SDMA SWAPS & DERIVATIVES MARKET ASSOCIATION

February 18, 2012

Elizabeth M. Murphy
Secretary
Security and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

Re: Request For Quote, Order Interaction & Viable Alternative Comments for the Notice of Proposed Rules Regarding the Registration and Regulation of Security-Based Swap Execution Facilities 17 CFR Parts 240, 242, and 249 [Release Number 34-63825; File No. S7-06-11, RIN 3235-AK93]

Dear Secretary Murphy,

The Swaps & Derivatives Market Association ("SDMA") appreciates the opportunity to provide further comments to the Securities and Exchange Commission (the "Commission") on its Notice of Proposed Rulemaking regarding Parts 240, 242 and 249 of Title 17 of the Code of Federal Regulation entitled "Registration and Regulation of Security-Based Swap Execution Facilities; Proposed Rules" ("Proposed Rules").

The SDMA is a non-profit financial trade group formed in 2010 to support the goals of the Dodd Frank Act. It believes that the systemic risk of OTC derivatives can be mitigated through their regulation, the creation of central clearing, and by ensuring open and transparent access to promote greater competition, lower transaction costs and increase liquidity. The SDMA is comprised of many US and internationally based broker-dealers, investment banks, furtures commission merchants and asset managers participating in all segments of the exchange-traded and over-the-counter derivatives and securities markets.

The SDMA strongly believes that the SEC's proposal for a Request-For-Quote ("RFQ") execution methodology that includes only one liquidity provider on a Security Based Swap Execution Facility ("SB SEF") is detrimental to the market because it prevents competition, inhibits pre-trade price transparency and merely continues business as usual in the swaps market. It is also unclear if a proper cost benefit analysis has been performed.

I. Summary of the Proposed Rules

DFA Section 761(a)(6), which amends Section 3(a) of the Securities Exchange Act of 1934, defines a security-based swap execution facility as "… a trading system or platform in which multiple participants

have the ability to execute or trade security-based swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility, that – (A) facilitates the execution of a security-based swaps between persons; and (B) is not a national securities exchange. The Commission has indicated in its proposed rule making that a SB SEF can meet these requirements by having either (a) Limit Order Book or (b) RFQ functionality for trade execution that permits the customer to make and display executable bids or offers if the customer chooses to do so. Under the Proposed Rules customers are only required to include one liquidity provider in a RFQ ("RFQ to 1") and can choose whether or not to disclose that information to the market. The Proposed Rules further provide that since RFQ for 1 is a customer choice (i.e.; customer can choose however many liquidity of providers they can query including one) then a SB SEF must have both RFQ and limit order book interaction functionality. Specifically it requires that any inquiry using RFQ to 1 must interact with any existing firm interest on the limit order book that is at the same or better price before interacting with interest on the RFQ.

One of the goals of the DFA's requirement of central trade execution on SB SEFs is to promote pre-trade price transparency. Pre-trade price transparency means that the market must have knowledge of and access to prices. Specifically, market participants must have knowledge of the current price (bid or offer) and must have access or be able to trade on those prices. The purpose of requiring a SB SEF to provide "multiple participants the ability to execute security-based swaps by accepting bids and offers made by multiple participants" ("Multiple to Multiple Requirement") is to provide the market with knowledge of and access to those executable bids or offers. Permitting RFQ to 1 and leaving the disclosure of that pre-trade price information up to the customer's discretion severely inhibits pre-trade price transparency and dangerously limits competition.

Some have argued that limited pre-trade price transparency is necessary to protect customers. The SDMA does not agree. While the customer certainly needs to be protected in the pre trade context, the broader market also must be protected and be allowed to operate efficiently and fairly. Simply put, the market must have immediate knowledge and access to trade orders before the trade occurs. To contemplate otherwise will dangerously limit fair dealing, transparency and inhibit new liquidity providers from entering the space to compete and lower transaction costs. Discussed in greater detail below, the SDMA offers several alternatives where this perceived tension is diffused and the needs of the individual customer and the market are not pitted against each other. By protecting both the market and the individual, trade transparency and competition will be fostered, and the goals of the DFA shall be met.

The Proposed Rules do not properly balance the needs of the market and the individual market participant. But there are several solutions.

II. What is Pre-Trade Transparency?

Pre-trade price transparency is just as important to liquidity and market integrity as post-trade price transparency. Pre-trade price transparency is a function of knowledge and equal access to orders as they enter the market and before they become trades.

