CITADEL

March 15, 2019

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

Re: Proposed Rule on SEFs and the Trade Execution Requirement (RIN 3038–AE25)

We appreciate the opportunity to provide comments to the Commodity Futures Trading Commission (the "Commission") on its proposal to amend the regulatory framework for swap execution facilities (the "SEF Proposal").[1]

The existing SEF regime has resulted in a more open, competitive and transparent OTC derivatives market, yielding material benefits for end investors in terms of pricing and liquidity, while reducing risk and complexity for market participants. Although we agree that the existing SEF regime can be further refined, the SEF Proposal significantly dismantles the current framework, threatening to reverse the material benefits that have accrued to market participants over the course of more than five years of SEF trading.

Our response focuses on three aspects of the SEF Proposal that are particularly consequential:

I. The SEF Proposal Abandons Multilateral and Transparent Execution, Harming Investors

The SEF Proposal advances a novel interpretation of the statutory definition of a SEF to include platforms that only offer bilateral trading protocols, such as single-dealer pages or RFQ-to-1, undermining market transparency and competition. In addition, the SEF Proposal completely eliminates minimum standards for multilateral and pre-trade transparent execution on SEFs by allowing all transactions to be executed via private one-to-one negotiations that resemble bilateral over-the-counter trading.

II. The SEF Proposal Endorses Anticompetitive Practices by SEFs

The SEF Proposal permits SEFs to engage in a variety of discriminatory practices by dramatically re-interpreting the statutory requirement for SEFs to provide market participants with impartial access. Sanctioning discriminatory access criteria will negatively impact market competition and liquidity, as new or smaller liquidity providers may be blocked from accessing necessary liquidity pools and clients may be deprived of any opportunity to access certain liquidity pools and trading protocols.

[1] 83 FR 61946 (Nov. 30, 2018), available at: https://www.cftc.gov/sites/default/files/2018-11/2018-24642a.pdf .

III. <u>The SEF Proposal Introduces Material Risks to the Clearing Workflow</u>

The SEF Proposal fundamentally alters current execution-to-clearing operational workflows for SEF trading by failing to preserve the current straight-through-processing ("STP") standards. Cleared swaps executed on a SEF would no longer be required to be submitted to a CCP within 10 minutes, introducing material market, credit, and operational risks. Further, bilateral breakage agreements between each pair of trading counterparties would now be permitted for cleared swaps on SEFs, disrupting liquidity provision and impeding access to SEFs.

In each of these three key areas, we will detail how:

- The current regulatory framework has provided material benefits to investors;
- The SEF Proposal will erode these documented benefits and impede market evolution;
- The SEF Proposal is inconsistent with the Commodity Exchange Act ("CEA");
- The SEF Proposal conflicts with internationally-harmonized standards; and
- The SEF Proposal fails to satisfy a cost-benefit analysis.

We urge the Commission to protect and strengthen the preeminent global position of U.S. capital markets by supporting regulations that are designed to make markets more fair, open, competitive, and transparent. While the current SEF Proposal would fail to do so, we believe there are more targeted and pragmatic steps that can and should be taken. Therefore, for each key area above, we also provide alternative policy suggestions that are designed to further streamline the SEF regime in a manner that is consistent with the CEA and that would preserve, and build upon, the documented benefits realized to date by market participants.

Our response to the SEF Proposal is informed by the market experience of two separate and distinct units – Citadel Securities, a leading global market maker, and Citadel, a global investment firm.

Citadel Securities is a leading global market maker across equities and fixed income asset classes, and entered the U.S. interest rate swaps market as a new liquidity provider following the implementation of the Commission's SEF rules. Citadel Securities has become one of the top liquidity providers in this market, increasing competition and improving conditions for end investors by introducing innovations such as firm on-screen pricing. Citadel Securities was recognized as the "rates flow market-maker of the year" in both 2017 and 2018,[2] and is a Commission-registered swap dealer and a self-clearing member.

Citadel is a leading investor in the world's financial markets, including in OTC derivatives markets regulated by the Commission. Citadel participates in these markets both on-SEF and off-SEF, and has directly witnessed the material benefits for end investors that have resulted from the implementation of the Commission's SEF rules.

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[2] *See* https://www.risk.net/risk-magazine/analysis/2480595/rates-flow-market-maker-of-the-year-citadel-securities and https://www.risk.net/awards/5362966/rates-flow-market-maker-of-the-year-citadel-securities.

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The SEF Proposal fundamentally re-interprets the statutory definition of a SEF to include platforms that only offer bilateral trading protocols, such as single-dealer pages or RFQ-to-1. In addition, the SEF Proposal eliminates minimum standards for multilateral and pre-trade transparent execution by allowing all SEF transactions to be executed via one-to-one private negotiations. These proposals threaten to reverse the material benefits that have accrued to clients under the current regulatory framework, including better liquidity, greater competition, and lower transaction costs.

Below, we detail the benefits of the current regulatory framework and the expected adverse impacts of the SEF Proposal. We then explain how these proposals are inconsistent with statutory requirements in the CEA, conflict with internationally-harmonized standards, and fail to satisfy a cost-benefit analysis. We also note that these proposals are inconsistent with the recommendations made by the U.S. Department of the Treasury in its 2017 Capital Markets Report, which specifically note the importance of maintaining multilateral and pre-trade transparent execution on SEFs.[3] Finally, we provide alternative suggestions that are designed to further streamline the SEF regime in a manner that is consistent with the CEA, while preserving the documented benefits realized by market participants.

A. The Current Regulatory Framework Has Provided Material Benefits to Investors

We leverage Citadel's experience as an end investor in the swaps markets, both on-SEF and off-SEF, to describe the material benefits for clients that have directly resulted from the market's transition to multilateral and transparent execution under the current SEF regime.

Prior to the introduction of SEFs, dealer-to-client trading in interest rate swaps ("IRS") and index credit default swaps ("index CDS") was opaque and fragmented, with most executions arising out of one-to-one private negotiations. Although electronic trading platforms existed, such as Bloomberg and Tradeweb, adoption rates were low and liquidity providers instead focused on bilateral means of communication with clients, such as single-dealer pages and "dealer runs."[4] When engaging with clients, liquidity providers would typically provide "indicative" quotes (as opposed to firm binding quotes), inviting interested clients to follow-up bilaterally in order to obtain an executable price for a specific instrument.

From a client's perspective, this market structure was disadvantageous for several reasons. The lack of published firm quotes and the unavailability of multilateral trading protocols compelled clients to rely on one-to-one private negotiations in order to obtain an executable price. Given that these executable prices were only then honored at that exact moment in time, clients

[3] *See* A Financial System that Creates Economic Opportunities: Capital Markets (October 2017) at page 145, available at: https://www.treasury.gov/press-center/press-releases/documents/a-financial-system-capital-markets-final-final.pdf.

[4] "Dealer runs" were lists of specific instruments that liquidity providers were interested in trading, along with indicative prices.

were unable to effectively put liquidity providers in competition and had little to no pre-trade transparency regarding other available prices in the market. Instead, clients faced the choice of either accepting the first executable price received or starting over with a new one-to-one negotiation, where pricing could move against the client as its trading interest was sequentially disclosed to additional market participants. As a result, this opaque and fragmented execution process impaired client access to best execution by denying clients the ability to effectively compare and evaluate the quality of prices.

In contrast, from the perspective of an incumbent liquidity provider, the pre-SEF trading environment was extremely beneficial. By providing only an indicative quote, a liquidity provider could solicit trading interest from clients, leading them to reveal their trading interest before responding with an executable price. The lack of published firm quotes and the inability to effectively put liquidity providers in competition also facilitated "tiered" pricing based on the identity of the client, enabling liquidity providers to extract greater profits from smaller market participants.

The statutory requirements in the CEA relating to SEFs, and the Commission's SEF rules, dramatically altered the dealer-to-client trading environment for IRS and index CDS by transitioning trading activity to multilateral and pre-trade transparent platforms. Two aspects of the current regulatory framework were central in this regard:

- <u>Ensuring SEFs are Multilateral</u>. SEFs are platforms that offer multilateral trading protocols, instead of only single-dealer pages or one-to-one negotiations; and

- <u>Enforcing Minimum Standards for Multilateral and Pre-Trade Transparent Execution</u>. Instruments subject to the trade execution requirement, which constitute a core segment of the IRS and index CDS market, are required to be transacted via multilateral and pre-trade transparent trading protocols, such as multilateral RFQs (i.e. RFQ-to-3).

Since SEFs are required to be multilateral, the market transitioned away from bilateral negotiations and single-dealer pages to platforms where quotes from multiple liquidity providers could be more easily consolidated and compared. At the same time, since a core segment of the IRS and index CDS market is required to be transacted via multilateral and pre-trade transparent trading protocols, the market transitioned away from a sole reliance on one-to-one private negotiations. Instead, liquidity providers suddenly had no choice but to compete with each other to win many client transactions.

This market evolution delivered material benefits for clients. The resulting competition and transparency has improved liquidity conditions, reduced transaction costs, and facilitated execution quality analysis. Clients have been empowered to put liquidity providers in direction competition. On-screen pricing has materially improved, becoming more competitive and dependable, as liquidity providers seek to differentiate their offerings in light of the increased competition. This trend has particularly benefited smaller market participants, as widely available on-screen pricing makes it more difficult for liquidity providers to discriminate against certain "tiers" of clients.

While the above description focuses on the experience of Citadel as a client in these markets, it is important to note that the increased price competition and transparency resulting from the current SEF regime also proved to be a catalyst for the entry of new liquidity providers, such as Citadel Securities. Prior to the introduction of multilateral and transparent SEFs, clients were unable to easily compare prices across liquidity providers, which impeded a new entrant from being able to clearly demonstrate that it could offer more competitive pricing than the incumbents. Therefore, clients were likely to continue selecting the established liquidity providers for one-to-one negotiations.

The introduction of pre-trade transparency and competitive execution under the current SEF regime fundamentally altered this dynamic, and provided new liquidity providers with an opportunity to compete for client business on a more level playing field. The entry of new liquidity providers further improves conditions for clients, as new liquidity providers introduce additional innovation to attract client business. For example, Citadel Securities became one of the top liquidity providers in USD IRS by introducing firm on-screen pricing (as opposed to indicative quotes), responding immediately to client RFQs, increasing quoted sizes, and demonstrating dependable liquidity provision during all types of market conditions. In response to this market competition, other liquidity providers have improved their offerings as well, further benefiting clients through better pricing and liquidity.

B. The SEF Proposal Will Erode Documented Benefits and Impede Market Evolution

The SEF Proposal significantly alters both of the beneficial aspects of the regulatory framework detailed above:

- <u>Reinterpreting the SEF Definition</u>. Platforms that only offer bilateral trading protocols would now be able to qualify as a SEF. According to the SEF Proposal, a platform that only offers single-dealer pages qualifies as a SEF as long as more than one single-dealer page is available.[5] Similarly, a platform that only offers a bilateral RFQ-to-1 trading protocol qualifies as a SEF as long as a client is permitted to send more than one RFQ-to-1 sequentially;[6] and

- <u>Eliminating Minimum Standards for Multilateral and Pre-Trade Transparent Execution</u>. The SEF Proposal permits all instruments to be executed on SEF via one-to-one private negotiations, even those subject to the trade execution requirement.[7]

These proposals threaten to reverse the material benefits that have accrued to clients under the current framework. Relegating SEFs from multilateral trading venues to nothing more than single-dealer pages or an RFQ-to-1 platform, where a client can only meaningfully interact with one liquidity provider at a time, risks fragmenting liquidity and impairing price discovery as available quotes become more difficult to consolidate and compare. In turn, eliminating minimum standards

[5] SEF Proposal at 61957.

[6] SEF Proposal at 61965, FN 136.

[7] SEF Proposal at 61978.

and allowing transactions subject to the trade execution requirement to be executed via one-to-one private negotiations can be expected to decrease overall competition and transparency, and increase transaction costs for clients as the market reverts to bilateral negotiations.

