



Via CFTC Comments Portal
March 15, 2019

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

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

Dear Mr. Kirkpatrick:

T. Rowe Price Associates, Inc. and its affiliates ("**T. Rowe Price**") serve as investment advisers to numerous individuals, institutions and investment funds, including mutual funds, common trust funds, UCITS, pension plans and other investment funds and products. As of January 31, 2019, T. Rowe Price managed approximately \$1.04 trillion in assets.

T. Rowe Price, on behalf of the funds and accounts that it manages, regularly executes swaps on swap execution facilities ("**SEF**"). As an active market participant, T. Rowe Price has a vested interest in the optimal functioning of the swaps markets as it seeks to obtain best execution on behalf of its clients. In our experience, the SEF execution mandate has brought about many benefits for the investors in our funds in that it has led to decreases in bid/ask spreads, transaction costs, operational risk and documentation requirements while increasing transparency, price discovery, available counterparties to trade with and speed of execution. For these reasons, we approach the above-referenced proposal¹ ("**Proposal**") with caution as we are concerned that such a fundamental overhaul of the SEF regulatory regime, proposed to be undertaken within merely 5 years of its inception, may reverse these benefits and introduce added uncertainty into the markets. However, the Proposal also introduces numerous positive changes that we support, most importantly, the retraction of the "made available to trade" process as well as the proposals in areas of SEF financial stability, risk monitoring, governance and the definition of "market participant".

¹ *Swap Execution Facilities and Trade Execution Requirement*, 83 Fed. Reg. 61946 (Nov. 30, 2018).

In this letter, we discuss aspects of the Proposal where we either disagree with the Commodity Futures Trading Commission's ("*Commission*") approach or offer suggestions on how to improve its various initiatives.

In short, we propose that:

- methods of execution should be evaluated and determined against liquidity characteristics of swaps and that a concerted regulatory push towards order book execution should be conducted;
- at least two SEFs should be required to list a swap before it becomes subject to the trading obligation;
- more discretion for SEFs regarding error trade policy should not come at the cost of retracting the void *ab initio* concept;
- the Commission should not change its guidance that breakage agreements represent an impermissible impediment to impartial access; and
- the Commission should not change its current approach with respect to block trade execution.

Below we discuss our views in greater detail.

Methods of Execution

The Commission is proposing to allow SEFs to offer any method of execution for Required Transactions² and not be limited to the currently mandated request for quote to three counterparties ("*RFQ3*") and Order Book functionality.³ The primary rationale for the proposal is that with the increased number of swaps that are anticipated to fall under the SEF execution requirement, more execution options are necessary to accommodate the various liquidity characteristics of the new swaps. In the words of the Proposal, "many episodically liquid swaps. . . will become subject to the trade execution requirement".⁴

The Proposal, by adopting a reform-minded approach, has opened the question on the direction in which the swaps markets should be headed and the role the Commission should play in steering the markets'

² As provided by the CFTC regulations, these are swaps that are required to be executed on SEFs.

³ This term is defined in the CFTC regulations as "trading system or platform in which all market participants have the ability to enter multiple bids and offers, observe or receive bids and offers entered by other market participants, and transact on such bids and offers." It is also commonly referred to as "CLOB", meaning a central limit order book.

⁴ *Proposal* at 61980.

evolution. Rather than debating whether a particular mode of execution should be required or not, we believe the more worthwhile goal for the Commission is to adopt a regulatory approach that will ensure that swaps, depending on their liquidity characteristics, are executed on SEFs under the methods that will maximize best execution. The right execution methods will lead to improved price discovery, narrowing of bid ask spreads, increased speed, certainty and operational ease of execution, reduced price impact and decrease in transaction costs. The goal is ambitious and may not be achieved entirely within the present rulemaking but it is worth pursuing. As a first step, which can be achieved presently, we recommend that the Commission encourage the transition of those existing Required Transactions, that are highly liquid and standardized, to execution on SEF Order Books.

