

⁴ See 17 CFR § 50.50(d).

⁵ *End-User Rule*, 77 Fed. Reg. at 42579.

⁶ CEA Section 5h(g).

⁷ CEA Section 1a(50).

⁸ See CEA Section 5(h).

⁹ See *Core Principles and Other Requirements for Swap Execution Facilities*, 76 Fed. Reg. 1214, 1219 (Jan. 7, 2011).

¹⁰ *Id.*; See also CEA Section 1a(50).

The Proposed Rule reverses the Agency's view on a number of different SEF requirements in the existing SEF rule that would impose an undue hardship on the way DPI and its community and regional bank clients conduct derivatives business. The Proposal requires all voice brokers to register with the CFTC as a SEF.¹¹ Furthermore, the Proposed Rule expands the scope of mandatory clearing requirements that would put a financial and operational strain on the segment of our bank clients who barely fall above the \$10 billion asset limit for the small financial institution clearing exception. Finally, the Proposal provides an insufficient amount of time for minor participants in the derivatives market to become compliant with the new regulation. If passed as it is currently written, the Proposal will create many impediments that will limit DPI's ability to provide this critical function to small financial institutions. Additionally, the Proposed Rule would create more inefficiency and reduce fairness for much of our client base. Below, we discuss why we believe certain aspects of the Proposed Rule would create a hinderance and not promote the Agency's goals as it relates swaps-only Introducing Brokers and to community and regional banks.

II. Expanded SEF Registration Requirement

DPI postulates that swaps-only brokers who service regional and community banks should be exempt from SEF registration under the Proposal. DPI primarily services regional and community banks who fall under the small financial institution clearing exception.¹² Therefore, the majority of the trades that DPI facilitates for execution are not cleared. While the Proposal expands the mandatory SEF requirement to all cleared trades, the vast majority of trades DPI assists with for execution do not fall under the proposed mandatory SEF requirement.¹³ Accordingly, it is logical to exempt swaps-only Introducing Broker firms who assist small financial institutions who qualify for and utilize the trade clearing exception from registering as a SEF themselves, since the clients served would be exempt from the SEF execution requirement. We feel the Proposal does not recognize this distinction for firms who service regional and community banks, therefore we ask the Agency to consider drafting an exclusion from SEF registration for firms like DPI, swaps-only Introducing Brokers, so that we may continue to service regional and community banks without incurring burdensome additional operational and financial cost.

DPI also services a number of community banks who do not benefit from the small financial institution clearing exception. However, we believe that alone should not be enough to require us to register as a SEF. Some of our bank clients have total assets that do exceed the \$10 billion threshold; therefore, they are required to clear. DPI provides consulting and execution services to these larger community banks in the same manner as they do for the small financial institutions exempt from clearing. In fact, many of these bank clients were previously exempt from clearing, but due to growth and expansion, they migrated across the \$10 billion threshold. Even though they are now required to clear, the types of transactions DPI supports for these banks are nearly always the same off-the-run transaction structures previously described that have non-standard tenors and contain amortization and option features that make them less liquid in the market and are not made available to trade (MAT). While we will discuss later in this letter why we disagree that these banks should be required to execute all cleared transactions on a SEF, we continue to focus on DPI's SEF registration requirement in light of the fact that we do support a subset of clients who are required to clear. Hypothetically, even if this fragment

¹¹ See 83 Fed. Reg. 61946 at 61952 and 61959.

¹² CFTC Regulation 50.50(d) or CFTC Staff No-Action Letter 16-01; Section 2(h)(7) of the CEA.

¹³ See supra note 11.

of the regional and community banking market were required to execute non-MAT, cleared transactions on a SEF, we see no reason why DPI should register as a SEF itself when we can simply assist this client base with accessing a registered SEF. The Agency should take into consideration the consulting value DPI provides to its clients, including helping our clients remain in compliance with regulations. We think the approach of assisting clients with accessing a SEF, where required, as opposed to requiring us to register as a SEF ourselves, promotes the same goals and objectives in the Agency's Proposal, without imposing undue strain on DPI. The regulatory oversight DPI receives from the CFTC and NFA today as a licensed Introducing Broker is sufficiently robust and complete – there is no added benefit or market protections derived from forcing us to also register as a SEF.