C. The SEF Proposal is Inconsistent with the Commodity Exchange Act

Reinterpreting the SEF Definition

Section 1a(50) of the CEA defines a SEF as "a trading system or platform in which *multiple* [emphasis added] participants have the ability to execute or trade swaps by accepting bids and offers made by *multiple* [emphasis added] participants in the facility or system, through any means of interstate commerce." The proposal to allow platforms to qualify as a SEF by only offering bilateral trading protocols, such as single-dealer pages or RFQ-to-1, is inconsistent with this statutory definition.

The SEF Proposal explicitly acknowledges that a single-dealer page or platform does not satisfy the multiple-to-multiple prong of the SEF definition.[8] Similarly, the SEF Proposal explicitly acknowledges that an RFQ-to-1 does not satisfy the multiple-to-multiple prong of the SEF definition.[9] However, the SEF Proposal asserts that a platform offering more than one single-dealer page or the ability to send more than one RFQ-to-1 sequentially complies with the SEF definition.[10]

This novel interpretation of the statutory definition reverses the Commission's current position[11] and, in practice, would render the multiple-to-multiple requirement meaningless. Permitting a market participant to engage in multiple one-to-one negotiations is not sufficient to provide that market participant with the ability to interact with the bids or offers of multiple liquidity providers (as is required by the statutory SEF definition), as bids and offers are only truly comparable when they can be obtained and traded against at the same time.

To illustrate the problems with the SEF Proposal's approach, consider how single-dealer pages are aggregated by Bloomberg, which appears to be the one "Single-Dealer Aggregator Platform" referenced in the SEF Proposal (note: these single-dealer pages are currently only permitted to be used for instruments that are not required to be executed on a SEF).[12] Each single-dealer page is displayed separately and provides indicative pricing offered by that particular dealer. Clients are invited to initiate a one-to-one negotiation in order to obtain an executable price for a specific instrument. Importantly, there is no ability for clients to interact with multiple dealers simultaneously as clients must interact with one single-dealer page at a time through one-to-one

[8] SEF Proposal at 61957.

[9] SEF Proposal at 61965, FN 136.

[10] *Id.* and SEF Proposal at 61957.

[11] *See* 78 FR 33476 (June 4, 2013) at 33498, 33563, available at: https://www.cftc.gov/sites/default/files/idc/groups/public/@lrfederalregister/documents/file/2013-12242a.pdf ("**Current SEF Rules**") and SEF Proposal at 61956.

[12] SEF Proposal at 62046, FN 930.

negotiation. Once a client obtains an executable quote from a given liquidity provider, the quote is typically only executable for a couple of seconds, and, therefore, in practice clients do not have the ability to obtain, and trade against, executable quotes from multiple liquidity providers at the same time through single-dealer pages.[13]

The prospect of sending multiple RFQ-to-1s raises similar concerns. While a trading venue may theoretically permit a client to send more than one RFQ-to-1 sequentially, the time required to initiate these distinct RFQs and the time limits placed on executable quotes by liquidity providers means that clients would not have the ability to obtain, and trade against, executable quotes from multiple liquidity providers at the same time.

The pre-SEF trading environment consisted of clients engaging in sequential one-to-one negotiations with individual liquidity providers. The SEF definition reflects clear congressional intent to increase market transparency and competition by transitioning trading activity to venues that must provide multilateral trading protocols. Notably, the Securities and Exchange Commission ("SEC') has interpreted the identical statutory definition of a "security-based swap execution facility" to exclude platforms that only permit one-to-one negotiations.[14] For example, the SEC concluded a platform that aggregates single-dealer pages does not satisfy the statutory definition since: "a participant in the aggregated single-dealer platform may only send a request to one dealer at a time and thus would not have the ability to interact with the bids or offers of multiple dealers simultaneously."[15] We urge the Commission to maintain its current well-reasoned legal interpretation that only offering bilateral trading protocols does not satisfy the multiple-to-multiple prong of the SEF definition in the CEA.

Eliminating Minimum Standards for Multilateral and Pre-Trade Transparent Execution

The CEA sets forth certain minimum standards that govern the execution of swaps on SEFs. First, as discussed immediately above, the statutory definition of a SEF requires multiple-to-multiple execution.[16] The SEF Proposal acknowledges that this definition serves as a "baseline requirement"[17] and a SEF can only offer a trading protocol that "meets the SEF definition."[18] Second, the SEF Proposal also acknowledges the clear statutory goal of promoting pre-trade price transparency through the regulatory framework applicable to SEFs.[19]

Despite acknowledging these statutory requirements, the SEF Proposal then appears to completely disregard them when detailing the trading protocols that SEFs would be permitted to

[13] We note that, in the extreme, this aspect of the SEF Proposal, combined with the proposed impartial access changes discussed in Section II of the letter, appear to permit a SEF to consist of nothing more than single-dealer pages of one liquidity provider and its affiliates.

[14] 76 FR 10948 (Feb. 28, 2011) at 10954, available at: https://www.sec.gov/rules/proposed/2011/34-63825fr.pdf.

[15] *Id.* at 10952, FN 33.

[16] CEA Section 1a(50).

[17] SEF Proposal at 61964, FN 134.

[18] SEF Proposal at 61980. *See also* SEF Proposal at 62055.

[19] *See, e.g.,* SEF Proposal at 61981 and CEA Section 5h(e).

offer. For example, the SEF Proposal fails to provide a single example of a trading protocol that does not meet the statutory definition of a SEF, even though it would appear difficult to conclude that one-to-one private negotiations satisfy the multiple-to-multiple requirement. Similarly, the SEF Proposal acknowledges that one-to-one private negotiations do not provide pre-trade price transparency, but then attempts to justify this by asserting that "those market participants sending RFQs to only one liquidity provider would be *forgoing pre-trade transparency, but would be doing so voluntarily* [emphasis added]."[20] However, the statute does not provide the Commission, market participants, or SEFs with the discretion to determine whether or not pre-trade transparency is required when trading on a SEF. Instead, Congress provided an explicit rule of construction.[21]

The CEA is clear that SEF trading must be multilateral and pre-trade transparent.[22] For this reason, the Commission previously concluded that one-to-one negotiations were not permitted for transactions required to be executed on a SEF, as otherwise "the multiple-participant-to-multiple-participant requirement in the SEF definition and the pre-trade price transparency goal would be undermined."[23] We urge the Commission to maintain this well-reasoned legal interpretation and ensure that minimum standards regarding multilateral and pre-trade transparent execution are enforced, even if SEFs are given additional flexibility regarding permitted trading protocols. In practice, these statutory minimum standards mean that one-to-one private negotiations, whether through RFQ, chat or otherwise, should not be permitted for transactions required to be executed on a SEF.

D. The SEF Proposal Conflicts with Internationally-Harmonized Standards

The SEF Proposal undermines the current alignment between US rules for SEFs and EU rules for multilateral trading facilities ("MTFs") and organised trading facilities ("OTFs"). This may negatively impact the existing equivalence agreement between the US and EU with respect to OTC derivatives trading venues.[24]

Reinterpreting the SEF Definition

The current equivalence agreement between the US and EU is supported by there being a consistent interpretation regarding the types of trading venues that can qualify as a SEF, MTF or OTF. Similar to the multiple-to-multiple prong of the SEF definition, MiFID II requires MTFs and OTFs to provide a system in which "multiple third-party buying and selling trading interests in financial instruments are able to interact in the system." [25]

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[20] SEF Proposal at 62061.

[21] *See* Current SEF Rules at 33554, FN 955.

[22] The existence of these statutory requirements is one reason why drawing comparisons to the regulatory frameworks applicable to other asset classes may be misplaced. *See* SEF Proposal at 61981, FN 295.

[23] Current SEF Rules at 33498.

[24] *See* https://www.cftc.gov/PressRoom/PressReleases/pr7656-17 and Commission Implementing Decision (EU) 2017/2238, available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017D2238&from=EN.

[25] Article 4(1)(22) and (23) of MiFID II.

A trading platform that offers nothing more than single-dealer pages or RFQ-to-1 trading functionality would not appear to satisfy this definition under MiFID II. In fact, these bilateral trading protocols more closely resemble off-venue trading activity conducted by systematic internalisers ("SIs") in the EU. For example, SIs typically maintain single-dealer pages.

In the event that trading platforms only offering bilateral trading protocols qualify as a SEF, as proposed, the current equivalence agreement may be negatively impacted. This is because EU market participants would then be able to satisfy the EU trading obligation on US platforms that are not considered multilateral under MiFID II, and instead resemble SIs, which are not a permitted method for complying with the EU trading obligation.

Eliminating Minimum Standards for Multilateral and Pre-Trade Transparent Execution

The current equivalence agreement between the US and EU is also supported by the fact that both jurisdictions have minimum standards regarding multilateral and pre-trade transparent execution on SEFs, MTFs and OTFs. As discussed above, MiFID II requires MTF and OTFs to offer a multilateral system. In addition, transactions on MTFs and OTFs are subject to specific pre-trade transparency requirements.[26]

By failing to maintain minimum standards regarding multilateral and pre-trade transparent execution on SEFs when providing additional flexibility regarding permitted trading protocols, the SEF Proposal risks negatively impacting the current equivalence agreement. This is because the current prohibition on one-to-one negotiations for instruments subject to the US trade execution requirement was critical in establishing comparability with EU pre-trade transparency rules, as the Commission was able to demonstrate that a market participant is always provided with multiple executable prices pre-trade, either through the responses to a multilateral RFQ or through accessing the available bids and offers in an order book. In contrast, under the SEF Proposal, these minimum standards are eliminated and EU market participants would be able to satisfy the EU trading obligation on US platforms through one-to-one private negotiations without being subject to any pre-trade transparency obligations as required under MiFID II.

E. The SEF Proposal Fails to Satisfy a Cost-Benefit Analysis

The cost-benefit analysis included in the SEF Proposal does not meet the statutory requirements of Section 15(a) of the CEA. Instead of seeking to accurately quantify the costs associated with the proposal, the SEF Proposal asserts that the Commission "currently lacks the requisite data and information to reasonably estimate them."[27] At the same time, the SEF Proposal disregards, among others, (i) academic research, (ii) publicly available market data, (iii) current SEF rulebooks, and (iv) other data available to the Commission as a result of its market oversight responsibilities. We document this available information below and analyze its significance in assessing the costs and benefits of the SEF Proposal.

[26] *See* Article 8 of MiFIR.

[27] SEF Proposal at 62051.

Reinterpreting the SEF Definition

The SEF Proposal only engages in a cursory analysis of the impact of reinterpreting the statutory definition of a SEF to include platforms that solely offer single-dealer pages or RFQ-to-1 trading functionality. This analysis is largely limited to conclusory statements, such as "[t]he Commission believes that the proposed application of the statutory SEF registration requirement to certain entities not currently registered should enhance the competitiveness and financial integrity of markets since these registered SEFs would be subject to relevant SEF core principles."[28]

These types of statements gloss over the significance of the current interpretation of the SEF definition, which has helped to facilitate a transition away from bilateral platforms, such as single-dealer pages, to platforms where quotes from multiple liquidity providers can be consolidated and compared. The SEF Proposal does not provide any of the Commission's own observations regarding this transition, such as (i) the opaque execution process that existed for clients prior to the introduction of SEFs, or (ii) the benefits that have subsequently accrued to clients, such as more competitive, transparent, and dependable on-screen pricing, better liquidity, and lower transaction costs. In addition, the SEF Proposal does not review relevant academic research that documents the tangible benefits of transitioning to multilateral trading platforms, including:

- Essays on the Market Structure and Pricing of Credit Derivatives.[29] This research finds that, compared to bilateral trading protocols, multilateral SEFs increase pre-trade transparency, facilitate comparison shopping, and create direct price competition among liquidity providers.[30] Multilateral SEFs are found to reduce client trading costs in index CDS by 40-50% compared to bilateral off-SEF trading protocols.[31]

- Centralized trading, transparency and interest rate swap market liquidity: evidence from the implementation of the Dodd-Frank Act.[32] This research finds that multilateral SEFs reduce search costs for clients and make it easier for clients to trade with the liquidity provider showing the best price.[33] Prior to the emergence of SEF trading, 28% of clients only dealt with a single liquidity provider and over 50% of clients dealt with three or fewer liquidity providers. As clients transitioned onto multilateral SEFs in February 2014, they

[28] SEF Proposal at 62055.