While we are in favor of liberalizing execution methods and allowing SEFs more options, we oppose the mechanical removal of RFQ3 and Order Book requirements without a careful consideration of the consequences of that action. RFQ3 has been instrumental in improving the execution quality of cleared swaps for clients of asset management firms. At this time, it is practically the only method of executing swaps on SEFs between dealers and buy side⁵ traders. Even though we don't anticipate a wholesale immediate removal of RFQ3 by SEFs if this proposal were to be adopted, the risk of disruption and negative consequences to the market this would cause is reason enough to argue in favor of retaining the requirement. There is also the added risk that without the requirement, RFQ3 could be gradually phased out due to inherent power imbalances in the market, to the detriment of clients of asset managers and other participants.

As far as Order Books, it is well known that little to no transaction volume in the dealer to customer markets is currently executed via this method. This is not an outcome of some inherent incompatibility of central limit order book execution and swaps trading. On the contrary, we believe that there currently exists a subset of highly liquid and standardized swaps, that are Required Transactions and that could and should be executed on Order Books. In the long run, we are in favor of transitioning as large a segment of the standardized and liquid swaps market as appropriate to clearing and execution on SEF Order Books. We are concerned that were the Commission to remove the Order Book requirement, this transition would be either blocked or seriously impeded.

For that reason, in addition to strongly urging the Commission to retain the Order Book functionality requirement, we also count on the Commission's role as a thoughtful overseer to steer the market towards more a wide-spread adoption of Order Book execution. We are less confident than the Commission that the

⁵ By "buy side", we refer to asset management firms and other market participants that typically trade on the other side of dealers, brokers and other liquidity providers.

swaps market, if liberalized and left to its own devices, will innovate and find the best solutions.⁶ In spite of the real benefits that SEF execution has brought to the buy side - and by extension to the millions of individuals whose savings and pensions are invested in funds and accounts managed by asset management firms like T. Rowe Price - the market has been largely inert since 2014 in terms of innovation and increased efficiency. Since the inception of the SEF execution requirement in early 2014, no new swaps were added to the initial list of “made available to trade” swaps and Order Book execution has not developed in the dealer to customer markets despite being the key mode of execution for most liquid swaps in the dealer to dealer market.

This inertia is prevalent despite the execution dynamics developing naturally that indicate a need to move beyond RFQ3 and to a truly multiple-to-multiple, anonymous execution. For example, we have observed that in the most liquid swaps, SEF execution has forced dealers to compete and one way they do so is by streaming prices. Now, a trader can see prices quoted by several dealers and the most efficient move would be to execute with the dealer that offers the most favorable execution. However, because SEF execution is currently operating under the RFQ3 protocol, the trader is forced to send requests to two additional dealers, thus increasing the risk of information leakage. Had Order Book execution been available, the trader would have been able to execute the trade anonymously and obtain best execution without compromising the integrity of his trading strategy. It would also have eliminated the obvious inefficiency of having to ask two dealers to respond to RFQs which the requester has no intent of acting upon.

These and other developments indicate to us that the most liquid and standardized segment of the swaps market is ready for Order Book execution. As is the case in all areas of economic activity, actors that have market-dominant positions have strong incentives to preserve the status quo.⁷ This is where the role of a thoughtful regulator, as the Commission has proved itself to be, can be most valuable. Mandating RFQ3, although it met with a lot of initial resistance from many market participants, resulted in real benefits for the overall market. By forcing liquidity providers as well as liquidity takers to compete and seek competitive quotes, it resulted in the narrowing of spreads, decreasing operational risk and a more efficient allocation of

⁶ *Proposal* at 61952. “The Commission believes that providing flexibility in execution methods will allow the swaps market to continue to naturally evolve and allow SEFs to innovate and provide more efficient, transparent, and cost-effective means of trading and execution.”