In daily life, consumers frequently wish to know the cheapest price at which an everyday item is for sale before they make their purchase. In fact, consumers determine two things. They generally check *price* and *availability*. In other words, whether the item for sale is offered at the lowest price and whether the item in question is available to them.

Limit Order Books. Transparent securities markets, like equities, operate today in the same way—albeit quicker. As buyers and sellers come together in a marketplace, they post their prices for all to see. In fact, would be buyers show prices where they would buy, known as "bids", and would be sellers show prices where they would sell, known as "offers".

Consumers in these markets then get to decide who has the lowest price from whom they can buy; and the highest price to whom they can sell their item. (Remember, consumers who wish to sell always seek to sell at the highest price—just like anyone would, if they were selling something on eBay.)

For efficiency purposes, these prices are sorted in order of "best" price – highest bid & lowest offer. These prices are displayed to all market participants equally and simultaneously; and as these prices change so too does the "best" price.

This method for managing prices, whether it be manual, voice or electronic is called a *Limit Order Book*.

Figure 1. Limit Order Book: Sony 40 Inch HDTV

Bids	***Offers***	
350	400	*The Market*
250	500	
150	550	
50	600	

Figure 1. illustrates a *limit order book* for a Sony 40 Inch HDTV. On the right side, you see offers sorted by price – lowest ($400) to highest ($600). On the left side you see bids (prices at which people will buy) sorted by price—this time highest bid ($350) to lowest bid ($50).

The highest bid ($350) and lowest offer ($400), called "the market", is the optimal price at which you can either sell or buy the Sony HDTV. Now consumers may purchase the cheapest TV at $400 with full knowledge that it is offered at the best price in the market.

Consumers do this every day without knowing, when they comparison shop. They seek out sellers and their prices, and then they order the cheapest first.

Pre-trade price transparency, as seen with limit order books, directly promotes a more liquid marketplace. As evidenced by other open markets, fairness and the customer's right to (1) know the best price and (2) have access to trade it attracts more participants, who in turn, trade more and thus create more liquidity.

Consider the alternative; imagine buying something and not knowing that the price at which you purchased the TV is not the cheapest price.

III. The Role of RFQ and SEFs

RFQ is a transaction method by which financial consumers can execute a trade. RFQ is a "quote driven" mechanism, whereas Limit Order Book trading is considered "order driven".

Conducted either by voice through a salesman or electronically, the customer initiates a price request where it queries a finite number of dealers to obtain a price where the financial consumer can trade. Responses to the inquiry are returned to the customer who then elects to trade or not trade on one of the available quotes. Typically, they will trade by selling at the highest bid or buying from the lowest offer.

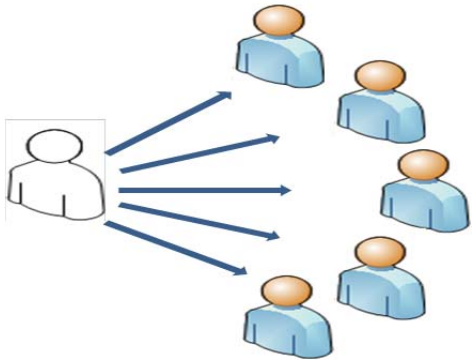

Figure 2: Request For Quote ("RFQ")

By its design RFQ limits the number of market participants that both see a trade and have access to the prices available. Since RFQ is not designed to be open to all market participants it is already a compromise in achieving the goal of pre-trade price transparency. Only a narrow set of market participants enjoys knowledge of prices and access to prices while the vast majortiy of the remaining participants are disadvantaged. One way to ensure greater RFQ transparency is to require that the customer query a greater number of participants.

IV. Balancing the Needs of the Market and Customer

A perceived tension exists between the needs of customers (i.e. buyers and sellers) and the market as a whole in the RFQ context. As discussed below, the market and customers have different concerns regarding what level of pre-trade price transparency is optimal.