[29] Junge, J., Essays on the Market Structure and Pricing of Credit Derivatives, November 2016, available at: https://infoscience.epfl.ch/record/222511/files/EPFL_TH7322.pdf.

[30] *Id.* at pages 71 and 75.

[31] *Id.* at page 71.

[32] Benos, E., Payne, R., and Vasios, M., Centralized trading, transparency and interest rate swap market liquidity: evidence from the implementation of the Dodd-Frank Act, Bank of England Staff Working Paper, May 2018, available at: https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2018/centralized-trading-transparency-and-interest-rate-swap-market-liquidity-update.

[33] *Id.* at page 26.

were able to easily access more liquidity providers, with only 8% dealing with a single liquidity provider and only 20% dealing with 3 or fewer liquidity providers.[34]

- Discriminatory pricing of over-the-counter derivatives.[35] This research finds that less sophisticated clients pay higher transaction costs when using bilateral trading protocols, but that transactions on multilateral RFQ platforms exhibit competitive spreads regardless of client sophistication levels.[36] Specifically, "the use of multi-dealer RFQ platforms removes the market power of dealers and compresses average spreads."[37]

- Over-the-Counter Markets.[38] This research finds that client transaction costs decrease to the extent a client can more easily find other liquidity providers, such as on a multilateral trading venue.

The SEF Proposal does not cite any of the academic research listed above. The Commission must take into account documented benefits of transitioning trading activity onto multilateral SEFs when evaluating the impact of permitting a SEF to offer nothing more than single-dealer pages or RFQ-to-1 trading functionality, where a client can only meaningfully interact with one liquidity provider at a time. In addition, the Commission should consider potential costs relating to (a) liquidity fragmentation (as new bilateral platforms emerge and certain liquidity providers shift liquidity provision away from multilateral platforms), (b) impaired price discovery (as available quotes become more difficult to consolidate and compare across the market), and (c) the impact on smaller and less sophisticated clients.

Eliminating Minimum Standards for Multilateral and Pre-Trade Transparent Execution

The SEF Proposal eliminates minimum standards for multilateral and pre-trade transparent execution and permits all instruments to be executed via one-to-one negotiations. While acknowledging that providing complete flexibility regarding trading protocols may reduce "the benefits from the existing system,"[39] the SEF Proposal makes three main assertions in response:

- Assertion #1: Providing SEFs with flexibility regarding trading protocols will "promote pre-trade price transparency in the swaps market by allowing execution methods that maximize participation and concentrate liquidity during times of episodic liquidity."[40]

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[34] *Id.* at page 26.

[35] Hau, H., Hoffmann, P., Langfield, S., and Timmer, Y., Discriminatory pricing of over-the-counter derivatives, ESRB Working Paper, December 2017, available at: https://www.esrb.europa.eu/pub/pdf/wp/esrb.wp61.en.pdf. We note that, while the paper focuses on the FX derivatives market, its conclusions regarding the impact of multi-dealer RFQ platforms are generally applicable across OTC markets.

[36] *Id.* at pages 22-23.

[37] *Id.* at page 23.

[38] Duffie, D., Gârleanu, N., and Pedersen, L.H., Valuation in Over-the-Counter Markets (November 2004) at page 2, available at: https://web.stanford.edu/~duffie/OTCmarkets.pdf.

[39] SEF Proposal at 62060.

[40] SEF Proposal at 61952. *See also* SEF Proposal at 62061.

- Assertion #2: SEFs still have the option of offering multilateral and pre-trade transparent trading protocols, so market participants "would not need to forgo the pre-trade transparency associated with these means of execution."[41]

- Assertion #3: The proposed elimination of the made available to trade ("MAT") process will result in more trading on SEF in index CDS and IRS subject to the clearing mandate and "increased potential for higher levels of pre-trade price transparency through increased participation."[42]

We evaluate these assertions below by reference to academic research, publicly available market data, and current SEF rulebooks.

We first reference published analysis of SDR data to detail the 2018 trading activity of index CDS and IRS instruments subject to the clearing mandate (which is the relevant data set given the SEF Proposal is predicated upon expanding SEF trading to encompass all instruments subject to the clearing mandate). Current trading activity in clearing-mandated instruments can be divided into four categories:

1. **Required Transactions**: On-SEF transactions in current MAT instruments (i.e. instruments that are required to be executed on or pursuant to the rules of a SEF).

2. **Permitted Transactions**: On-SEF transactions in other clearing-mandated instruments (non-MAT) that are voluntarily executed on a SEF.

3. **Off-SEF MAT Transactions**: Off-SEF transactions in current MAT instruments that are relying on an exemption from the trade execution requirement, such as the end-user exemption or the inter-affiliate exemption.

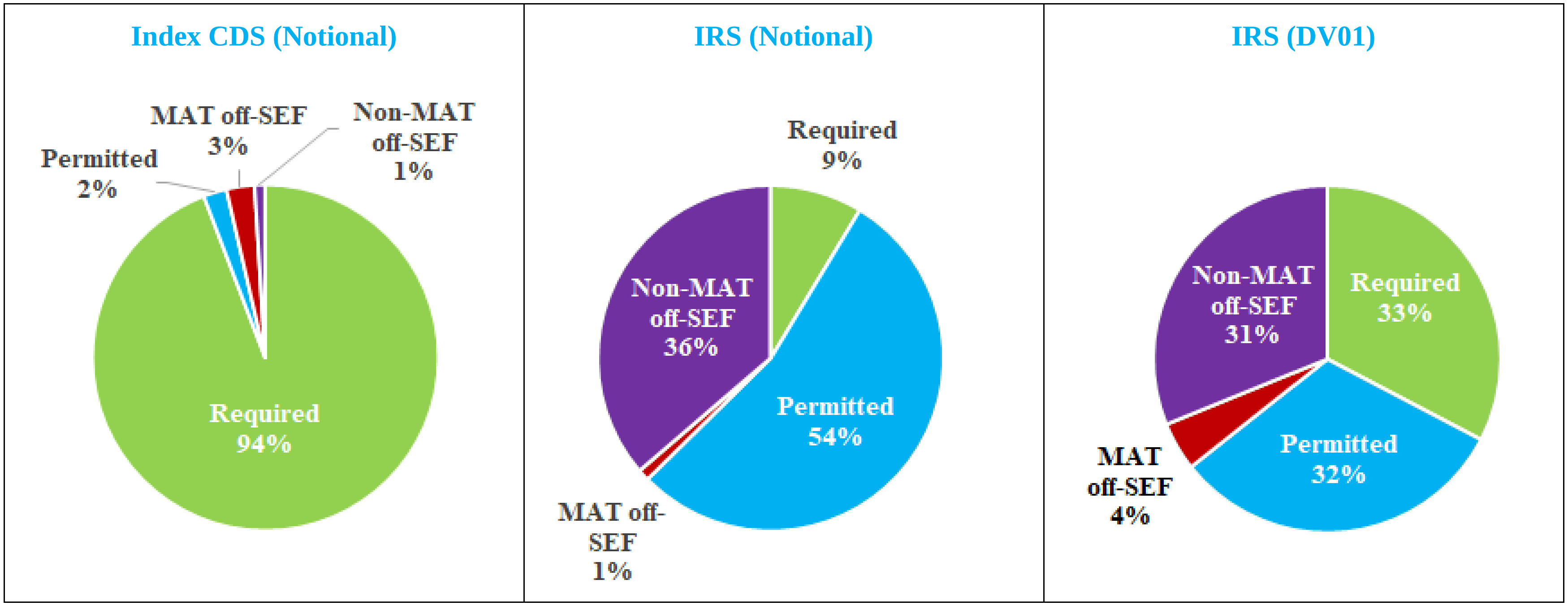
4. **Off-SEF Non-MAT Transactions**: Off-SEF transactions in other clearing-mandated instruments.

The charts below show 2018 trading activity in clearing-mandated index CDS and IRS instruments. We then use this data, among others, to analyze the costs and benefits of the SEF Proposal for each of the four categories above.

[41] SEF Proposal at 62060.

[42] SEF Proposal at 61984.

Analysis of 2018 Trading Activity in Clearing-Mandated Index CDS and IRS



Source: Clarus Financial Technology (https://www.clarusft.com/what-traded-on-sef-in-2018/)

(i) Required Transactions: Costs and Benefits

The analysis of SDR data presented above clearly demonstrates that Required Transactions are a critically important segment of the market:

- For index CDS, 94% of all trading activity in clearing-mandated instruments occurs in Required Transactions, as measured by notional.

- For IRS, over 50% of on-SEF trading activity in clearing-mandated instruments occurs in Required Transactions, as measured by DV01 (a more accurate risk-based measure, as the Commission has recognized that notional amount is not the best measure of the size of the IRS market[43]).

- Furthermore, Required Transactions account for an even greater proportion of dealer-to-client IRS trading activity on-SEF. An analysis of Bloomberg SEF trading activity found that Required Transactions account for approximately 75% of new trading activity in clearing-mandated IRS instruments.[44]

- Required Transactions account for a greater proportion of dealer-to-client IRS trading activity on-SEF because most of the on-SEF trading activity in Permitted Transactions occurs in FRA and OIS instruments, which are almost exclusively executed on a dealer-to-dealer basis on-SEF.[45]

The importance of Required Transactions, particularly with respect to dealer-to-client trading activity, means that the proposed elimination of minimum standards for multilateral and pre-trade transparent execution on SEFs will have significant adverse effects and fails an objective cost-benefit analysis. Under current Commission rules, Required Transactions are not permitted to be executed via one-to-one private negotiations on a SEF. This has resulted in a competitive and pre-trade transparent trading environment that has delivered tangible benefits to clients:

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[43] Haynes, R., Roberts, J., Sharma, R. and Tuckman, B., "Introducing ENNs: A Measure of the Size of Interest Rate Swap Markets" (January 2018), available at: https://www.cftc.gov/sites/default/files/About/Economic%20Analysis/Introducing%20ENNs%20v4.pdf; *see also* Remarks of Chairman J. Christopher Giancarlo before Derivcon 2018 (Feb. 1, 2018), available at: https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo35.

[44] "What Traded On-SEF in 2018?" Clarus Financial Technology (Feb. 12, 2019), available at: https://www.clarusft.com/what-traded-on-sef-in-2018/.

[45] *Id.*

- Academic research has found that client trading costs have decreased by (a) 40-50% for index CDS[46] and (b) $7 to $11 million *per day* for USD IRS[47] when comparing on-SEF execution to off-SEF.[48]

- Separate analysis of SDR data confirms that the competitive and pre-trade transparent SEF trading environment has resulted in material pricing and liquidity benefits, with minimal price dispersion observed for Required Transactions that is "two orders of magnitude" lower than the price dispersion observed for off-SEF trading activity.[49]

The SEF Proposal does not cite to any of the research detailed above nor does the Commission attempt to perform its own analysis of available data to assess the benefits that have accrued to clients under the current regulatory framework with respect to the execution of Required Transactions. As a result, the Commission is unable to accurately identify the potential costs associated with the proposal to allow all Required Transactions to be executed via one-to-one private negotiations on a SEF.

Instead, the SEF Proposal seeks to minimize the impact on Required Transactions by making two main assertions. We present each of these assertions in turn and detail their flaws.

<u>SEF Proposal Assertion #1</u>: Providing SEFs with flexibility regarding trading protocols will "promote pre-trade price transparency in the swaps market by allowing execution methods that maximize participation and concentrate liquidity during times of episodic liquidity."[50]

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[46] *Supra* note 31.

