Christopher Kirkpatrick March 15, 2019
Secretary of the Commission
Commodity Futures Trading Commission ("CFTC" "Commission")
Three Lafayette Centre
1155 21st Street NW.
Washington, DC 20581

17 CFR Parts 9, 36, 37, 38, 39, and 43 RIN 3038–AE25
Proposed Rule: Swap Execution Facilities and Trade Execution Requirement[1] ("SEF Rule")

Submitted electronically to https://comments.cftc.gov

Dear Mr. Kirkpatrick,

The Institute for Agriculture and Trade Policy (IATP)[2] appreciates this opportunity to comment on the proposed SEF Rule. IATP last wrote to the Commission on August 13, 2018, concerning the Notice on Proposed Rulemaking (NPRM): De Minimis Exception to the Swaps Dealer Definition.[3] A subsection of our letter was titled "Allowing SDs [Swaps Dealers] to propose their own de minimis calculation methodology: An NPRM proposal for the Commission to reject before all others." In our view, that proposal, together with many other features of the NPRM that delegated Commission authorities to SDs, would make a rule developed from the NPRM exceedingly difficult to enforce.

The SEF rule is critically important to derivatives market integrity because the largest bank holding companies still trade just a small fraction of their contracts on Designated Contract Markets (regulated exchanges). Among the four bank holding companies that dominate the swaps market, in the third quarter of 2018, JP Morgan Chase traded 90.8 percent of its derivatives contracts Over the Counter (and just 9.2 percent on exchanges); Citibank 89.1 percent; Goldman Sachs 79.2 percent; and Bank of America 92.1 percent.[4] These and other SDs have resisted emulating the futures trading model, save for heeding the G20 leaders' commitment to centrally clear OTC trades to reduce the risk of counterparty default cascades. [5] Since the "futurization of swaps" appears to be moribund, the Commission must ensure that the SEFs emulate the high degree of price formation transparency, low transaction costs and operational efficiencies of the DCMs.

The proposed SEF Rule would allow "flexibilities" in trade execution to an extent that very likely would overwhelm the under-resourced Commission's monitoring and enforcement capacity. The proposed SEF rule would meet the challenges of enforcing trade execution flexibilities by allowing SEFS to determine the staffing levels, resources and tasks to enable compliance with Commission rules: "Section 37.203(c) [of the 2013 SEF rule] currently requires a SEF to establish and maintain sufficient compliance staff and resources to conduct a number of

2105 FIRST AVENUE SOUTH 110 MARYLAND AVE NE, SUITE 307
MINNEAPOLIS, MINNESOTA 55404 WASHINGTON, D.C. 20002
(612) 870-0453 (202) 543-8602

enumerated tasks, such as audit trail reviews, trade practice surveillance, market surveillance, and real-time monitoring," (Federal Register (FR) November 30, 2018, p. 61998).

The proposed SEF Rule would decrease these enforcement duties by eliminating enumerated surveillance and monitoring tasks that enable enforcement: "The Commission proposes to eliminate the enumerated tasks and replace them with the phrase 'self-regulatory obligations under the Act and Commission regulations,'" (FR 61998). By means of this radical change in surveillance requirements, the Commission seeks to resolve potential enforcement problems created by its proposed flexibilities.

Corollary to allowing the SEFs to determine which surveillance tasks it performs to meet "self-regulatory obligations," the proposed SEF rule would change the SEF's obligations for automated trade surveillance to accommodate the flexibilities introduced:

> The Commission proposes to eliminate the specific automated trade surveillance system capabilities enumerated under § 37.203(d), except for the ability of a SEF to reconstruct the sequence of market activity. Specifically, the Commission proposes to retain this concept by amending the remaining rule language to require that a SEF's automated trade surveillance system be capable of detecting potential trade practice violations and reconstructing the sequence of market activity and trading, (FR 61999).

The immediate purpose of eliminating enumerated, automated trade surveillance system capabilities to be built into the SEF's electronic trading system is to allow for each SEF to design a surveillance system that will digitize paper, voice-brokered and email messaging orders for incorporation into the automated trade surveillance system. How the Commission would determine that each surveillance system would comport with the Commission's delegation of its surveillance and enforcement authorities to the SEF remains unspecified in the proposed rule.

The broader purpose of eliminating enumerated surveillance tasks and enumerated automated trade system capabilities is to enable each SEF to determine its own methods of swaps trading and execution without fear of violating enumerated surveillance obligations and trade system capabilities specified in the 2013 SEF rule. The Commission "proposes to allow a SEF to offer any method of execution for all swaps trading and execution, rather than only an Order Book or RFQ [Request for Quote] System … 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," (FR 61952).