⁷ As succinctly stated by Professor Darrell Duffie, (whose argument regarding dealers’ incentives with respect to futurization of swaps equally holds for order book execution on SEFs) “[a] small number of big dealers have had an effective oligopoly in the intermediation of OTC derivatives markets. According to International Swaps and Derivatives Association data for 2010 assembled by David Mingle, 82 percent of the notional outstanding value of OTC derivatives globally was held by the largest 14 dealers. In the U.S., the top 5 dealers maintain 95.5 percent of the total derivatives positions held by U.S. banks and their affiliates, according to statistics provided by the Office of the Comptroller of the Currency. At least until recently, significant intermediation profits for dealers in OTC derivatives have been made possible in part by the relative opaqueness of OTC markets. Because of this, dealers did not have much incentive to encourage the futurization of swaps.” See Commentary by Darrell Duffie on Futurization of Swaps, Bloomberg Government, January 28, 2013, available at https://www.darrellduffie.com/uploads/policy/DuffieBGOV_FuturizationOfSwaps.pdf.

costs and resources. Given the initial resistance, it is fair to ask if RFQ3 would have been this widely adopted without the compulsive force of the Commission's regulations.

In the same way that RFQ3 played a role in transitioning swap execution from the bilateral, "over the counter" model to an electronic marketplace, we believe that the next phase of innovation and regulatory action should be directed towards enabling Order Book execution of the most liquid and standardized swaps. This does not mean that we are advocating for a forcible transition of the entire swaps market to order books. Rather, the liquidity profile of a swap is the best indicator of what the appropriate execution method should be. For that reason, we encourage the Commission to work with all types of market participants to solicit data and opinions in order to define objective liquidity and other criteria that could be applied to mandate execution of the most liquid swaps on SEF Order Books. The experience and practice of inter-dealer execution platforms that currently maintain vibrant CLOB marketplaces would be invaluable here, as well as views of non-traditional liquidity providers, asset managers, corporates, institutional traders and other market participants. The result would be a reliable methodology that would be applied to define a subset of liquid swaps for mandatory execution on SEF Order Books.

To conclude with a view that underpins our entire approach to the Proposal, we believe that SEF reform should be approached with the goal of achieving the most efficient markets possible. Efficient markets mean fair markets, where no actor occupies an unduly dominant position without providing value in exchange and where execution and transaction costs are proportionately allocated among participants, commensurate to their roles. In the swaps market, the large dealers have traditionally held market-dominant position and the advent of mandated SEF execution undoubtedly began to erode that power. To be clear, the market dominant position of the dealers was mostly justified and necessary in the early days of the swaps market. In those times, due to the novelty, uncertainty, illiquidity and immaturity of the market as well as the low number of participants, dominant liquidity providers were essential in lifting that market off the ground and they may have justifiably commanded a disproportionate claim on the overall value that was created. However, the markets have since evolved and a different paradigm should be the goal for the next phase of innovation. In the trading of swaps that are highly standardized and liquid and where traditional roles of liquidity providers and takers are blurred, that paradigm is an electronic anonymous marketplace offering transparency, speed, certainty and efficiency of execution.

As an asset management firm to whom many individuals have entrusted their hard-earned savings to invest, we have an obligation to our clients to ensure that we execute swaps used to hedge risks and implement investment strategies at an optimal cost. We believe that preserving RFQ3 and Order Book functionality, applying a concerted effort to transition highly standardized and liquid swaps onto Order Books and at the

same time allowing SEFs to introduce other appropriate methods of execution is the right way towards achieving the goal of efficient markets.

Determination of Swaps Subject to the Trading Obligation

The Commission is proposing to remove the current voluntary “made available to trade” (“*MAT*”) process and provide that all swaps required to be cleared would automatically have to be traded on a SEF if a single SEF lists them.

All else being equal, T. Rowe Price believes that more cleared swaps should be traded on SEFs and we support this proposal. However, we would like to draw the Commission’s attention to two points that should be addressed to enhance this process.

In describing the liquidity characteristics of swaps that could become subject to the trading requirement under the Proposal, the Commission states that “the markets for many of these swaps may consist of only a few trades per day or, in some cases, a few trades per month.”⁸ Even though the Commission was stating this in support of its proposal to liberalize execution methods, a question should be asked whether any swap that trades few times a month is suitable for either clearing or for execution on a multiple-to-multiple trading venue. No swaps that are currently mandated for clearing nearly approach those levels of illiquidity. However, especially given the current proposal to discard the *MAT* process, we urge the Commission to evaluate future clearing determinations through the perspective that the clearing and trading mandates are now being equalized.