[47] *Supra* note 32 at page 23. We note that this study leveraged data from LCH and DTCC to compare execution costs and liquidity dynamics before and after SEFs were introduced in order to "isolate the effects of the introduction of SEF trading on liquidity and competition" (see page 4). Price dispersion measures were used to assess execution costs, supplemented by price impact measures and quoted spread data to assess market liquidity. Any transaction fee separately charged by a SEF to its members is not relevant for these metrics, but we note that, to the extent it was, it would be expected to marginally reduce the identified cost savings for clients, since there are no platform fees for off-SEF bilateral trading. Therefore, the low per-trade transaction fees currently charged by certain SEFs do not explain the material cost savings identified in this study.

[48] We note that the SEF Proposal also fails to acknowledge that at least one of the limited number of studies cited therein highlights the importance of minimum standards for multilateral and pre-trade transparent execution, stating that "the two-tiered market structure—**at least when combined with measures limiting dealer market power, such as** post-trade transparency and **a requirement to put a minimum number of dealers in competition for trades** [emphasis added]—constitutes a viable alternative to all-to-all trading in swap markets." Collin-Dufresne, P., Junge, B. and Trolle, A.B., "Market Structure and Transaction Costs of Index CDSs" (September 2017) at page 6, available at: https://www.aeaweb.org/conference/2018/preliminary/paper/HA3dNy8B.

[49] "What Traded On-SEF in 2018?" Clarus Financial Technology (Feb. 12, 2019), available at: https://www.clarusft.com/what-traded-on-sef-in-2018/.

[50] SEF Proposal at 61952. *See also* SEF Proposal at 62061. Separately, we note that the assertion that swap market liquidity is episodic conflates the frequency of executed transactions (which is by nature variable, not constant) with the availability of bids and offers in the markets and presence of ready and willing buyers and sellers (which is constant). The SEF Proposal does not present any compelling evidence that swaps market liquidity is in fact episodic.

An analysis of the trading protocols currently offered by SEFs for Required Transactions demonstrates that this asserted benefit is illusory. In reality, if the SEF Proposal is finalized, the only new trading protocol expected to be offered for Required Transactions is one-to-one private negotiations, supported via electronic RFQ, chat, or voice. This will undoubtedly reduce competition and pre-trade transparency for the execution of Required Transactions.

This conclusion is reached through a review of current SEF rulebooks and discussions with SEF operators. The SEF Proposal neglects to list the trading protocols that have been approved for Required Transactions, instead implying that the market is currently limited to two options: RFQ-to-3 or Order Book.[51] This is not the case. In 2015, former Chairman Massad detailed the Commission's approach for approving additional trading protocols, stating:

> *"We want to make sure there is some flexibility in methods of execution as long as Dodd-Frank's requirements are met. Earlier this year, our staff confirmed that an auction match trading protocol was acceptable as long as the SEF rulebook provides adequate transparency regarding the process for setting the offer price."* [52]

A review of current SEF rulebooks confirms that the Commission has allowed significant flexibility regarding trading protocols for Required Transactions, as long as minimum standards regarding multilateral and pre-trade transparent execution are satisfied. For example, out of the 9 SEFs[53] reporting 2018 trading activity in Required Transactions for IRS, at least 6 offer voice trading protocols[54] and at least 6 offer work-up or auction trading protocols.[55] The electronic dealer-to-client SEFs have also innovated, offering new trading protocols for Required Transactions such as Request-for-Stream (streaming firm or indicative prices), Request-for-Market (two-sided quotes can be requested), Trade-at-best (weighs factors such as price, firmness, and time), and List (quotes can be requested on multiple transactions simultaneously). As further evidence of the current flexibility provided to SEFs by the Commission, below are 13 trading protocols listed in the BGC Derivative Markets SEF rulebook as available for Required Transactions:[56]

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[51] *See, e.g.*, SEF Proposal at 62057.

[52] Keynote Remarks of Chairman Timothy Massad before the Swap Execution Facility Conference (October 26, 2015), available at: https://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-32.

[53] BGC Derivative Markets, Bloomberg SEF, DW SEF, GFI Swaps Exchange, ICAP Global Derivatives Limited, tpSEF, Tradition SEF, trueEX, and TW SEF.

[54] BGC Derivative Markets, DW SEF, GFI Swaps Exchange, ICAP Global Derivatives Limited, tpSEF, and Tradition SEF.

[55] BGC Derivative Markets, DW SEF, GFI Swaps Exchange, ICAP Global Derivatives Limited, Tradition SEF, and trueEX.

[56] *See* http://www.bgcsef.com/wp-content/uploads/2017/01/BGC_Rulebook_12-13-16.pdf.

Order Book	Fully Electronic Work-Up	Volume Match Trading
Volume Match Plus	Customer Match Trading	Regular Voice Trading
Voice Work-up	Hybrid Voice	RFQ Voice Trading Facility
Technology-Assisted Voice Trading Facility		Customer Match Voice Trading Facility
Volume Match Plus Voice Trading Facility		Volume Match Voice Trading Facility

Comparing the trading protocols offered by SEFs for Required Transactions with those offered for Permitted Transactions (where there are no regulatory restrictions) identifies only one main difference: one-to-one private negotiations are currently offered for Permitted Transactions but are prohibited for Required Transactions.[57] Feedback from SEF operators confirms that offering one-to-one private negotiations for Required Transactions *is the only change* with respect to trading protocols that can be expected to directly result from the SEF Proposal. As a result, the SEF Proposal will unquestionably reduce pre-trade transparency and competition for the execution of Required Transactions by allowing opaque, bilateral negotiation to re-emerge for instruments that currently benefit from transparent, competitive execution.

SEF Proposal Assertion #2: SEFs still have the option of offering multilateral and pre-trade transparent trading protocols, so market participants "would not need to forgo the pre-trade transparency associated with these means of execution."[58]

This line of argument appears to acknowledge the conclusion reached above, which is that the new trading protocols expected to be introduced for Required Transactions will reduce pre-trade transparency and competition. In response, the SEF Proposal suggests that market participants could just ignore these new trading protocols in order to preserve the benefits of the current regulatory framework.

Instead of strengthening the Commission's case, this assertion highlights the lack of justification for amending the current regulatory framework. If the only way to preserve the documented liquidity, pricing, and transparency benefits for Required Transactions is to ignore the changes effected by the SEF Proposal, then no changes should be made. In addition, this assertion fails to consider the important role of minimum regulatory standards in ensuring a competitive and transparent execution process for clients on SEFs. Before the current SEF rules were introduced, clients purportedly had the ability to choose between bilateral and multilateral trading protocols. However, as detailed above, the establishment of minimum standards in the SEF rules regarding multilateral and pre-trade transparent execution for Required Transactions dramatically changed the market, empowering clients to put liquidity provides in competition and resulting in material benefits for clients. Eliminating these minimum standards and once again permitting one-to-one private negotiations for all Required Transactions risks reversing many of these gains, with the associated costs of (a) decreased competition among liquidity providers, resulting in less dependable on-screen pricing, (b) fewer new entrants providing liquidity, and (c) impaired price discovery.

[57] We note that risk mitigation services are also offered for certain Permitted Transactions, particularly FRAs, but are not directly relevant to the execution of Required Transactions.

[58] SEF Proposal at 62060.

We note that the negative impact of eliminating the current minimum standards will only increase if the Commission modifies the SEF Proposal to remove the prohibition on pre-execution communications for instruments that are subject to the trade execution requirement.[59] In this scenario, market participants could bilaterally negotiate a transaction off-SEF and then leverage a one-to-one private trading protocol offered by a SEF to merely formalize the already-agreed transaction terms, with the SEF more closely resembling a trade capture facility instead of a venue for transparent and competitive execution.

(ii) Permitted Transactions: Costs and Benefits

Permitted Transactions are already executed on SEFs and there are no regulatory restrictions regarding the trading protocols that can be used. This would remain unchanged under the SEF Proposal, and therefore, there is no obvious benefit for Permitted Transactions.

In contrast, there are potential costs for Permitted Transactions that the SEF Proposal has failed to consider. Research has shown that the multilateral and pre-trade transparent execution process on SEFs for Required Transactions has positive spill-over effects for Permitted Transactions, improving liquidity and reducing transaction costs.[60] Research has also shown that multilateral SEFs reduce search costs for clients and make it easier for clients to trade with the liquidity provider showing the best price.[61] Eliminating these minimum standards may, therefore, impose the same costs detailed above in paragraph (ii) with respect to Required Transactions. These costs are primarily relevant for IRS, as only 2% of trading activity in clearing-mandated index CDS is in Permitted Transactions.

(iii) Off-SEF MAT Transactions: Costs and Benefits

Off-SEF MAT Transactions rely on an exemption from the trade execution requirement, such as the end-user exemption or the inter-affiliate exemption. The SEF Proposal does not propose modifying the scope of these exemptions, and therefore there is no obvious cost or benefit for this category of transactions.

(iv) Off-SEF Non-MAT Transactions: Costs and Benefits

Under the SEF Proposal, Off-SEF Non-MAT transactions in clearing-mandated index CDS and IRS will be required to be traded on a SEF if the instrument is listed by a SEF. This proposed expansion of the trade execution requirement is the elimination of minimum standards for multilateral and pre-trade transparent execution on SEFs.

[59] *See* Keynote Address of Chairman J. Christopher Giancarlo Before the ABA Business Law Section, Derivatives & Futures Law Committee Winter Meeting (Jan. 25, 2019), available at: https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo63.

[60] *See supra* note 29 at page 71 and "What Traded On-SEF in 2018?" Clarus Financial Technology (Feb. 12, 2019), available at: https://www.clarusft.com/what-traded-on-sef-in-2018/.

[61] *Supra* note 33.

> SEF Proposal Assertion #3: The proposed elimination of the MAT process will result in more trading on SEF in index CDS and IRS subject to the clearing mandate and "increased potential for higher levels of pre-trade price transparency through increased participation."[62]

In order to evaluate this assertion, we reference the SDR data detailed above to examine Off-SEF Non-MAT transactions:

For index CDS, Off-SEF Non-MAT transactions account for only 1% of trading activity in clearing-mandated instruments. Therefore, in contrast to the assertion in the SEF Proposal, expanding the trade execution requirement to cover these instruments will not increase overall market transparency.

For IRS, Off-SEF Non-MAT transactions account for approximately one-third of trading activity in clearing-mandated instruments:

- We agree that some of these instruments are suitable for SEF trading, including fixed-to-float swaps in currencies other than USD, EUR, or GBP and certain commonly traded forward-starting swaps (e.g. 1Y1Y and 5Y5Y). However, market transparency is only improved by bringing additional instruments onto SEF if the relevant trading protocols are multilateral and transparent. Continuing to transact these instruments via one-to-one negotiations, as permitted by the SEF Proposal, would not represent a change to the status quo.

- The suitability of SEF trading is less apparent for other Off-SEF Non-MAT instruments.

    - Short-dated FRA and OIS transactions account for more than 60% of the trading activity,[63] and SDR data shows that 93% of these transactions are one year or less in duration.[64]

    - Fixed-to-float swaps account for most of the remaining trading activity,[65] and a closer analysis finds that many of these transactions are relatively custom and bespoke in nature, with (a) 75% having forward-starting effective dates (including IMM), and (b) 10% having back-starting effective dates (indicating compression activities).[66]

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[62] SEF Proposal at 61984.

[63] "What Traded Off-SEF in 2018?" Clarus Financial Technology (Feb. 6, 2019), available at: https://www.clarusft.com/what-traded-off-sef-in-2018/.

[64] *Id.*

[65] *Id.*

[66] *Id.*

- In addition, many of the more commonly-traded forward-starting swaps are executed as part of a package transaction with Treasury futures, and the SEF Proposal has not explained how these packages will be brought onto SEF without amending CME Rule 538, which currently prohibits a swap from being traded on a SEF if it is part of an invoice spread package.

Overall, the proposed expansion of the trade execution requirement will increase costs and complexity for market participants, while failing to meaningfully increase market transparency, as the status quo of one-to-one bilateral negotiations will continue for today's non-MAT instruments, but will now be labeled SEF execution.