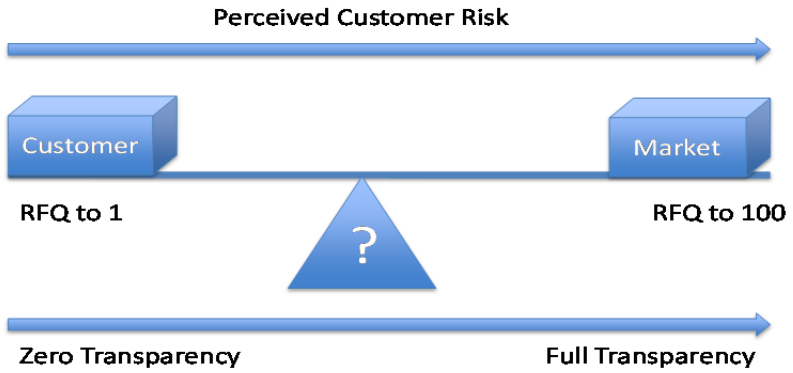

Figure 3: Perceived Tension between Customer and Market with RFQ

Each time the customer initiates a RFQ they reveal three key pieces of sensitive market information to get a quote: their (1) identity, (2) size and (3) market direction. Customers perceive their risk increasing as more price providers are included in RFQs. They are concerned that disclosure of their sensitive market information will be abused by the price provider(s) with market knowledge acquired through the customer's RFQ. Customers will seek to obtain the best price by including the lowest number of liquidity providers in a RFQ. As a result, customers are willing to sacrifice pre-trade transparency.

However, the customer's needs are not completely aligned with the market's need for information. The market wants to observe all relevant market data in order to allocate capital efficiently, maximize its trading decisions and manage risk optimally.

At all times the market wants to know best price and availability of trading. "Best price" is a function of buyers knowing the lowest price at which they can buy and sellers knowing the highest price at which they can sell. Availability is a function of the market knowing how many customers there are, and the size (number of products bought or sold) and volume of the transactions. Simply put, the market needs full price transparency to operate efficiently.

V. Solutions

The market's need for full pre-trade price transparency and the customer's desire for limited pre-trade price transparency are not mutually exclusive. There are several solutions, made possible by the use of central clearing, that provide the market with pre-trade price transparency while addressing customer concerns regarding information leakage.

A. Anonymous Request For Quote ("ARFQ")

In an ARFQ the customer would initiate a price request to liquidity providers without revealing their identity. The responses to the RFQ would be returned to the customer who then elects to trade or not trade on one of the available quotes. Typically, RFQ has a limited level of pre-trade price transparency, because only the customer and the liquidity provider responding have access to pre-trade price

information. Since the customer's identity is not revealed in an ARFQ the customer's inquiry and the responses received could be disclosed to the market without harm to the customer. As compared to traditional RFQ, ARFQ provides a significant improvement in the availability of pre-trade price information to the market.

To ensure greater RFQ transparency the customer should be required to query a greater number of participants. The SDMA strongly supports the use of RFQ/ARFQ that requires the inclusion of a minimum of three liquidity providers. The SDMA also strongly supports the Commodity Futures Trading Commission's approach of requiring that a customer include a minimum of five liquidity providers in a RFQ. Including at least three liquidity providers in a RFQ/ARFQ would provide the market with greater pre-trade price transparency and enhance market liquidity. Any concerns about information leakage could be addressed through use of an ARFQ.

B. <u>Anonymous Request For Market ("ARFM")</u>

Central clearing now provides for swaps trades to occur anonymously without requiring customer identity. This more open market architecture permits customers to ask for a more flexible AFRM. With an ARFM, the customer sends out an inquiry to the market, shielding two of the three variables it would give out in a RFQ: (1) customer name and (2) customer direction. Specially, the customer stays anonymous (shielding their name) and requests a "market" (shielding their direction) by asking for a two-sided price (both a bid and an offer) so as to not reveal whether the customer is a buyer or a seller. The customer only shows its size i.e. how many it would like to trade. With ARFM, the customer's information is less likely to be abused and is not at odds with the marketplace. The response provided to the customer can be made available to the market, thus meeting the market's need for pre-trade price transparency. The SDMA strongly supports the use of AFRM that requires the inclusion of a minimum of three liquidity providers which would enhance pre-trade price transparency and market liquidity.

C. <u>Limit Order Book ("CLOB")</u>

Trading on a Limit Order Book allows buyers and sellers to come together in a marketplace to post their prices, without revealing their identity, for all to see. Prices are sorted in order of "best" price (i.e.; highest bid and lowest offer), and provides the financial consumer an indication of the market "depth". These prices are displayed to the entire market equally and simultaneously; and as these prices change so too does the "best" price. Orders are matched on a price time priority basis. In addition, customers can work their orders in small pieces to prevent revealing their size. Anonymous trading on a limit order book provides the market with the greatest amount of pre-trade price transparency while protecting the customer from information leakage. Limit Order Book functionality is currently is deployed in the interdealer market which is 40% of daily volume in the credit default swap market today. Although it is a voice order limit book, requiring such order book methodology to trade as "voice hybrid" where screens are used in combination with brokers is not difficult to do. The question is, if dealers are happy with this mode of execution for themselves, why then could it not be deployed to the buy-side customer?