By removing the *MAT* process, the Proposal shortens or nearly eliminates the time lag between effective dates of the clearing and trading obligations. This accentuates a weakness in the current *MAT* process, namely that listing of a swap on a single SEF is sufficient to trigger the trading obligation. We recommend that before the entire market can be bound to execute a particular swap on SEFs, at least two SEFs should be determined to have listed the swap in question. This would ease the burden for asset management firms and other entities of having to connect to and become “participants” on many different SEFs. Currently, most firms trade predominantly on one SEF and may be participants on one or two additional ones. Requiring at least two SEFs to list increases the chance that a market participant is already connected to a SEF that introduces a new swap to the list of Required Transactions.

⁸ *Proposal* at 61981.

The Commission proposes to allow SEFs the discretion to decide how to resolve trades that have been rejected for clearing, including whether to continue to apply the void *ab initio* concept. In the Commission’s words, the “proposal would explicitly permit a SEF to establish its own rules regarding error trades rejected from clearing, which the Commission believes would facilitate a SEF’s ability to establish its own error trade procedures that it believes is best suited to its particular market, including whether to maintain an approach based on the void *ab initio* concept for trades rejected from clearing due to non-credit related errors.”⁹

We agree in principle that giving SEFs more discretion to resolve error trades is a worthwhile aim, but we urge to Commission not to abandon the void *ab initio* concept to achieve it. In establishing the void *ab initio* approach, the Commission has correctly reasoned that:

The price of a swap depends, in part, on whether it is intended to be cleared. Consequently, if a swap that is intended to be cleared is rejected, a material term to the contract is unfulfilled. Therefore, the Divisions believe that any trade that is executed on a SEF or DCM and that is not accepted for clearing should be void *ab initio*.¹⁰

Further, the Commission has rightfully concluded that treating rejected trades as void *ab initio* “obviates the need to have so-called ‘breakage agreements’ between market participants and . . . [that] [t]he imposition of such agreements would be an impairment to impartial access to SEFs.”¹¹ Accordingly, the Commission has instructed SEFs, FCMs and swap dealers not to require breakage agreements as a condition for access to trading on a SEF.

This guidance has brought about significant benefits for asset management firms and other non-dealer market participants by easing the operational and legal burdens that would be implicated by a contrary approach. The guidance also furthers the statutory goals of the Dodd-Frank Act to promote execution of swaps on SEFs since it ensures impartial access to all participants. Because breakage agreements such as ISDA master agreements and cleared derivatives execution agreements cannot be required as a condition to access SEFs, asset management firms now can execute a swap (intended for clearing) on a SEF with any counterparty, regardless of whether it has an ISDA agreement with that counterparty. Thus, many more execution options

⁹ *Proposal* at 62001.

¹⁰ CFTC: *Staff Guidance on Swaps Straight-Through Processing*, September 26, 2013.

¹¹ *Id.*

for asset managers are created which helps them fulfill their fiduciary duty of best execution owed to their clients. This is also the correct legal outcome since an ISDA agreement is inappropriate to govern a cleared swap that is executed on a SEF, since the clearing house is interposed between the counterparties and they don't have any direct exposure to each other. ISDA agreements are intended for OTC execution where the initial two counterparties to the trade continue to have credit exposure and contractual obligations to each other during the life of the trade.

It is important to note that the benefits of impartial access described above inure to the market as a whole as they enhance price discovery and liquidity. They are reason enough for preserving intact the current Commission's guidance on void *ab initio* and breakage agreements. It is difficult to envision any possible improvements that may be achieved by providing SEFs more "discretion" in their error trade policies that would outweigh these benefits. As an active SEF participant since the inception of the SEF trading obligation, we have not experienced any incidents that would lead us to question the viability of the current SEF error trade procedures. Errors are generally resolved effectively and with minimal disruption and we don't see this as an area in need of any fundamental restructuring.