We note the assertion that expanding the trade execution requirement will result in greater market transparency becomes even weaker to the extent the trade execution requirement is ultimately expanded less than initially proposed, including as a result of adopting prescriptive criteria that serve to limit the number of new instruments that are brought into scope.[67]

(v) Conclusion: Costs and Benefits

The current SEF framework has successfully promoted the trading of swaps on SEFs while increasing pre-trade transparency, consistent with the statutory objectives in the CEA.[68] 96% of trading activity in clearing-mandated index CDS is already executed on-SEF, while 65% of trading activity (based on DV01) in clearing-mandated IRS is already executed on-SEF. Overall SEF volumes have increased significantly since SEFs were first introduced in late 2013 and since the trade execution requirement was first introduced in February 2014.[69]

Much of this on-SEF trading activity is in Required Transactions, which represent a key portion of dealer-to-client trading activity in particular. Current Commission standards requiring multilateral and pre-trade transparent execution for Required Transactions has resulted in material benefits for clients, including lower transaction costs and increased liquidity, competition, and transparency. As detailed above, the cost-benefit analysis does not support allowing transactions currently subject to the trade execution requirement to be executed via one-to-one private negotiations, which would lead to:

- Required Transactions: Material costs for both index CDS and IRS, as allowing one-to-one private negotiations reduces pre-trade transparency and competition. On the other hand, no benefits are identified, as SEFs already have been provided with significant flexibility regarding trading protocols (other than one-to-one negotiations).

[67] *See* Keynote Address of Chairman J. Christopher Giancarlo Before the ABA Business Law Section, Derivatives & Futures Law Committee Winter Meeting (Jan. 25, 2019), available at: https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo63.

[68] CEA Section 5h(e).

[69] "What Traded On-SEF in 2018?" Clarus Financial Technology (Feb. 12, 2019), available at: https://www.clarusft.com/what-traded-on-sef-in-2018/.

- Permitted Transactions: Additional costs for IRS, as the multilateral and pre-trade transparent execution process on SEFs for Required Transactions has positive spill-over effects for swaps that are voluntarily executed on SEFs. On the other hand, no benefits are identified, as SEFs already have complete flexibility regarding permitted trading protocols for these transactions under current Commission rules.

- Off-SEF Non-MAT Transactions: Additional costs for IRS, as market participants must transition the execution of relatively custom and bespoke instruments onto SEFs. On the other hand, minimal potential benefits are identified, as almost no clearing-mandated index CDS is traded off-SEF and many of the IRS instruments are short-dated OISs and FRAs, forward-starting swaps that are part of invoice spread packages that may not be able to be traded on SEF at all unless changes are made to CME Rule 538, or more custom and bespoke swaps that will continue to be negotiated bilaterally through one-to-one trading protocols.

The failure to satisfy a cost-benefit analysis is even more stark when viewed in the context of trading activity by category. For index CDS, 96% of trading activity in clearing-mandated instruments is already executed on-SEF, with almost all in Required Transactions. *The costs that would result for these transactions cannot be justified by bringing another 1% of trading activity onto SEFs.* For IRS, 65% of trading activity (based on DV01) in clearing-mandated instruments is already executed on-SEF, with over half in Required Transactions. *The costs that would result for these transactions cannot be justified by bringing short-dated OISs and FRAs and relatively custom and bespoke fixed-to-float swaps onto SEFs to be negotiated bilaterally through one-to-one trading protocols.*

We note that the cost-benefit analysis moves even further against the SEF Proposal to the extent the proposal is modified to allow pre-execution communications away from a SEF for Required Transactions or the trade execution requirement is ultimately expanded less than initially proposed, including as a result of adopting prescriptive criteria that serve to limit the number of new instruments that are brought into scope.

F. Suggested Alternatives

We urge the Commission to consider a more tailored approach that is consistent with statutory requirements and international standards, and mitigates many of the potential costs detailed above.

First, the Commission should maintain its current legal interpretation of the SEF definition to preclude platforms that solely offer bilateral trading protocols, such as single-dealer pages or RFQ-to-1s.

Second, we support the Commission providing SEFs with additional flexibility relating to permitted trading protocols by developing a more formal process for staff to review and approve new trading protocols. However, minimum standards requiring multilateral and pre-trade transparent execution on SEFs must be retained, as is required by the CEA, such that one-to-one private negotiations are not permitted for transactions that are required to be executed on a SEF. Limited exemptions from this prohibition are appropriate to maintain for block trades and certain bespoke package transactions that are not required to be executed on a SEF. We note that this approach is consistent with the U.S. Department of the Treasury recommendations, which specifically note the importance of maintaining multilateral and pre-trade transparent execution on SEFs.[70]

Third, in order to further promote pre-trade transparency as required by the CEA, the Commission could consider replacing the current requirement for every SEF to offer an Order Book with less prescriptive principles designed to improve the execution process for clients. For example, (i) a SEF should not be permitted to limit the number of liquidity providers that a client can include on an RFQ, (ii) any SEF participant should have the ability to display firm executable prices on the SEF that are differentiated from indicative prices and to make them accessible to all other SEF participants, and (iii) a SEF should provide full interaction between its available trading protocols such that, before trading, clients are always made aware of whether a better firm price is being offered somewhere else on the platform.

This alternative approach preserves the benefits of the current system while codifying a less prescriptive set of requirements for SEFs relating to permitted trading protocols. Consistent with statutory requirements, this approach is designed to promote SEF trading and increase pre-trade transparency.

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[70] *Supra* note 3.

II. The SEF Proposal Endorses Anticompetitive Practices by SEFs

The SEF Proposal fundamentally re-interprets the statutory requirement for SEFs to provide market participants with impartial access in order to permit SEFs to engage in a variety of discriminatory practices. These discriminatory practices will negatively impact market competition and liquidity, as new or smaller liquidity providers may be blocked from accessing necessary liquidity pools and clients may be deprived of any opportunity to access the unique liquidity pools and trading protocols offered by trading venues that historically catered to the dealer-to-dealer segment of the market.

Below, we detail the benefits of the current regulatory framework and the expected adverse impacts of the SEF Proposal. We then explain how the proposals are inconsistent with statutory requirements in the CEA, conflict with internationally-harmonized standards, and fail to satisfy a cost-benefit analysis. We also note that these proposals are inconsistent with the recommendations made by the U.S. Department of the Treasury in its 2017 Capital Markets Report, which specifically note the importance of maintaining impartial access to SEFs.[71] Finally, we provide alternative suggestions that are designed to further streamline the SEF regime in a manner that is consistent with the CEA, while preserving, and building upon, the documented benefits realized by market participants.

A. The Current Regulatory Framework Has Provided Material Benefits to Investors

We leverage the experience of Citadel Securities as a new liquidity provider to describe how the dealer-to-dealer segment of the swaps market evolved as a result of the implementation of the statutory requirement for SEFs to provide market participants with impartial access.

Dealer-to-dealer trading activity typically occurs on trading venues operated by interdealer brokers ("IDBs"), as liquidity providers tend to avoid negotiating transactions directly with one another for competitive reasons. Prior to the introduction of SEFs, restrictive membership criteria were used to limit access to these IDB trading venues to a select group of incumbent liquidity providers. For example, membership was often explicitly limited to banks that were self-clearing members at a CCP.

These access limitations ensured that the incumbent liquidity providers were insulated from competition, as potential new liquidity providers were blocked from accessing necessary pools of liquidity for pricing and hedging purposes. Without access to the dealer-to-dealer segment of the market, it was practically impossible for a new entrant to provide liquidity to clients.

The Commission's SEF rules dismantled previously existing access barriers by implementing the statutory requirement for SEFs to provide market participants with impartial access.[72] The final SEF rules clarified that selective membership criteria would be prohibited, such as requiring

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[71] *Supra* note 3.

[72] CEA Section 5h(f)(2)(B)(i).

self-clearing membership at a CCP,[73] as well as discriminatory fee structures.[74] In addition, the Commission issued subsequent guidance to address other access barriers that SEFs were attempting to implement relating to membership criteria and trading protocols.[75]

Implementing impartial access standards had an immediate impact for IRS and index CDS trading activity on SEFs. With greater certainty regarding access to the dealer-to-dealer market, new liquidity providers emerged in both IRS and index CDS.[76] For example, Citadel Securities has become one of the top liquidity providers in USD IRS – and while innovation and competitive differentiation fueled that growth – Citadel Securities may have never been able to enter the market at all without the implementation of impartial access standards. The emergence of new liquidity providers has benefited clients by increasing price competition, reducing transaction costs, diversifying sources of liquidity, and leading to innovations such as the provision of firm on-screen pricing.

While the above description focuses on the experience of Citadel Securities as a new liquidity provider in these markets, it is important to note that the access limitations previously employed by IDBs also prevented clients from accessing the competitive pricing and liquidity found on these trading venues. The current implementation of impartial access has removed many of the more blatant barriers that prevented clients from accessing certain SEFs, but, as acknowledged in the SEF Proposal, additional barriers remain, such as the practice of "post-trade name give-up" and the lack of average pricing functionality.[77] Citadel, like many clients, continues to support the Commission addressing these remaining barriers in order to facilitate client access to a wider range of SEFs.[78]

B. The SEF Proposal Will Erode Documented Benefits and Impede Market Evolution

The SEF Proposal fundamentally alters the current impartial access standards by allowing SEFs to discriminate among market participants, as long as they are not considered "similarly situated."[79] The SEF Proposal allows each SEF the discretion to determine which market participants should be considered "similarly situated."[80]

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[73] Current SEF Rules at 33508.

[74] §37.202(a)(3).

[75] Staff Guidance on Swap Execution Facilities Impartial Access (November 14, 2013), available at http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/dmostaffguidance111413.pdf.

[76] *See, e.g.,* "New players break into credit derivatives", FT (Nov. 17, 2015), available at: https://www.ft.com/content/22b83fa4-8c6e-11e5-8be4-3506bf20cc2b.

[77] SEF Proposal at 61964, FN 129.

[78] *See, e.g.,* "Brokers defy BlackRock over average pricing on Sefs," Risk.net (Aug. 27, 2015), available at: https://www.risk.net/derivatives/2423396/brokers-defy-blackrock-over-average-pricing-sefs; and Managed Funds Association Position Paper on Why Eliminating Post-Trade Name Disclosure Will Improve the Swaps Market (March 31, 2015), available at: https://www.managedfunds.org/wp-content/uploads/2015/04/MFA-Position-Paper-on-Post-Trade-Name-Disclosure-Final.pdf.

[79] SEF Proposal at 61993.

[80] *Id.*

In practice, this would permit the re-introduction of membership criteria designed to insulate incumbent liquidity providers from competition by blocking access to the dealer-to-dealer segment of the market. Under the SEF Proposal, it appears that a SEF would be permitted to limit membership in the following ways:[81]

Membership Criteria		Anticompetitive Implication
Self-clearing members of a CCP for OTC derivatives	⇨	Excludes (i) new or smaller liquidity providers that do not have a self-clearing membership and (ii) clients
Registered swap dealers	⇨	Excludes (i) new or smaller liquidity providers that may be floor traders and (ii) clients
Banks or liquidity providers with a minimum amount of Tier 1 capital	⇨	Excludes (i) non-bank liquidity providers and (ii) clients
Liquidity providers that have been “enabled” by, or have bilateral documentation with, a minimum number of other liquidity providers	⇨	Excludes (i) new or smaller liquidity providers and (ii) clients
Liquidity providers with a minimum amount of transaction volume	⇨	Excludes (i) new or smaller liquidity providers and (ii) clients

These same criteria could also be used to limit the types of entities that are eligible to provide liquidity on dealer-to-customer SEFs. Similar discrimination would also be permitted by SEFs when applying trading protocols or setting fees.[82]

This type of discriminatory treatment is prohibited under current Commission rules.[83] Allowing these types of practices will negatively impact market competition and liquidity, as new or smaller liquidity providers may be blocked from accessing the dealer-to-dealer segment of the market, curtailing their ability to offer liquidity to clients. In turn, clients may be permanently blocked from certain SEFs, depriving them of any opportunity to access the liquidity and trading protocols offered by those SEFs, and impeding natural market evolution.