These solutions, ARFQ, RFM, ARFM and CLOB, make it possible for customers to shield sensitive information from the market before they trade. All three solutions enable the customer to shield their identity. Both the ARFM and the limit order book enable the customer to shield their direction. Because the limit order book makes it easier to break the size of a trade in several smaller pieces and

work them contemporaneously, the limit order book has the added advantage of enabling the customer to shield the size of their transactions. With all these methods, the individual interests are not pitted against the needs of the market. Customer information is shielded, while the market access to pre-trade transparency of orders so that it can operate efficiently and fairly.

VI. If RFQ for 1 is the Final Rule, Then Order Interaction must be Mandatory

RFQ for 1 is perceived as offering customer choice but it ignores the rights of the broader market to obtain relevant, real-time market data. Allowing a single dealer to be the sole determinant of a price and be the only party with access to the information creates a clear disadvantage to the market as a whole. It's akin to having inside information and being allowed to trade with that knowledge. This is clearly not the intent of any regulatory framework. The level playing field envisioned by the DFA cannot be achieved when a select group of liquidity providers have a clear advantage over the market.

The SDMA believes regulatory framework established by the DFA requires that market prices — whether they be actionable bids or offers — must be available to all market participants equally and simultaneously. Whether or not the market will receive such pre-trade price information should not be left completely to the customer's discretion, it must be mandatory. In order to address customer concerns and provide the market with the pre-trade price transparency required under the DFA, the SDMA urges the Commission to adopt the price transparency solutions of limit order book, ARFQ and/or ARFM that require customers to query at least three liquidity providers.

If the Commission does not adopt these proposed solutions, then the SDMA urges the Commission to require that a SB SEF have both RFQ and limit order book functionality that enables mandatory order interaction between them.

A. Disadvantages of RFQ to 1 Without Order Interaction

RFQ to 1 without order interaction is harmful to the market for several reasons. First, it severely limits pre-trade price transparency. In an RFQ to 1, since the customer is not required to disclose pre-trade price information, only the customer and the included liquidity provider have knowledge and access of pre-trade prices. As a result, there is no price transparency for the market. Such limited pre-trade price transparency is completely at odds with the goals the DFA.

In a RFQ to 1 only the customer and responder have knowledge of the trade information, which is in essence a single dealer platform that is prohibited by the statute from operating in the cleared security-based swap market. As discussed above, the DFA mandates the creation of SB SEFs which require that multiple participants have the ability to trade security based swaps by accepting bids and offers made by multiple participants. A single dealer platform is a trading method of "one to many", meaning it permits only one dealer to interact with many customers. It does not provide multiple participants the ability to trade with multiple participants. In addition, since only one dealer is providing price information, a single dealer platform does not provide bids and offers made by multiple participants.

Moreover, the liquidity provider responding to the RFQ to 1 has inside information that they can act upon, which gives them an unfair advantage over the market. As a result of other liquidity providers not having knowledge of prices they do not have access to the market. Liquidity providers cannot compete if they are denied access to the market.

B. Advantages of RFQ to 1 with Order Interaction and Stand Alone Limit Order Books

1. Increased Competition and Liquidity

Providing market participants with knowledge of and access to prices will create a more level playing field. As discussed, RFQ to 1 provides very limited pre-trade price transparency. However, if the RFQ interacts with existing interest on the limit order book the order is disclosed to the market. This pre-trade price disclosure will permit smaller dealers to trade against those prices and promote competition in the market. Access to price information and the ability to compete will attract new market entrants who will, in turn, increase transparency and lower transaction costs.

The pre-trade price transparency that results from order interaction will enable all participants in the market to receive prices equally and simultaneously as well as satisfy the multiple to multiple requirement. A select group of liquidity providers will no longer have the advantage of possessing information that they can use at the expense of the rest of the market. Because all market participants will have equal access to pre-trade prices there will be fair dealing. Fair dealing makes the market's prices more reliable and creates market integrity. As market integrity increases, liquidity will increase as new entrants continue to join the market.