The Commission's argument for allowing swaps to be executed by any method the SEF chooses concerns the costs to the SEF of maintaining the Order Book for illiquid and "episodically" traded Credit Default Swaps (CDSs), (FR 61964). It is perhaps idle to observe, at this late date, that the natural evolution of the CDS product, market and trading methods require more stringent and specific scrutiny than what has been proposed in an eight-page International Swaps and Derivatives Association letter.[6]

Since interest rate derivatives still account for about 75 percent of total derivatives notional value,[7] to make maintenance of an Order Book optional based on the volume of trading in the far smaller CDS market is a disproportionate response to the "episodical" CDS trading volume.

Indeed, in footnote 129, the Commission cites other reasons for low volume SEF trading on the Order Book, such as swap participant name give up following the execution of transactions (making the swaps participant known to the market post-trade) and "the current lack of certain trading features, such as the ability to calculate volume weighted average pricing," (FR 61964). Both of these shortcomings could be remedied by much more targeted changes to the 2013 SEF Rule, as recommended by Commissioner Dan Berkowitz (FR 62145) and Commissioner Rostin Benham (FR 62143), rather than allowing SEFs to abandon the Order Book and RFQ requirements for swaps trading in all asset classes.

The proposed SEF Rule would eliminate the trade execution requirement and allow the SDs who own or control the SEFs to customize trading and execution methods even for highly standardized swaps that currently are traded very efficiently, at a very low cost and with very high price transparency on the Order Book or via RFQ bids. The Commission proposes to allow this complete flexibility, not based on any demonstrated all asset class failure of the Order Book or RFQ System, but on the mere belief that SEFs could further innovate or "naturally evolve" if they were only freed of any required method of execution. If a swaps customer were to complain about high execution costs, low price transparency and/or execution inefficiencies, the Commission could not use the SEF's Order Book or RFQ System as a data source and regulatory benchmark for investigation. Instead, the Commission would have to use its scarce resources inefficiently to investigate investors' complaints about whether each "innovative" method of execution resulted in higher execution costs and/or lower price transparency for each swap transaction.

Despite the Commission's repeated claims that the proposed SEF rule is consistent with the authorities on derivatives trading of the Dodd-Frank Wall Street Reform and Consumer Financial Protection Act ("Dodd-Frank Act"), Commissioner Dan Berkowitz's dissent on release of the proposed SEF Rule for comment, stated it "would gut the impartial access [for all market participants] requirement of the Dodd-Frank Act," (FR 62144). If the SEF Rule were adopted as proposed, it would be unlikely to survive a court challenge. During litigation, the 2013 SEF rule would still be in force, but lingering uncertainty about litigation outcomes might inhibit an increase in the number of new swap market participants and of new sources of swaps liquidity.

However, according to the *Wall Street Journal*, following meetings with major SDs, CFTC Chairman Christopher Giancarlo plans to withdraw much of the proposed SEF Rule and re-release some portion of it after reviewing further market participant comments.[8] If this reporting is accurate, most of the Obama administration SEF rule will remain in the final rule because SDs and market participants have found that the market integrity benefits of the 2013 SEF rule greatly exceed the costs of providing that integrity.

Commissioners Berkowitz and Rostin Benham have outlined more targeted changes to the 2013 SEF Rule that they would like the Commission to propose. In general, these changes would increase competition in the swaps market and promote pre-trade price transparency. As Commissioner Berkowitz notes, "Five dealers currently account for nearly two-thirds of the interest rate swap market, which is the largest swap product category," (FR 62146). Ongoing investor litigation against SD interest rate swap bid-rigging and other competition-depressing and market-distorting practices is but one indication that more competition and price transparency in the swaps market is urgently needed.[9]

As long as the swaps market remains concentrated in a handful of huge SDs, litigation costs and settlements may be written off as a cost of a business so lucrative that no litigation settlement or regulatory fine will dissuade recidivism. Indeed, the gradual phasing out of the multibillion-dollar, scandal-plagued London Interbank Offered Rate (LIBOR)[10] and its replacement by an interest rate derived from a basket of rates[11] will be less likely to succeed if the U.S. swaps market structure remains dominated by a small SD club empowered by the proposed SEF rule to determine its methods of trade execution and trade data surveillance.