C. The SEF Proposal is Inconsistent with the Commodity Exchange Act

The CEA requires SEFs to “provide market participants with impartial access to the market.”[84] Importantly, this statutory requirement applies to all market participants, not just “similarly situated” market participants. If Congress had intended to limit the application of this requirement,

[81] *See* SEF Proposal at 61993-95.

[82] *See* SEF Proposal at 61995-97.

[83] *See supra* notes 73-75.

[84] CEA Section 5h(f)(2)(B)(i).

it could have easily modified the provision to require SEFs to "provide **similarly situated** market participants with impartial access to the market." Congress did not elect to do so.

By proposing to limit the impartial access requirement to "similarly situated" market participants, and providing SEFs with the discretion to define "similarly situated," the SEF Proposal overrides clear congressional intent and eviscerates the statutory requirement. As described above, the proposed interpretation of impartial access will permit a host of discriminatory practices designed to wall-off certain SEFs and limit access to a handful of bank liquidity providers.[85]

The SEF Proposal attempts to justify this proposed interpretation by arguing that the CEA does not mandate an all-to-all trading environment.[86] However, the SEF Proposal then renders this argument moot by acknowledging that an all-to-all trading environment has not developed under its current interpretation of impartial access.[87] Therefore, by definition, the current impartial access standards do not mandate an all-to-all trading environment. Instead, the current impartial access standards have required SEFs to remove discriminatory barriers that historically prevented new liquidity providers from entering the market and clients from selectively accessing the unique liquidity pools and trading protocols offered by IDB trading venues. This removal of discriminatory access barriers, as required by the CEA, has resulted in greater competition and market-led innovation.

The SEF Proposal also points to a separate statutory provision that requires SEFs to "establish and enforce compliance with any rule of the swap execution facility, including [. . .] any limitation on access to the swap execution facility."[88] Rules of statutory construction dictate that, to the extent possible, these two provisions must be interpreted in a manner that does not create a conflict. In this regard, we note that the impartial access requirement is clear and unqualified,[89] and the provision above appears in a separate subsection of the CEA. Together, these two statutory provisions result in the conclusion that SEFs may have rules that limit access to the trading venue, but such rules (similar to all other SEF rules) must be consistent with the separate impartial access requirement. For example, SEFs are permitted to establish participant eligibility criteria, such as those set forth in each SEF's rulebook today. However, such participant eligibility criteria must be impartial and non-discriminatory, instead focusing on topics such as whether the prospective member is in good standing, solvent, an ECP, not subject to a statutory disqualification, and properly licensed. In addition, SEFs are permitted to establish rules to deny, suspend, or permanently bar members from the venue based on their trading activities, including as part of disciplinary proceedings or emergency actions. However, again, these rules must be applied in an impartial and non-discriminatory manner.

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[85] This conclusion is supported by the access barriers previously employed by IDBs and the several documented instances of anticompetitive behavior by the incumbent liquidity providers in the OTC derivatives markets (e.g., *In Re Credit Default Swaps Antitrust Litigation*)

[86] SEF Proposal at 61993.

[87] SEF Proposal at 62062.

[88] CEA Section 5h(f)(2)(A) and SEF Proposal at 61993.

[89] *See* CEA Section 5h(f)(2)(B)(i).

Instead of the straightforward interpretation above, the SEF Proposal attempts to create a conflict between these two statutory provisions in order to justify limiting the scope of the clear and unqualified impartial access requirement. As a result, the SEF Proposal overrides clear statutory intent in order to permit SEFs to discriminate against specific types of market participants.

The discussion above highlights that the SEF Proposal is also inconsistent with section 15(b) of the CEA, which requires the Commission to "endeavor to take the least anticompetitive means" in achieving its policy objectives. If the policy goal is to not mandate an all-to-all trading environment, then the proposed revisions to its current impartial access standards are unnecessary since an all-to-all trading environment has not developed under the current interpretation of impartial access. Permitting SEFs to discriminate against specific types of market participants will have material anticompetitive effects that particularly disadvantage new or smaller liquidity providers and clients.

D. The SEF Proposal Conflicts with Internationally-Harmonized Standards

The current equivalence agreement between the US and EU is supported by there being consistent standards regarding access to SEFs, MTFs, and OTFs. Similar to the impartial access requirement in the CEA, MiFID II requires MTFs and OTFs to establish non-discriminatory rules governing access.[90] ESMA issued additional guidance that clearly prohibits the same access barriers currently prohibited by the Commission relating to membership criteria and trading protocols, including self-clearing membership, minimum trading activity, or "enablements" by other liquidity providers.[91]

By replacing the current impartial access standards with an interpretation that permits SEFs to discriminate against specific types of market participants, the SEF Proposal risks negatively impacting the US-EU equivalence agreement. This is because certain SEFs may impose discriminatory access criteria that have the effect of preventing EU clients or new EU liquidity providers, among others, from fairly accessing the venue.

E. The SEF Proposal Fails to Satisfy a Cost-Benefit Analysis

The SEF Proposal only engages in a cursory analysis of the impact of reinterpreting the statutory requirement for SEFs to provide market participants with impartial access. This analysis largely consists of circular reasoning, which asserts that (i) the main effect of the proposal is to not mandate an all-to-all trading environment, and (ii) since an all-to-all trading environment has not developed under the Commission's current interpretation of impartial access, "costs to market

[90] MiFID II Article 18(3).

[91] ESMA Q&A on MiFID II and MiFIR market structure topics, Section 5.1, Question 3, available at: https://www.esma.europa.eu/sites/default/files/library/esma70-872942901-38_qas_markets_structures_issues.pdf.

participants may not change much from the current situation."[92] This analysis is deeply flawed and does not meet the statutory requirements of Section 15(a) of the CEA.

First, the SEF Proposal fails to accurately assess the practical impact of permitting SEFs to discriminate against specific types of market participants. The current impartial access standards have resulted in SEFs dismantling barriers that were used to limit access to IDB trading venues to a select group of bank liquidity providers. Permitting these barriers to be re-introduced will result in significant costs for market participants that have nothing to do with whether or not an all-to-all trading environment exists.

For example, paragraph (B) above illustrates how SEFs will be able to discriminate against new or smaller liquidity providers. Without reliable and secure access to the dealer-to-dealer segment of the market, it will be practically impossible for these firms to provide liquidity to clients. As a result, the SEF Proposal can be expected to result in reduced competition among liquidity providers, reversing the observed benefits of lower transaction costs and diversified sources of liquidity under the current SEF rules.[93] Market research has documented efforts by bank liquidity providers to retain market power in certain OTC derivatives by avoiding the Commission's current impartial access requirements.[94] These efforts to insulate themselves from competition will now be expressly permitted in the SEF Proposal.

In addition, clients will be prohibited from selectively accessing the unique liquidity and trading protocols offered by IDB trading venues, as the SEF Proposal explicitly endorses dealer-only SEFs.[95] Market research has found that SEFs operated by IDBs may offer more competitive pricing in certain instruments compared to other SEFs.[96] SEFs operated by IDBs also offer unique trading protocols, given the use of voice brokers. While the SEF Proposal asserts that an expanded set of trading protocols will be available to market participants, it fails to acknowledge that many of these trading protocols are only available on SEFs operated by IDBs and, therefore, the revised interpretation of impartial access will result in clients being unable to access many of them. Similarly, clients may be unable to comply with the expanded trade execution requirement contemplated in the SEF Proposal, as certain instruments may only be available for trading on SEFs operated by IDBs.

The SEF Proposal also fails to evaluate the impact on market-wide liquidity and price discovery. Despite acknowledging that "[t]he Commission has further observed that when markets are open and transparent, prices are more competitive and markets are more efficient,"[97] the proposed interpretation of impartial access will result in the exact opposite, as each SEF can limit membership to a specific subset of market participants. This will fragment liquidity, impair price

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[92] SEF Proposal at 62062.

[93] *See supra* note 29 at page 69 and *supra* note 32 at page 23.

[94] *Supra* note 32 at page 30.

[95] SEF Proposal at 61995.

[96] Quantifying Interest-Rate Swap Order Book Liquidity, Greenwich Associates (Q1 2016), available at: https://www.greenwich.com/fixed-income-fx-cmds/quantifying-interest-rate-swap-order-book-liquidity.

[97] SEF Proposal at 61982.

discovery, and reduce transparency, as the various barriers imposed by SEFs will make it more difficult for market participants to access, consolidate and compare available quotes.

Second, the SEF Proposal's focus on not mandating an all-to-all trading environment is misplaced. As acknowledged in the SEF Proposal, the Commission's current interpretation of impartial access has not resulted in the market transitioning to an all-to-all trading environment.[98] Therefore, the current impartial access standards do not mandate an all-to-all trading environment. Importantly, however, they do provide the ability for such an evolution to organically occur by dismantling artificial barriers. By endorsing dealer-only SEFs and a two-tier market structure,[99] the Commission is inappropriately dictating market structure outcomes. To the extent the SEF Proposal is correct that "[m]aintaining certain types of markets, such as the dealer-to-dealer market, should be beneficial to all market participants, including participants in the dealer-to-client market,"[100] then such an outcome should be expected to naturally occur. The Commission should not be reversing existing rules in order to preserve the status quo and restrict market-led innovation by allowing improper discrimination against specific types of market participants.

F. Suggested Alternatives

We urge the Commission to reconsider its proposed approach on impartial access. As discussed above, the current impartial access standards have correctly implemented the statutory mandate and have resulted in the dismantling of barriers that were used to limit access to IDB trading venues to a select group of bank liquidity providers.

The Commission should re-affirm its current impartial access standards and formally codify the additional guidance that was issued to address other access barriers that SEFs were attempting to implement relating to membership criteria and trading protocols.[101] This includes prohibiting (i) enablement mechanisms, (ii) criteria designed to discriminate against specific types of firms, (such as by referencing self-clearing membership, a minimum amount of capital, a certain type of registration or incorporation, or a minimum level of trading activity), (iii) criteria designed to prevent a firm from being both a liquidity taker and a liquidity provider, and (iv) requirements for bilateral documentation between trading counterparties in order to execute cleared swaps. It is critical that the impartial access standards continue to apply to all aspects of a SEF's operation, including membership criteria, trading protocols, and fees, in order to prevent anticompetitive practices. This alternative approach would follow the U.S. Department of the Treasury recommendations, which recognize the importance of maintaining impartial access on SEFs.[102]

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[98] SEF Proposal at 62062.

[99] SEF Proposal at 61995 and 62060.

[100] SEF Proposal at 62060.

[101] *Supra* note 75.

[102] *Supra* note 3.

III. The SEF Proposal Introduces Material Risks to the Clearing Workflow

The SEF Proposal fundamentally alters current execution-to-clearing operational workflows for SEF trading by failing to preserve the current STP standards. Cleared swaps executed on a SEF would no longer be required to be submitted to a CCP within 10 minutes, raising the prospect of material delays between execution and clearing that lead to unnecessary market, credit, and operational risks. In addition, bilateral breakage agreements between each pair of trading counterparties would now be permitted for cleared swaps on SEFs, disrupting current trading relationships and reducing access to trading counterparties.

Below, we detail the benefits of the current regulatory framework and the expected adverse impacts of the SEF Proposal. We then explain how these proposals are inconsistent with statutory requirements in the CEA, conflict with internationally-harmonized standards, and fail to satisfy a cost-benefit analysis. Finally, we provide alternative suggestions that are designed to further streamline the SEF regime in a manner that is consistent with the CEA, while preserving the documented benefits realized by market participants.

A. The Current Regulatory Framework Has Provided Material Benefits to Investors

We leverage the experience of both Citadel and Citadel Securities to describe the material benefits for all market participants trading on SEFs that have directly resulted from the Commission's current STP standards.

Prior to the introduction of SEFs, there was a lack of market consistency regarding the execution-to-clearing workflow for OTC derivatives that were intended to be cleared. This lack of consistency unnecessarily complicated the trading of cleared swaps, which should be more accessible to market participants since central clearing eliminates bilateral counterparty credit risk and the need for complex bilateral trading and credit support documentation between each and every pair of potential trading counterparties.