2. Lower Transaction Costs: Optimal Cost-Benefit Analysis

The move from decentralized swaps market to the centralized system of SB SEFs mandated by the DFA will lead to narrower bid ask spreads or transaction costs. SB SEFs will bring greater price transparency to the currently opaque market for SB swaps. As pre-trade price transparency increases a greater number of liquidity providers will have access to pricing. This will enable them to compete with other liquidity providers on pricing, which will result in price compression.

For example in Figure 1 which illustrates the market for a Sony TV as $350 bid and $400 offered, the bid ask spread is $50. If there are a lot of stores selling Sony TVs (i.e. there is competition) one store might lower its price to $390. Another store anxious to sell TVs could lower the price further to $380. Each time the price is lowered the bid / ask spread gets narrower and there is "price compression". Each time the price is lowered the consumer saves money on the cost of the TV (i.e. they save money on their transaction costs). The same is true in the financial markets where liquidity providers will compete for business by offering the best price.

It is well documented that increased competition and price transparency helps lower transaction costs. A recent study published by Deloitte estimated that transaction costs paid today in the swaps markets are about $55 Billion annually[1]. Deloitte estimates that with greater pre-trade price transparency and

[1] http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/FSI/us_fsi_OTCRevenues_POV_upated_080311.pdf

the influx of more price providers — these costs will decline by at least 35% or $19 Billion. The SDMA[2] recently confirmed such numbers by analyzing trade volumes and transaction costs from LCH and the DTCC.

If the SEC were to perform a proper and complete cost benefit analysis, the SDMA believes it would also understand that increased competition encouraged by the above alternative execution methodologies (including RFQ-1 with order interaction) will lessen costs, promote competition and increase transparency in the market place.

3. Promotes Real-Time Work Flows

Execution on a limit order book will also promote real-time work flows of cleared trades. Real time work flows provide trade certainty which lessens systemic risk and ultimately increases confidence, liquidity and price discovery for investors to make better decisions. The current work flow in the swaps market takes hours to days or weeks adding significant systemic risk to the global marketplace.

Trade counterparties need to know whether or not the trade is good (i.e. that it will be accepted for clearing) as soon as possible. Delay between the time of trade execution and acceptance into clearing creates uncertainty due to market risk (i.e. if the trade will not clear then it will have to be broken). Trade uncertainty inhibits market liquidity because market participants will not execute a new trade until they know that their last trade is good. Consequently, trade certainty guaranteed by real-time work flows increases confidence and liquidity in the SEF and the overall marketplace.

Trades executed on a limit order book can be cleared in real-time following the practices used in the listed derivatives and equity markets. Prior to trading, each market participant would have a clearing account with a member of the clearinghouse. Each clearing member will have set limits for the customer at the clearinghouse that will permit customer trades to be accepted for clearing up to the stated limit. Once the trade has been executed on the limit order book it is sent to the clearinghouse for acceptance. Once accepted, the clearinghouse will send the trade counterparties notification that the trade has been accepted for clearing. Recently, for the first time ever in the market, using limit order book technology, the time lapse between trade execution and acceptance into clearing was proven possible to be less than two seconds.[3] The expectation is milliseconds in the near future.

VII. Conclusion

Proposed Rules that permit RFQ to 1 do not properly balance the needs of the market and the individual market participant. The SDMA urges the Commission to adopt other alternatives such as (1) limit order book, (2) ARFQ that includes at least three liquidity providers, and (3) ARFM that includes at least three liquidity providers, because these solutions properly balance these needs of customers and the market as well as satisfy the multiple to multiple requirement. If the Commission determines not to include

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[2] www.thesdma.org

[3] http://www.thejavelin.com/press-releases/javelin-and-cme-execute-and-clear-41-billion-of-interest-rate-swaps-in-real-time

these alternatives and only RFQ to 1, then the SDMA urges that there be mandatory order interaction between the RFQ and the limit order book. The SDMA strongly believes that order interaction will help provide a level playing field that will lead to increased competition, greater liquidity and reduced transaction costs. The SDMA would also encourage the SEC to perform a proper cost benefit analysis to properly appreciate the benefits of the above suggested execution methods where the interests of the individual market participant are not pitted against the broader needs of the market to operate fairly and efficiently,

The solutions proposed would be in the best interest of customers and the market as it would increase price transparency, promote competition, enhance liquidity and improve market efficiency.

Best Regards,

Michael Hisler
The Swaps & Derivatives Market Association