From: Robert Rutkowski
Sent: Monday, March 18, 2019 1:12 PM
To: questions
Subject: Swap Execution Facilities and Trade Execution Requirement, RIN 3038-AE25; Request for Comment on Name Give-up, RIN 3038-AE 79

Chairman J. Christopher Giancarlo
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Swap Execution Facilities and Trade Execution Requirement, RIN 3038-AE25; Request for Comment on Name Give-up, RIN 3038-AE 79

Dear Chairman:

Commenting on the Commodity Futures Trading Commission ("CFTC" or "Commission")'s Proposed Rule on Swaps Execution Facilities (SEFs) and the Trade Execution Requirement (the "Proposed Rule") and the Request for Comment on Post-Trade Name Give Up (the "Comment Request").

Proposed Rule on Swaps Execution Facilities
This Proposed Rule would make fundamental and radical changes in existing SEF requirements and therefore to the implementation of the Dodd-Frank Act trade execution requirements. These changes run roughshod over the intent of Congress in enacting requirements that swaps be executed on multiple-to-multiple trading exchanges that offer impartial access to market participants.

By eliminating the current minimum trade execution requirements – Request for Quote (RFQ) to three counterparties or execution on a centralized Order Book – the Proposed Rule guts the "competitive exchange" aspect of SEFs. By permitting SEFs to discriminate between different types of market participants the Proposed Rule effectively eliminates impartial access requirements and permits the return of dealer-only trading clubs. Given that this Proposed Rule allows any means of execution and any group of dealers to create SEFs that exclude competitors and end users, it is difficult to see how the swaps trading regime it permits would differ from the pre-Dodd Frank "derivatives dealer club" that existed prior to the 2008 financial crisis.

Even elements of the rule that would in other circumstances have value are negated by the elimination of core SEF requirements contained in this rule. For example, in another context one would be supportive of the proposal to eliminate the current Made Available to Trade (MAT) procedure and instead requiring all listed swaps designated for

mandatory clearing to also be subject to mandatory SEF trading. However, pairing that proposal with an elimination of core trade execution requirements on SEFs effectively eliminates its value, since without these trade execution requirements transacting on a SEF will not result in the competitive and systemic risk benefits that exchange trading is intended to create. Likewise, in another context we would favor the expanded limitations on pre-arranged trades in this proposal, but are concerned that these limitations lose much of their value given the effectively unlimited forms of trade execution that would now be permitted on SEFs.

I also agree with the Commission's assessment that the low level of traded interest rate swap notionals – apparently less than 10 percent - that are actually subject to the full set of trade execution requirements (i.e. are Required Transactions) is a real problem that calls for Commission action. But again, the elimination of the trade execution requirements that give SEFs their competitive exchange character is not a solution to the issue of evasion of the execution requirements.

In this context, I would also note that the current SEF exchange trading requirements which would be eliminated by this proposal are not exactly restrictive. Parties to a trade that falls under MAT requirements are only required to submit a request for quote to three unaffiliated counterparties, and the SEF must register the trade in the order book. As AFR argued in 2011, an RFQ to a limited number of counterparties is already some distance from a full multiple-tomultiple exchange trading system. The Proposed Rule refers repeatedly to the need for more "flexibility" for SEF execution methods, but the current system is already extremely flexible as compared to futures exchanges, and was made so in order to accommodate the less standardized nature of swaps as compared to futures. The elimination of execution requirements moves beyond flexibility to simply abandon the goal of multiple to multiple exchange-type trading, which the Commission effectively claims is too restrictive for cleared derivatives.

In general, it is no victory at all to move more transactions under SEF rules if those rules no longer require SEFs to subject swap trades to greater openness, transparency, and competition. Reducing SEFs to simple service providers that assist in the process of trade confirmation and reporting but lack exchange functionality or competition requirements may increase volume. But it also abandons the underlying policy rationale for SEF trading. Market participants are already perfectly willing to use SEFs as long as their transactions are not subject to the execution requirements that would be eliminated in this proposal (as noted in footnote 261 of the Proposed Rule, over half of interest rate swaps are conducted on SEFs but less than 10 percent are subject to competitive trade execution requirements).

What is perhaps most disturbing about the Proposed Rule is that it evidences a pervasive lack of awareness of the core policy justifications and goals of exchange-type trading on SEFs. The proposal does not discuss or in some cases even cite recent research that demonstrates substantial benefits to end users of competitive SEF trading under current rules. Studies by the Bank of England and the CFTC's own economists demonstrate that trading which is compliant with current execution requirements significantly narrows spreads and lowers prices for end users.

