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By Electronic Submission

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

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

Dear Mr. Kirkpatrick:

Thank you for the opportunity to comment on the proposed amendments to regulations relating to swap execution facilities ("SEFs") and designated contract markets (collectively, the "Proposal"). As an active participant in the swaps market, Two Sigma[1] is concerned that the Proposal would reverse the improvements made in recent years under the current regulatory framework and make the trading of liquid, standardized swaps less transparent, less competitive, and considerably less efficient.

Two Sigma is an active member of the Managed Funds Association and the Alternative Investment Management Association and shares many of the concerns raised in the letters those organizations have filed. However, Two Sigma is writing separately to further explain its concern with a specific element of the Proposal — the elimination of the requirements that SEFs offer an Order Book or functionality to send a request-for-quote to at least three unaffiliated market participants ("RFQ-3") for all swaps subject to the trade execution requirement.

Two Sigma's approach to trading

Two Sigma's concern with the Proposal is rooted in its approach to trading. Two Sigma trades on behalf of its investors in equities, futures, currencies, and derivatives in over forty countries using a disciplined, systematic approach. Two Sigma's approach to trading involves combining financial markets expertise, massive amounts of data, and world-class computing power in an effort to generate positive results for its investors.

[1] Two Sigma is a family of financial services companies, including three CFTC-registered commodity trading advisors (Two Sigma Investments, LP, Two Sigma Advisers, LP, and Two Sigma Investor Solutions, LP).

The first market in which the firm traded was U.S. equities, and that remains its most active market even after more than sixteen years of expanding into other liquid markets globally. The U.S. equity market is the most data-rich and liquid capital market in the world, providing a level of rapid feedback that makes it very well-suited to the way Two Sigma trades. In keeping with this approach, Two Sigma has expanded into markets that are similarly liquid and data-rich including some liquid, standardized swaps.

Trading costs and structural difficulties engendered by the applicable regulatory framework are very important considerations in Two Sigma's decision about whether (and how much) to trade a given product. If a regulatory structure diminishes pre-trade price transparency in a product, Two Sigma will likely reduce its trading volume in that product. While some firms have an overriding need to trade swaps regardless of their regulatory framework and market structure, Two Sigma does not trade a financial instrument unless it suits the firm's systematic, data-driven, and cost-sensitive approach.

The current U.S. framework for trading liquid, standardized swaps has produced significant benefits

While far from perfect, Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") did succeed in fostering the development of a liquid and transparent market for standardized swaps, where previously no such market existed. As a result of the RFQ-3 and Order Book mandate, the market for many of these standardized swaps now often resembles exchange-listed futures insofar as traders have the benefit of pre-trade transparency in deep, competitive markets with simple execution and central clearing.[2]

To be clear, Dodd-Frank did not succeed by simply requiring standardized swaps to trade on SEF, but rather by also mandating that SEFs provide the types of trade execution functionalities that enhance transparency and competition — specifically, RFQ-3 and Order Books. While we of course would welcome innovative execution methods that provide at least the same level of transparency and competition as RFQ-3, today's regulatory framework has produced tangible benefits that we fear are unlikely to continue without a regulatory mandate for the functionality that is so beneficial to end-users today.

There is significant evidence that RFQ-3 and the Order Book requirements have increased competition and transparency while lowering trading costs for liquid, standardized swaps. The

[2] While certain segments of the swap market have come a long way, some aspects of the current RFQ-3 functionality still disproportionately favor dealers at the expense of end-users and institutional investors even in liquid, standardized swaps. To foster more competitive markets, one recommendation would be to make the RFQ systems request two-sided quotes, instead of forcing end-users and institutional investors to always disclose the side of their trading intent to dealers as part of the RFQ-3 process.

evidence is not fanciful or partial; Two Sigma rigorously conducts its own analysis and has found that transaction costs have gone down as a result of the current regulatory framework. As costs have declined, Two Sigma and likely other market participants have increased their swaps trading, thereby enhancing the depth and liquidity of markets for many types of swaps, creating a virtuous cycle. The Commodity Futures Trading Commission ("CFTC") can justifiably be proud of this accomplishment.

Despite our experience, the Proposal eliminates the Order Book and RFQ-3 requirements, stating that "[w]hile the proposal may result in a reduction of the benefits from the existing system, this cost may be mitigated because every SEF still has the option of offering an Order Book and continuing to offer market participants the ability to submit RFQs to multiple liquidity providers on the SEF." Two Sigma disagrees with this assessment.

Although it might be possible for a handful of the largest end-users and institutional investors to exert sufficient commercial pressure to continue trading through RFQ-3 or a SEF Order Book, it is much more likely that, in the absence of the mandated execution functionalities, the overall market in standardized, liquid swaps will deteriorate.[3] Under the Proposal, pricing is likely to be worse for all market participants with the most significant adverse effect on smaller end-users.

In the pre-Dodd-Frank swaps market, even for larger firms like Two Sigma, pre-trade price transparency and competition between dealers was limited, trade processing and clearing was challenging, and the market did not lend itself to electronic, systematic trading. Unfortunately, the Proposal as it stands today would bring these negatives back into the market because it greatly overestimates the ability of end-users and institutional investors to demand executions via RFQ-3 or Order Books. Even large firms like Two Sigma have limited power to impose trading paradigms on swap dealers, particularly now that the largest 10 dealers represent more than 90 percent of notional amount traded in U.S. swaps markets. Validating this concern, the only new execution method Two Sigma has seen proposed that is not permitted under today's rules is RFQ-1, which would be a clear step backward that diminishes the liquidity and quality of the market for liquid, standardized swaps.