The Commission's recently announced investigations into foreign corporate bribery to manipulate benchmarks that underlie derivatives prices[12] may only half succeed in protecting derivatives market integrity. The Commission (and Justice Department) may prosecute successfully cases of foreign corporate bribery with the cooperation of foreign authorities. However, if the Commission eliminates the most efficient means to enable oversight of its delegation of Commission authorities to the SEFs (i.e. enumerated surveillance tasks of trades in the Order Book or RFQ system), the oversight of U.S. SEF "self-regulatory obligations" will be hobbled by a plethora of SEF-designed trade methods and surveillance systems. Foreign authorities may be less inclined to cooperate with U.S. authorities on corporate bribery in underlying benchmarks if they find evidence that U.S. agencies have designed a weak structure of surveillance for U.S. SDs and SEFs.

The Commission's proposal for a two-year compliance delay for SEF registration by foreign swaps brokering entities from the date of the final rule is accompanied by questions 16-18 (FR 61963). IATP's general response to these questions is that the length of the delay should be calibrated to the time required to phase out the Libor and phase in an overnight interest rate based on traded contracts. If the Commission allows a compliance delay for SEF registration to be set to accommodate the complaints of individual foreign swaps brokering entities, the implementation of the SEF rule will be delayed to the detriment of U.S. swaps participants.

IATP hopes that these brief comments will assist the Commission to make targeted modifications to the 2013 SEF Rule that the Commission can monitor and enforce, as an agency dependent on Congress for its resources and reauthorization. As we noted in our August 2018 comment letter, IATP's public interest in the swaps market is not limited to the relatively small volume of agricultural swaps trading but concerns the much larger interest rate universe that impacts every farm and ranch family and every rural community. It is critical that swaps dealing and execution not return to the pre-Dodd-Frank price formation opacity and under-regulated markets.

IATP is a member of Americans for Financial Reform and supports AFR's comments on this and other rulemakings.

Respectfully,

Steve Suppan, Ph.D.
Senior Policy Analyst
Institute for Agriculture and Trade Policy

[1] https://www.cftc.gov/sites/default/files/2018-11/2018-24642a.pdf

[2] IATP is a nonprofit, 501(c)(3) nongovernmental organization, headquartered in Minneapolis, Minn., with offices in Washington, D.C. and Berlin, Germany. IATP has participated in the Commodity Markets Oversight Coalition (CMOC) since 2009, and the Derivatives Task Force of Americans for Financial Reform since 2010. IATP has submitted several comments on CFTC rulemaking, and on consultation papers of the International Organization of Securities Commissions, the European Securities and Markets Authority, and the European Commission's Directorate General for Internal Markets.

[3] https://comments.cftc.gov/PublicComments/CommentList.aspx?id=2885

[4] "Quarterly Report on Bank Trading and Derivatives Activities: Third Quarter," Office of the Comptroller of Currency, December 2018. "Appendix: Table 3, Distribution of Derivatives Contracts." https://www.occ.gov/topics/capital-markets/financial-markets/derivatives/pub-derivatives-quarterly-qtr3-2018.pdf

[5] E.g. Phillip Stafford, "US swaps market resists futures trading model," *Financial Times*, March 16, 2015.

[6] Joe Rennison and Sujeet Indap, "Wall Street tries to clean up $8t market for credit derivatives," *Financial Times*, March 13, 2019.

[7] "Quarterly Report on Bank Trading and Derivatives Activities," Office of the Comptroller of Currency, September 2017, at 3. https://www.occ.gov/topics/capital-markets/financial-markets/derivatives/pub-derivatives-quarterly-qtr2-2017.pdf

[8] Gabriel T. Rubin, "Wall Street Backlash Sinks Plan to Transform Swaps Market," *Wall Street Journal*, January 22, 2019. https://www.wsj.com/articles/wall-street-backlash-sinks-plan-to-transform-swaps-market-11548154800

[9] E.g. Johnathan Stempel, "Banks must face interest rate swap class action: US judge," Reuters, July 28, 2017.

[10] Martin Arnold, Emma Dunkley and Paul McClean, "Regulator calls on banks to replace Libor by 2022," *Financial Times*, July 27, 2017.

[11] E.g. Phillip Stafford, "Intercontinental Exchange plans alternative rate to the tarnished Libor," *Financial Times*, January 24, 2019.

[12] Kadhim Shubber and Gregory Meyer, "US regulator opens probes into foreign bribery cases," *Financial Times*, March 6, 2019.