Below, we list the issues that led to this lack of consistency and detail how they were addressed by the Commission's STP standards:

- **Submission timeframes**. It would often take hours, if not days, following execution for a transaction to be submitted to, and accepted for clearing by, a CCP. This extended length of time between execution and clearing acceptance introduced risks for both market participants and CCPs. In particular, these delays increased market, credit, and operational risks for market participants, as a transaction could not be considered successfully executed until it was accepted for clearing. In addition, these delays impaired the ability of CCPs to monitor current market trading activity and the number of transactions pending submission to clearing, information that is important for a CCP's risk management framework, particularly during volatile market conditions.

  In order to minimize delays between execution and clearing acceptance, the Commission established STP standards that require (i) SEFs to submit all cleared swaps to a CCP no later than 10 minutes after execution,[103] and (ii) CCPs to accept or reject transactions within 10 seconds of receipt.[104]

- **Clearing certainty**. There was little pre-trade visibility regarding whether a potential transaction would successfully clear and a lack of consistency regarding what would happen if the transaction was subsequently rejected from clearing. When combined with the submission delays described above, many market participants concluded that this uncertainty introduced an unacceptable level of market, credit and operational risk. As a result, bilateral breakage agreements were introduced to manage, and allocate responsibility for, these potential risks arising during the period between execution and clearing acceptance. This re-introduction of bilateral trading documentation undermined one of the main benefits of central clearing and limited client access to a broader range of trading counterparties.

  In order to provide greater certainty to market participants that a transaction will successfully clear, the Commission established STP standards that require pre-execution credit checks by a client's clearing member to ensure available clearing capacity.[105] In the rare circumstance that a transaction passes the pre-execution credit check but nonetheless is rejected by the CCP, the STP standards permit the transaction to be resubmitted for clearing in order to address operational or clerical errors within one hour of the CCP's rejection.[106] In the event a transaction cannot be successfully cleared, it is considered to be void *ab initio*.[107] This approach provides a consistent standard for all SEF transactions that are intended to be cleared, and obviates the need for bilateral breakage agreements, which were subsequently prohibited by the Commission for SEF transactions.[108]

The Commission's STP standards have been successfully implemented by the industry since 2013 and have significantly enhanced the SEF trading environment. The combination of pre-execution credit checks and well-defined submission timeframes has reduced market, credit, and operational risks for SEF trading, and has focused market participants on streamlining the execution-to-clearing workflow. As a result, the void *ab initio* backstop has rarely been used, but has promoted SEF trading by enabling clients to seamlessly trade cleared swaps without complex bilateral documentation and with a wider range of trading counterparties. This ease of trading

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[103] CFTC Letter No. 15-67 (Dec. 21, 2015), available at: http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/15-67.pdf.

[104] "Staff Guidance on Swaps Straight-Through Processing" (Sept. 26, 2013), available at: http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/stpguidance.pdf.

[105] *Id.*

[106] CFTC Letter No. 17-27 (May 30, 2017), available at: https://www.cftc.gov/sites/default/files/idc/groups/public/@lrlettergeneral/documents/letter/17-27.pdf.

[107] *Supra* note 104.

[108] Staff Guidance on Swap Execution Facilities Impartial Access (November 14, 2013) at FN 3, available at http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/dmostaffguidance111413.pdf.

cleared swaps on SEFs has also facilitated the entry of new liquidity providers, such as Citadel Securities, that do not have legacy bilateral trading documentation in place with clients.

B. The SEF Proposal Will Erode Documented Benefits and Impede Market Evolution

The SEF Proposal elects to retain only some of the current STP standards that have been successfully implemented by SEFs and market participants.

- **Submission timeframes**. The SEF Proposal eliminates the requirement for SEFs to submit transactions to a CCP no later than 10 minutes after execution, but retains the requirement that CCPs must accept or reject transactions within 10 seconds of receipt.[109]

- **Clearing certainty**. The SEF Proposal retains pre-execution credit checks and the requirement that transactions are to be considered void *ab initio* if rejected by a CCP for credit reasons.[110] However, the SEF Proposal eliminates void *ab initio* and the accompanying prohibition on breakage agreements for transactions that are rejected by a CCP due to operational or clerical errors, and SEFs are provided with complete flexibility to establish bespoke error trade policies in these circumstances.[111]

These proposed changes would fundamentally alter current operational workflows for SEF trading, and introduce unnecessary market, credit, and operational risk. By eliminating the requirement for SEFs to submit executed transactions to a CCP within a prescribed timeframe, market participants and CCPs lose predictability regarding the submission process. The prospect of material delays between execution and clearing submission increases market, credit and operational risks for trading counterparties, and makes it more likely that bilateral breakage agreements would be introduced for cleared swaps where permitted under the SEF Proposal. As detailed above, bilateral breakage agreements undermine key benefits of trading cleared swaps on SEFs, including ease of trading and access to a wider range of trading counterparties, and impede market evolution, as certain trading protocols (e.g. anonymous trading) are based on the assumption that bilateral trading documentation is not required for cleared swaps. The prospect of breakage being owed from one trading counterparty to another for a cleared swap also serves as a material impediment to the entry of new liquidity providers, as counterparty credit assessments and the negotiation of bilateral documentation may be required in order to establish a trading relationship.

C. The SEF Proposal is Inconsistent with the Commodity Exchange Act

The CEA requires SEFs to ensure the financial integrity of swaps entered on or through their facilities, including with respect to clearing and settlement.[112] The Commission's current STP standards are designed to implement this statutory requirement by establishing, among others,

[109] SEF Proposal at 62022-23.

[110] SEF Proposal at 62001 and 62023-24.

[111] SEF Proposal at 62001.

[112] CEA Section 5h(f)(7).

consistent clearing submission timeframes for SEFs and procedures for addressing clearing rejections.[113]

In contrast, the SEF Proposal has failed to demonstrate how the proposed STP changes are consistent with the CEA. As detailed above, the proposed changes introduce unnecessary market, credit, and operational risk by fundamentally altering the current execution-to-clearing workflow for cleared swaps on SEFs. For example, eliminating the requirement for SEFs to submit executed transactions to a CCP within a prescribed timeframe increases the likelihood that transactions will be delayed, and potentially rejected, from clearing. It appears difficult to conclude that relaxing the existing standards that have been successfully implemented by market participants since 2013 will promote the financial integrity of swaps executed on SEFs that are intended to be cleared.

D. The SEF Proposal Conflicts with Internationally-Harmonized Standards

The Commission's current STP standards served as a model for the EU, which implemented nearly identical standards as part of MiFID II. In particular, under EU regulations, (i) pre-execution credit checks are required, (ii) MTFs and OTFs must submit transactions to a CCP no later than 10 minutes after execution (and even more quickly if the transaction is executed electronically), (iii) CCPs must accept or reject transactions within 10 seconds of receipt, (iv) resubmission is permitted to address operational or clerical errors, and (v) bilateral breakage agreements are not contemplated for MTF or OTF transactions that are rejected from clearing.[114]

By proposing to modify important elements of the current STP standards, such as eliminating the prescribed timeframe for SEFs to submit transactions to a CCP, the SEF Proposal risks negatively impacting the current equivalence agreement. This is because SEFs may no longer provide the same robust execution-to-clearing operational workflows that protect EU market participants transacting on MTFs and OTFs.

E. The SEF Proposal Fails to Satisfy a Cost-Benefit Analysis

The SEF Proposal attempts to minimize the costs associated with altering the current STP standards by asserting that the proposed changes are "consistent with existing industry practices."[115] This is inaccurate, and results in the Commission failing to conduct a cost-benefit analysis that meets the statutory requirements of Section 15(a) of the CEA.

Submission Timeframes

The first significant change proposed is eliminating the requirement for SEFs to submit transactions to a CCP no later than 10 minutes after execution, and replacing it with a qualitative "prompt, efficient, and accurate" standard. The SEF Proposal puts forward two arguments as to

[113] *See* §37.702

[114] Commission Delegated Regulation (EU) 2017/582, available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0582&from=EN.

[115] SEF Proposal at 62081.

why this should not represent a significant change: (i) many SEFs are not meeting the current 10 minute requirement anyway,[116] and (ii) market participants are still incentivized to confirm trades in a timely manner.[117] In addition, the SEF Proposal argues that more flexible STP standards may be required given the proposed expansion of the trade execution requirement and permitted trading protocols.[118] We discuss each of these arguments below.

First, the SEF Proposal asserts that "many SEFs [. . .] have not been able to meet the time frame when using manual affirmation hubs,"[119] but fails to provide any substantiating data regarding current compliance rates. In our experience, current compliance rates are high, with (a) nearly all dealer-to-client on-SEF index CDS and IRS transactions submitted to clearing within seconds, and (b) most dealer-to-dealer on-SEF index CDS and IRS transactions submitted within approximately 10 minutes after execution, even for voice transactions where manual affirmation is still used by the SEF. Based on our analysis, only one SEF appears to have consistent difficulties in meeting the 10 minute standard. Instead of weakening the standards to cater for this one SEF, and risking a reversal of the significant progress made since the STP standards were first introduced, the Commission should require outlier SEFs to address any issues that are preventing compliance.

These high compliance rates should not be surprising, as the current 10 minute standard was originally proposed by the industry. Notably ISDA, representing market participants and trading venues, represented to the Commission in July 2015 that all SEF-executed transactions (voice and electronic) could be successfully submitted to clearing within 10 minutes by April 2016[120] and subsequently published best practice principles designed to ensure full compliance.[121] This industry involvement in the existing STP standards also contributed to the EU adopting an equivalent 10 minute submission timeframe for all cleared swaps executed on MTFs and OTFs under MiFID II.[122]

Second, while it is true that market participants have incentives to confirm trades in a timely manner, unfortunately the clearing submission process is not in the control of any individual market participant. Instead, the submission process only proceeds as quickly as the slowest party involved, with a market participant bearing the risk of delays by (i) the SEF in initiating the clearing submission and (ii) its trading counterparty (for transactions that require manual affirmation). Data relating to the execution of cleared swaps that are not subject to the Commission's STP standards demonstrates that incentives alone are insufficient to ensure a timely clearing submission process. This data also shows the lack of an alternative mechanism for clients

[116] SEF Proposal at 62022.

[117] SEF Proposal at 62081.

[118] SEF Proposal at 62022.

[119] SEF Proposal at 62022.

[120] Letter from Steven Kennedy, Global Head of Public Policy, ISDA (July 27, 2015), available at: https://www.isda.org/a/fKiDE/isdas-proposed-plan.pdf.

[121] ISDA Best Practice Principles on Swaps Straight-through Processing (June 13, 2016), available at: https://www.isda.org/a/pKiDE/stp-wg-stp-general-principles-final.pdf.

[122] *Supra* note 114.

to demand that their liquidity providers ensure a timely clearing submission process, given that clients need to maintain access to the limited number of liquidity providers that are available. Our analysis found that many swaps executed off-SEF still take hours to be submitted to clearing, even though fewer parties are involved in the clearing submission process (e.g. just the two trading counterparties instead of a SEF as well). Materially different submission timeframes between on-SEF and off-SEF transactions are observed even when the relevant trading counterparties, clearing members, and CCP are all identical. In fact, our analysis found that off-SEF swaps can still take until the day after execution to successfully clear.

Third, expanding the trade execution requirement and permitted trading protocols, as proposed, does not provide support for weakening the current STP standards for SEF trading. This is because all clearing-mandated index CDS and IRS instruments already trade on SEFs today as Permitted Transactions (notably on SEFs operated by IDBs), and are therefore subject to the current STP standards.[123] In addition, as detailed in Section I of this letter, many SEFs already offer a wide range of trading protocols, including voice, work-ups, and auctions, for both Permitted Transactions and Required Transactions. Therefore, the SEF Proposal is not expected to directly result in either new instruments or new trading protocols being offered on SEFs that are not already offered on at least one SEF today. Current compliance rates demonstrate that the 10 minute standard provides sufficient flexibility to be achievable across the full range of instruments and trading protocols (voice and electronic) offered on SEFs. As further evidence, we note that MiFID II has the same 10 minute standard even though MTFs and OTFs are given complete flexibility regarding permitted trading protocols and support trading in the full range of clearing-mandated instruments.