III. Expanded Mandatory SEF Trade Execution Requirement

It is burdensome financially as well as technologically for regional and community banks who exceed the small bank clearing exception threshold, but are not currently trading MAT derivative transactions, to sign up to a SEF. Regional and community banks are not in the day-to-day business of trading swaps. Swap transactions are an ancillary part of their core banking business of deposit gathering and lending. Swap products are either used to hedge their balance sheet or are offered to their end-users in the course of providing floating rate business loans as a means for their end-user borrowers to hedge or mitigate risk. These banks are not entering into interest rate swap transactions for speculative purposes. In the current state, it is already a significant undertaking and financial strain for these types of banks to comply with the existing clearing requirements. They have to spend fees -- typically ranging from \$10,000 to \$20,000 per month -- and post increased amounts of margin to access and utilize FCMs to access the cleared markets. All the while, these banks are participating in a tiny fraction trading activity / volume that does not justify the large fixed fees and increased margin interest costs they pay to FCMs. The majority of trading that these banks engage in tend to have small notional amounts (\$1mm - \$50mm) compared to the overall swap market averages. The trading frequency of these institutions is nearly undetectable in comparison to the overall annual market trading count. Adding the requirement for this end user, non-speculative segment of the derivatives market to additionally become a SEF member and execute on a SEF will impose greater operational and financial burden on these institutions, all for the sake of addressing a nearly non-existent source of risk within the overall market activity. DPI feels that the foregoing factors, including low trading volumes, bespoke nature of the transactions, and currently robust regulatory oversight for this segment outweigh the need to impose an additional hardship on community banks by requiring that they execute all cleared trades on a SEF. If the rule were to be implemented as proposed, some community banks may completely shut down this type of hedging activity thereby choosing to take significant duration risk on their either own balance sheet or transferring such duration risk to their borrowers by forcing them to remain floating on their borrowings.

IV. Timing for Compliance

Finally, the time permitted for compliance with the final rule as stated in the Proposal is an unreasonably short and unrealistic time allowance. If passed in its current state, the Proposal gives counterparties who are not included in the Category 1 or Category 2 designation 270 days to comply with expanded trade execution requirements.¹⁴ Nine months provides insufficient time for DPI or our impacted regional and community bank clients to implement SEF connectivity,

¹⁴ *Id.*

especially since major SEFs are not motivated to facilitate such connectivity with market participants with smaller traded volumes today. As the Agency has experienced with implementation of prior regulation requiring an overhaul of infrastructure, larger institutional players in the market receive outsized priority from the vendors involved with providing the services required for compliance with the regulations. “Other counterparties” do not receive the attention to properly establish the relationship necessary to be compliant with the regulations. Often times, the Agency is faced with extending deadlines and issuing No-Action Relief for parties who are having difficulty receiving the necessary services to comply with the rules. Given the drastic changes in the Proposal overall, SEFs will be overwhelmed adapting to the new rules in addition to onboarding new members who need them to meet the requirements. Our clients are unlikely to get the support they need, especially in light of industry adaptation to the new regulation. Therefore, we request that the Agency consider expanding the time allotted to comply with the new regulation be expanded to at least 18 months for swaps-only Introducing Brokers and community and regional banks, should fuller relief as per Sections II and III above not be forthcoming.

V. Conclusion

We appreciate the Agency’s consideration and attention to our comments. We respectfully ask that you consider our concerns for the major components of the Proposal that would most severely disadvantage regional and community bank participants and the swaps-only Introducing Brokers who support their efficient access to the derivative marketplace:

- Expanded SEF-registration requirement should not include swaps-only Introducing Brokers
- Expanded Mandatory SEF trade execution requirement should not apply to community and regional banks that clear
- The proposed compliance window for final rule compliance is unreasonably/unrealistically short and should be extended

We look forward to the Agency taking our concerns into consideration as it plans future market reform for our shared goals of promoting competition, price efficiency and market transparency.

If you have any questions on our comment letter, please feel free to contact me, Steven Hawk, Co-CEO, or Pradeep Bhatia, Co-CEO at (415) 992-8200.

Sincerely,

/s/ Melanie Wheeler

Melanie Wheeler
General Counsel and Chief Compliance Officer