Beyond the simple economic benefits of greater competition and openness, the proposal shows no awareness of the key role of exchange trading in the Dodd-Frank derivatives architecture, and specifically its relationship to price discovery and systemic risk. Exchange trading has the potential and is intended to diversify the population of liquidity providers in the market, allowing more trading options and decreasing the market's reliance on "too big to fail" counterparties. Effective exchange trading should also encourage greater standardization of derivatives instruments, and greatly facilitate risk management by clearinghouses by generating a stream of reliable price information over time. In the absence of effective competitive exchange trading, the cleared derivatives ecosystem becomes more concentrated and risk management becomes more reliant on modeled correlations between illiquid instruments and a small number of liquid traded swaps. The extensive and detailed trade execution mandates in the Dodd-Frank Act are motivated by these crucial complementarities between exchange trading and derivatives clearing.

But the Commission does not appear to appreciate these potential benefits of exchange trading. Indeed, in a recent white paper on cross-border regulation the Commission portrays trade execution requirements as essentially unrelated to systemic risk. The White Paper sharply differentiates between the motivations for clearing and exchange trading and does not acknowledge the ways in which transparent and competitive exchanges are related to clearing and risk management. Without appreciation of these benefits there is no motivation for the Commission to protect and expand core trade execution requirements that encourage competition, standardization, and liquidity.

Even though derivatives clearing and exchange trading are complementary, there do differ in one crucial aspect. Competitive exchange trading is a potential threat to the increased margins and profits that large dealers get by being market insiders. Clearing is not such a threat, and indeed can increase returns by permitting lower regulatory capital and greater margin netting. Thus, dealer attitudes toward competitive exchange trading and clearing are likely to differ greatly. The Proposed Rule ascribes the enormous discrepancy between the small fraction of interest

rate swaps which are Required Transactions (under MAT trade execution requirements) and the very high proportion of cleared interest rate transactions to cumbersome and inflexible trade execution requirements. This is a key justification for eliminating trade execution requirements and CLOB functionality at SEFs.
However, a more likely reason for this discrepancy is that powerful dealer banks have a direct economic incentive to discourage open and competitive exchange trading, but often wish to encourage derivatives clearing. Because the current MAT process is dependent on SEFinitiative in calling for trade execution requirements to be imposed, dealers are able to use their influence with SEFs to discourage the imposition of the trading mandate. Since just four dealer banks controlling about ninety percent of the U.S. derivatives market, these dealers have enormous power to control order flow to SEFs. It is highly unlikely that a SEF would call for a product to be subject to MAT requirements if a key dealer bank felt that this would threaten their trading profitability in that product.

It is the Commission's responsibility to act against these anti-competitive incentives by mandating competitive trading in cases where high-volume derivatives are subject to the clearing mandate. Frankly, the fact that less than ten percent of interest rate swaps are fully subject to MAT competitive trade execution requirements while close to ninety percent are being cleared should be an embarrassment to the Commission. The proper response to this gap is not to deregulate SEF trading by introducing practically unlimited flexibility in trade execution, but to reform the MAT process and link it more closely to the clearing mandate. Effective risk management in clearing requires a basic level of liquidity and volume in swaps. There should be a presumption that if a derivative is safe to clear then it is also likely to be possible to trade that derivative in some form of multiple-to-multiple exchange-type system that offers price transparency and competition.

In sum, the Commission should step back from the ill-considered deregulatory path in this Proposed Rule. Instead, the Commission should reconsider the market and systemic risk benefits of open and competitive exchange trading and seek to bring these benefits to a greater share of the market through reform of the MAT process. This is both in accord with the public interest and in accord with Congressional intent in the Dodd-Frank Act, which sought a unified system of competitive exchange trading and clearing for liquid derivatives.

Post-Trade Name Give Up

Mandated post-trade name give up is not appropriate in a cleared swaps market. Preventing anonymity in trading serves to advantage dealer insiders as compared to buyside customers in numerous ways. By doing so, it discourages competitive liquidity providers and thus undermines the competitiveness and systemic risk benefits of exchange trading.

In the extreme case mandatory name give-up permits retaliation by large dealers against those who bid against them. However, even short of retaliation the provision of information through name give-up creates additional ways for large dealers to use their market power to discourage competition. I would refer the Commission to recent work by economists from the University of Toronto and the Wharton School which models the ways in which mandatory name give-up increases dealer scope for price discrimination by informing them as to the characteristics of their counterparties. Such anti-competitive price discrimination increases dealer profits and reduces public welfare, while increasing spreads on traded exchanges relative to over the counter transactions.

I would thus urge the Commission to ban mandatory post-trade name give up on SEFs.

Yours sincerely,
Robert E. Rutkowski

cc:
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