Eliminating the 10 minute standard will result in transactions taking longer to be submitted to a CCP, similar to off-SEF transactions that are not covered by the Commission's STP standards today. This will lead to unnecessary costs for both market participants and CCPs. Delayed clearing submissions will introduce additional market, credit and operational risks for market participants, as a transaction cannot be considered successfully executed until it is accepted for clearing. In addition, delayed clearing submissions will impair the ability of CCPs to predictably monitor the flow of incoming transactions, introducing new risks that must be addressed in risk management frameworks, including late-day submissions and associated late-day margin calls, particularly during volatile market conditions.

In light of these costs, the SEF Proposal fails to present a compelling case for eliminating the current 10 minute standard. In fact, the SEF Proposal acknowledges that "acceptance or rejection for clearing in close to real time is crucial both for effective risk management and for the efficient operation of trading venues."[124] We urge the Commission to further consider the practical impact of removing the 10 minute standard, and to provide related data, such as:

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[123] We understand that many SEFs operated by IDBs list all of the clearing-mandated index CDS and IRS for trading.

[124] SEF Proposal at 62023.

- Current compliance rates, broken down by instrument type;

- Changes in average submission times for on-SEF transactions since the STP standards were introduced;

- Number of SEFs still using manual affirmation processes, and for which types of instruments and trading protocols;

- Number of SEFs and market participants that still have consistent difficulties in complying with the 10 minute standard;

- Average submission times for cleared off-SEF transactions that are not subject to STP standards;

Clearing Certainty

The second significant set of changes proposed is (i) eliminating the void *ab initio* backstop for on-SEF transactions that are rejected by a CCP due to operational or clerical errors and (ii) failing to maintain the prohibition on breakage agreements for SEF transactions. These changes raise the prospect of bilateral breakage agreements being introduced for cleared swaps executed on SEFs, particularly in light of the market, credit and operational risk created by the proposed elimination of the 10 minute clearing submission timeframe. Introducing breakage agreements would impose the following unnecessary costs on market participants, none of which appear to have been considered in the SEF Proposal:

- **Liquidity disruption**. In light of the current STP standards, bilateral documentation has not been put in place between trading counterparties on SEFs for cleared swaps. To the extent market participants considered breakage agreements necessary in light of the risks introduced by the proposed STP changes, there could be material disruption to liquidity provision and trading activity while these agreements are being negotiated between each pair of trading counterparties.

- **Reduced access to counterparties**. One the main benefits of central clearing is the elimination of bilateral counterparty credit risk and bilateral trading documentation, which enables clients to access a broader range of counterparties.[125] Academic research has shown that central clearing and SEF trading dramatically increased the number of liquidity providers that clients transact with for swaps.[126] Introducing breakage agreements for cleared swaps executed on SEFs undermines this benefit, impairing the ease of trading cleared swaps and limiting client access to new sources of liquidity.

[125] *See, e.g.*, Incentives to centrally clear over-the-counter (OTC) derivatives: A post-implementation evaluation of the effects of the G20 financial regulatory reforms (Nov. 19, 2018) at Figure D.3 (page 26), available at: http://www.fsb.org/wp-content/uploads/R191118-1-1.pdf.

[126] *Supra* note 32 at page 26.

- **Decreased competition**. As detailed above, the introduction of breakage agreements for cleared swaps executed on SEFs creates significant hurdles that limit client access to new liquidity providers, including counterparty credit assessments and the negotiation of bilateral documentation. The re-introduction of bilateral counterparty credit risk for cleared swaps also creates a pretext for SEFs to implement discriminatory access criteria, such as limiting access to self-clearing members of a CCP.

- **Additional complexity**. The void *ab initio* backstop establishes a consistent, market-wide standard in the event a SEF-executed transaction cannot be successfully cleared. By eliminating this backstop for transactions rejected due to operational or clerical errors and allowing each SEF to establish bespoke error trade policies, the SEF Proposal significantly increases complexity for market participants, as the impact of a clearing rejection may be different from one SEF to another. This lack of consistent standards may create confusion and negatively impact liquidity, particularly in volatile market conditions.

- **Restrictions on innovation**. Certain trading protocols, such as anonymous order book trading, cannot operate as intended if bilateral documentation is required between trading counterparties. Removing the void *ab initio* backstop and re-introducing bilateral counterparty credit risk for cleared swaps impairs the ability of SEFs to innovate with respect to trading protocols, which appears to be contrary to other aspects of the SEF Proposal.

In light of the costs detailed above, the Commission must present a compelling case for modifying the current STP standards. However, the SEF Proposal fails to provide any evidence to suggest that the current STP standards are not operating in an effective and beneficial manner for market participants. To the contrary, the current STP standards have dramatically reduced market, credit, and operational risk when trading cleared swaps on SEFs and have resulted in a robust execution-to-clearing workflow where clearing rejections are extremely rare. In fact, we have been unable to identify a single transaction executed on-SEF in 2018 by either Citadel or Citadel Securities that was declared void *ab initio*. We urge the Commission to conduct a more fulsome cost-benefit analysis, including providing market-wide statistics on the overall percentage of transactions that have been declared void *ab initio*, before modifying STP standards that have been successfully implemented by the market since 2013 and have served as a model for other jurisdictions.

F. Suggested Alternatives

Instead of proposing modifications that would introduce unnecessary risks and costs for market participants, the Commission should formally codify the current STP standards, including (i) the additional STP guidance,[127] (ii) the no-action letter setting forth the 10 minute clearing submission

[127] *Supra* note 104.

timeframe,[128] (iii) the no-action letter permitting resubmissions to correct operational or clerical errors[129], and (iv) the prohibition on breakage agreements for SEF transactions.[130] As is the case today, these standards should apply to all cleared swaps executed on or pursuant to the rules of SEFs (including block transactions, consistent with current market practices[131]), regardless of the trading protocol employed, which CCP is clearing the transaction, and whether the transaction is subject to the clearing mandate (or is voluntarily cleared).[132]

In codifying the ability of SEFs to allow resubmissions to correct operational or clerical errors, we support providing SEFs with additional flexibility to determine the best procedures to streamline the error correction and resubmission process. For example, SEFs should not be required to make an affirmative finding that the trade resulted from an error, and should be permitted to allow the trading counterparties to quickly initiate the error correction process. However, all SEFs should remain subject to the same one hour deadline to effect a resubmission and the void *ab initio* backstop should remain applicable to the extent a transaction cannot be successfully cleared.

In addition to codifying the current STP standards for SEF transactions, we encourage the Commission to consider similar standards for off-SEF trading activity that are designed to improve market functioning and efficiency. For example, in the EU, transactions executed away from trading venues are required to be submitted to clearing within 30 minutes of execution.[133]

[128] *Supra* note 103. In doing so, the Commission should retain the overarching standard that "trades should be accepted or rejected for clearing as soon as technologically practicable as if fully automated systems were used."

[129] *Supra* note 106.

[130] *Supra* note 108.

[131] *See* CFTC Letter No. 17-60 (Nov. 14, 2017), available at: https://www.cftc.gov/sites/default/files/csl/pdfs/17/17-60.pdf, which we recommend codifying.

[132] A more in-depth analysis of current data, as suggested herein, may demonstrate that certain targeted exceptions are warranted, such as for risk mitigation services offered by SEFs for FRAs.

[133] *Supra* note 114.

IV. Other Topics

A. Scope of the Trade Execution Requirement

(i) Instruments

Both Citadel and Citadel Securities agree with the Commission that the current SEF-driven MAT determination process has proven to be suboptimal. Additional instruments should be considered for mandatory SEF trading, such as fixed-to-float swaps in currencies other than USD, EUR, or GBP and certain commonly traded forward-starting swaps (e.g. 1Y1Y and 5Y5Y). However, the proposal to eliminate the MAT process entirely risks bringing into scope custom and bespoke instruments, particularly in the interest rate asset class, that may not well-suited for mandated multilateral and pre-trade transparent execution on SEFs. In addition, the proposal may discourage further expansions of the clearing obligation, even though certain FX non-deliverable forwards and additional CDS indices are being cleared in material volumes.

Instead of relaxing minimum standards for SEF execution in order to cater for these custom and bespoke instruments, we recommend that the Commission revise the MAT process such that it has a central role in setting the appropriate scope of the trade execution requirement. We note that this approach is consistent with the process in the EU under MiFID II and the recommendations made by the U.S. Department of the Treasury in its 2017 Capital Markets Report.[134]

We also agree with the Commission that trading activity in package transactions containing a component that is subject to the trade execution requirement should continue to transition onto SEFs.[135] In this context, we recommend that the Commission engage with the CME to amend CME Rule 538 so as to allow invoice spread packages containing an interest rate swap and an interest rate future to trade on SEFs. Currently, CME Rule 538 prevents a swap that is traded on, or subject to the rules of, a SEF from serving as the related position component of an Exchange for Risk or Exchange of Option for Option transaction. In our view, there is not a clear legal or operational justification for this limitation, and the conflict between CME Rule 538 and the trade execution requirement must be resolved in order to facilitate the transition of invoice spread packages onto SEFs.

(ii) Market Participants

While we support the proposal to codify an exemption from the trade execution requirement for transactions where an exemption from the clearing obligation applies, this exemption should be limited to the currently available exemptions set forth in part 50 (*Clearing Requirement and Related Rules*).[136] The Commission should refrain from pre-emptively granting exemptions for

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[134] *Supra* note 3.

[135] *See* SEF Proposal at 62039.

[136] *See* SEF Proposal at 62038.

potential future modifications of part 50, as any such future modifications should be evaluated on a case-by-case basis pursuant to CEA Section 4(c).

In addition, market participants should be required to actually elect an exemption from the clearing obligation in order to be eligible for the corresponding exemption from the trade execution requirement.[137]

(iii) Implementation Timing

To the extent the scope of the trade execution requirement is expanded, it is important that liquidity in those instruments transitions onto SEFs in an efficient manner. In our view, phasing-in an expansion to the trade execution requirement by counterparty type introduces unnecessary complexity for market participants. The initial implementation of the trade execution requirement in 2014 proceeded quite smoothly with all market participants being subject to the same compliance date, even though everyone was connecting to SEFs for the first time. The SEF Proposal has failed to justify altering this previous approach.

B. Pre-Execution Communications and Block Transactions

Both Citadel and Citadel Securities strongly agree with the Commission continuing to prohibit pre-arranged trading to ensure that competitive execution occurs on SEFs.[138] However, the proposed blanket prohibition on any off-SEF pre-execution communications may be problematic, particularly with respect to the negotiation of block transactions. Dealer-to-client SEFs do not currently offer voice functionality, and it appears unlikely that individual SEFs would install dedicated phones, as suggested in the SEF Proposal.[139] Therefore, clients would be required to alter current trading practices in order to comply with the prohibition on pre-execution communications, which could make the negotiation of block transactions in particular more costly.

C. Improving SEF Disclosures

Both Citadel and Citadel Securities support the Commission's efforts to increase the level of transparency provided by SEFs with respect to trading protocols and the use of discretion.[140] In addition, we believe SEFs should be required to publicly disclose (i) all fees imposed on members, including for connectivity or API access, and (ii) the details of any market maker or trading incentive programs offered, including the eligibility criteria and the discounts or rebates provided. This type of disclosure will ensure a baseline level of transparency for market participants.

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[137] *See* SEF Proposal at 62040.

[138] *See* SEF Proposal at 62043.

[139] SEF Proposal at 62061.

[140] *See* SEF Proposal at 61982.

We thank the Commission for considering our comments on the SEF Proposal. Please feel free to call the undersigned at (646) 403-8200 with any questions regarding these comments.

Respectfully,

/s/ Stephen John Berger

Managing Director

Global Head of Government & Regulatory Policy