In addition, granting more discretion to SEFs on error policies could be accomplished without any changes to the void *ab initio* concept for a great proportion of trade error scenarios. For errors that are discovered before a trade is submitted for clearing, the void *ab initio* concept would not even be implicated because it would not have been submitted for, let alone rejected from, clearing. Similarly, for resolving error trades that have already cleared, the void *ab initio* concept would not be a hindrance because the trade was not rejected for clearing. The only possible implication then is for trades that have been rejected from clearing because of an error not related to credit reasons. First, that scenario is unlikely since a DCO could hardly spot an error in terms upon which to reject a trade as it would not know the intent of the parties. But even if this happens on occasion, voiding the trade and asking the parties to resubmit, which can typically happen in a matter of minutes if not seconds, is not that heavy of a burden to justify removing the void *ab initio* concept and opening the door to the breakage agreement requirement.

We urge the Commission not to reverse its existing guidance as it has brought about significant benefits to non-dealer SEF participants and enhanced market liquidity.

The Proposal intends to change the way block trades are executed. It wants to (1) require SEFs to prohibit its participants from engaging in pre-execution communications away from its facility, including negotiating or arranging the terms and conditions of a swap prior to its execution on the SEF; (2) eliminate the “occurs away” requirement for swap block trades and (3) require block trades to be executed on a SEF’s trading system or platform. The Commission is counting on the flexible execution methods espoused by the Proposal to mitigate the impact to price. “For example, the Commission believes that allowing SEFs to use flexible means of execution for swap transactions negates the need to allow swap block trade execution to occur away from SEFs.”

We oppose the changes advocated here and especially the prohibition of pre-execution communications. The Commission argues that “submission of trade terms negotiated or arranged via direct communications between participants, e.g., a swap dealer and a client, away from a SEF allows liquidity formation to occur outside of the SEF regulatory framework, which undermines the statutory SEF goals.”¹² However, the Commission is basing most of these arguments on its observations of the dealer to dealer markets or on execution of swaps on SEFs that are not subject to the trading requirement. It has not sufficiently considered the portion of the executions that represent block trades.

The main benefits of current CFTC regime with respect to block trade execution are well understood. Currently, buy side traders are allowed to negotiate privately with dealers to execute large size trades in order to avoid undue price impact and increased transaction costs. These negotiations are extremely sensitive and a trader will often perform detailed market reconnaissance before deciding on the one dealer the trader wishes to approach and where enough trust exists so that sensitive trade information can be revealed. As we understand it, the Commission does not purport to prohibit pre-execution communications altogether but wants them to occur only on SEF trading platforms. In other words, these communications could still occur between two private parties as long as they don’t take place away from a SEF. But, if a negotiation is allowed to remain private, whether it occurs on or off a SEF would make no difference with respect pre-trade price transparency. On the other hand, artificially interposing a SEF between what should be a confidential, private negotiation, only increases the risk of information leakage as this sensitive information becomes accessible to outside parties. As of now, no SEF provides a platform for these types of communications and even if one existed, there is no assurance that the parties’ confidential information would be secure.

¹² *Proposal* at 61987.



We don't agree that a radical disruption of block trade execution, which has been justifiably recognized as deserving special treatment under the current CFTC regulatory regime, advances the statutory goals of promoting SEF execution. SEF execution is promoted by making the markets more efficient and providing an environment in which the greatest number of trades can be executed with minimal price impact. A mere increase in trade count without regard to the negative consequences that any such measure would bring could reverse the important gains in SEF execution quality that have been made in the 5 years since inception of SEFs. In our view, that would run contrary to the goal of promoting SEF execution. For large asset management firms and other market participants that trade in large sizes, the block trade regime has been indispensable in achieving best execution for their clients. The Commission's proposal puts this ability at risk with no tangible benefits to show for it and we urge the Commission to reconsider.

We appreciate your consideration of our views on this significant proposal. If you have any questions or would like to discuss our letter, please do not hesitate to contact Marc Wyatt, Head of Global Trading at (410) 345- 7316, marc_wyatt@troweprice.com or Predrag Rogic, Senior Legal Counsel at (410) 345-4999, predrag_rogic@troweprice.com.

Sincerely,

/s/ Marc Wyatt

Marc Wyatt, Vice President and Head of Global Trading
T. Rowe Price Associates, Inc.

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Predrag Rogic, Vice President and Senior Legal Counsel
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