We are also concerned that the proposed amendments to the straight-through processing standards will erode recent accomplishments to reduce systemic risk and improve operational efficiency. The current standards provide market participants with certainty that trades will be cleared quickly, thereby mitigating counterparty risk and increasing flexibility in trading. The Proposal, however, puts those important benefits at risk by eliminating timing thresholds to submit trades for clearing and by no longer declaring all trades rejected for clearing as *void ab*

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[3] As explained by Commissioner Berkovitz, without a mandate for RFQ-3, "dealers could undermine the effectiveness of the RFQ process by offering incentives to trade on single-dealer platforms or voice-brokered SEFs."

initio. These proposed changes may well assist SEFs in handling trades in illiquid, non-standardized swaps, but they will also undermine markets for liquid, standardized swaps and make them less competitive and operationally inefficient.

The current SEF regime is not one-size-fits-all — and that's not a problem

Instead of highlighting the CFTC's success in fostering SEF trading and competitive markets for standardized swaps, the Proposal centers on the perceived failures of the Dodd-Frank regime to facilitate SEF trading in the illiquid, non-standardized segment of the swaps market. But in Two Sigma's view, it is not a problem that the mandated functionalities of SEF trading are best suited for liquid, standardized products. This is the basis for the current distinction between swaps that are "Made Available to Trade" and "Permitted Swaps," which in our view reflects the common-sense idea that different minimum regulatory requirements can apply to swaps with markedly different liquidity profiles.

The Proposal rightly states that the products subject to mandatory SEF trading "are generally the most standardized and liquid swaps contracts," which reflects the CFTC's success in managing the made-available-to-trade process to ultimately focus on the most active segment of the market. However, the Proposal seems to purport that the relatively limited ***types*** of swaps subject to mandatory SEF trading is a negative as it has "limited the amount of trading and liquidity formation occurring on SEFs." We do not share this concern. SEFs currently facilitate trading in liquid, standardized swaps that are of great importance to investors and the U.S. economy more broadly.[4]

The Proposal aims to remedy the fact that many ***types*** of swaps are not well-suited for the current SEF regime by eliminating key minimum requirements that have made SEFs so useful for trading liquid, standardized swaps — and which Two Sigma would argue have caused the overall total ***number*** of swap contracts traded on SEF to go up. The Proposal's recommendation to move to a lowest-common denominator SEF regime, while nominally aimed at increasing the ***types*** of swaps traded on SEFs, will remove beneficial elements of market structure for the most active part of the swaps market, likely leading to a decrease in the total ***number*** of swaps traded on SEF. In short, the Proposal seems to prioritize encouraging the less liquid segment of the swaps market to execute on SEFs by weakening the SEF regime, at the expense of, and without recognizing the deleterious effects that doing so would have on, the vital instruments that are trading well on SEFs today.

[4] In 2018, approximately 78.8 percent of the notional amount of index credit default swaps and 55.8 percent of the notional amount of interest rate derivatives traded on SEF, according to data from the International Swaps and Derivatives Association.

To the extent that the CFTC seeks to bring additional types of swaps trading onto SEFs, we do not object. Two Sigma is supportive of any innovations that would improve the transparency and liquidity of non-standardized swaps as long as the changes do not adversely affect the current framework that works well today for swaps that are Made Available to Trade.

Under the Proposal, non-standardized instruments will trade without meaningful pre-trade price transparency with RFQ-1 functionality and, more importantly perhaps, without the operational safeguards of the current straight-through processing standards. As a result, the Proposal is very unlikely to meaningfully benefit end-users who trade non-standardized swaps, and almost certainly not to an extent that might compensate for the harm inflicted by the Proposal on markets for liquid, standardized swaps. The Proposal seriously miscalculates the costs and benefits of this tradeoff.

Increasing the types of instruments trading on SEF should not be an objective of the Commission if it comes at the cost of the actual benefits to market participants that the current regime provides today. In Two Sigma's opinion, it is better to leave liquid, standardized swaps trading under the current robust SEF regime and tackle challenges in the illiquid, non-standardized swaps market separately.

The Proposal would do significant damage to a framework that has delivered tangible benefits for the trading of liquid, standardized swaps

The swaps market we have today required legislators and regulators to put rules in place that forced the market to change, and change in fairly significant ways. Those reforms — particularly RFQ-3 and the Order Book — have produced demonstrable benefits to all investors and end-users who conduct business in the liquid, standardized swaps market. It is true that Dodd-Frank took a relatively prescriptive approach to the swaps trading framework, but without that approach the swaps market likely would have remained opaque and uncompetitive. Allowing additional "flexibility" in the execution of swaps is likely to result in a "back to the future" scenario where pricing gets worse, transparency goes down, and dealers use their inherent advantages to make swaps trading less competitive and more expensive for end-users. The Proposal even scraps the important improvements facilitated by the CFTC's current straight-through processing standards, knocking the marketplace back six years to grapple once again with operational challenges and counterparty credit risk as trades are submitted to central clearinghouses.

Two Sigma fears that without maintaining specific regulatory requirements, today's swaps market will shrivel and the past few years will only be remembered as a brief period where liquid, standardized swaps traded in a transparent, competitive, and investor-friendly manner. The CFTC can prevent this outcome by maintaining the requirements that SEFs offer an Order

Book and RFQ-3 functionality for all liquid, standardized swaps currently subject to the trade execution requirement, and we strongly urge the Commission to do so.

Respectfully submitted,

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